

# Taxation *in* Australia

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*Philip Bender, ATI*

## **Fringe benefits tax: is there a better way?**

*Sam Gathercole*

## **Reimagining land use: sustainability and tax**

*Courtney van Zyl, FTI, and  
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### Invitation to write

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

For details about submitting articles, see Guidelines for Publication on our website [taxinstitute.com.au](https://taxinstitute.com.au), or contact [publications@taxinstitute.com.au](mailto:publications@taxinstitute.com.au).



## Tax News – at a glance

by TaxCounsel Pty Ltd

# December – what happened in tax?

The following points highlight important federal tax developments that occurred during December 2025. A selection of the developments is considered in more detail in the “Tax News – the details” column on page 365 (at the item number indicated).

### Trust administration systems

The government has released for consultation draft amendments to the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (and explanatory materials) that would streamline how closely-held trusts report beneficiary tax file numbers. **See item 1.**

### Electric car discount review

In a joint media release on 12 December 2025, the Treasurer and the Minister for Climate Change and Energy released the terms of reference for the statutory review of the electric car discount. **See item 2.**

### Personal services businesses: Pt IVA

The Commissioner has released a practical compliance guideline that explains when the ATO will be more likely to have cause to apply compliance resources to consider the potential application of the general anti-avoidance provisions of the income tax law (Pt IVA ITAA36) to an alienation arrangement where personal services income of an individual is derived through a personal services entity that is conducting a personal services business (PCG 2025/5). **See item 3.**

### Non-business rental property income and deductions

The Commissioner has released a draft ruling and two draft practical compliance guidelines that provide guidance for individuals who earn non-business income from a rental property (TR 2025/D1; PCG 2025/D6; PCG 2025/D7). **See item 4.**

### Departure prohibition orders

The ATO is actively using departure prohibition orders as part of a broader shift towards strengthening payment performance and debt collection. **See item 5.**

### Tax Practitioners Board: 2026 compliance priorities

The Tax Practitioners Board has announced its 2026 compliance priorities, with a view to providing greater transparency and clarity to the tax profession. **See item 6.**

### CGT: market value issues

In a recent decision, the Full Federal Court (Charlesworth, O’Sullivan and Horan JJ) has unanimously held that, for the purposes of applying the \$6 million maximum net asset value test that applies in the context of the CGT small business concessions, the market value of each of the two minority shareholdings in a company was properly to be determined on a pro rata basis by reference to the consideration received for the whole of the shareholdings (*Kilgour v FCT* [2025] FCAFC 183). **See item 7.**

### Refinancing

The taxpayer has lodged an application for special leave to appeal to the High Court from the decision of the Full Federal Court in *Charles Apartments Pty Ltd v FCT* [2025] FCAFC 180. In that case, the Full Federal Court held that the taxpayer was not entitled to a general deduction for interest on the refinancing principle.

### Amendment of assessments

The Federal Court (Derrington J) has considered the operation of the Commissioner’s power to amend an assessment where the completion of a contract for the sale of a CGT asset takes place in an income year later than the income year in which the contract was entered into (*Sunna v FCT* [2025] FCA 1499).



## President's Report

by Tim Sandow, CTA

# An Institute larger than the sum of its parts

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President Tim Sandow on the strength of a combined voice in our advocacy and beyond.

As we kick off 2026, the Institute is in a period of planning and laying the foundations for our future. But those foundations are built on the bedrock of our past and of who we are as an organisation.

The Tax Institute's strength has always been in connection. Connecting passionate tax practitioners to each other. Connecting those practitioners to new ideas, analysis and thinking. Connecting practitioners to opportunities to improve our tax system and grow their professional practice.

Nowhere is the power of a collective voice clearer than in our advocacy work. Our community is made of many experts who are exemplary in their own field, each one a valuable voice in the advocacy space.

But what is perhaps even more valuable is that, at the Institute, we are able to draw on perspectives, ideas and examples from members across the board – combining the insight of experts with decades of experience with practitioners from other parts of the tax world who may have unique approaches to an issue, or with young practitioners who bring a fresh and original perspective to old problems.

They say that insanity is doing the same thing over and over again and expecting different results. Our diverse community gives us access to a wide range of ideas to help us navigate problems in new and constructive ways, contributing a cohesive view of what the tax profession as a *whole* really thinks.

One excellent example is the work currently being done around family trust distributions tax. This work is a member-driven initiative to examine a part of our tax system that is unfair, complex and ripe for change. Our volunteers from various technical committees have put their heads together to dissect this issue in a way that's unique to the Institute. Isn't that an incredible thing to be able to say?

When I say "we" bring together different perspectives in this kind of advocacy work, I mean that you, our members do. Our talented Tax Policy & Advocacy team front many of our advocacy efforts, but we are by no means relying on this small group of people to form The Tax Institute's advocacy work.

Our members are the ones coming together from every corner of tax to consider the problems and opportunities before us. Our volunteer community number at least 800 practitioners. You can't buy the kind of energy that rises from that many incredible people putting their efforts toward a shared goal. You can't bottle it, you can't prompt AI for it, you can't fake it. That's what makes the Institute what it is.

## Shaping the future of our Institute community

At the end of 2025, Scott shared with our members news that our Board has signed a heads of agreement with the Institute of Public Accountants (IPA) to explore an exciting opportunity whereby The Tax Institute would join the IPA Group. This month, we will be holding consultation sessions with our members regarding the proposed agreement with IPA. I encourage you to go along to these sessions.

Our goal in exploring this opportunity is to protect what the Institute is today – a prestigious Institute with a reputation for excellence, a deep focus on taxation, and an incredibly insightful community – while ensuring we can continue to enhance your member experience for years to come. Your input during this due diligence phase is, as it always is, incredibly valued and important.

As always, we have our members' best interests at front and centre of our plans. I encourage you to be involved in consultation and to invest in the future of your Institute – because it is invested in yours.



## CEO's Report

by Scott Treatt, CTA

# Building a stronger, better future together

CEO Scott Treatt reflects on strategic discussions about the future of our Institute.

As we wrapped up 2025, I was pleased to be able to share the exciting strategic news with you that our Board has signed a heads of agreement with the Institute of Public Accountants (IPA) to explore the viability of The Tax Institute joining the IPA Group.

If this proposal proceeds, it would bring together a professional community of more than 60,000 members and students, creating a larger, more influential voice for tax and public practice professionals while broadening the services and support available to you.

Under this proposed model, The Tax Institute would leverage the IPA Group's member service infrastructure to deliver more efficient and effective services, systems and support to you. It would allow the Institute to invest in important and timely projects, including improvements to our technology platforms and overall member experience with bolstered resourcing and support.

Vitality, nothing about the proposal changes who we are as an Institute. Our diverse membership of accountants, lawyers, SMEs and academics will be at the centre of any future plans as we explore this opportunity to enrich our members' experience.

### Where to from here?

As we head into the new year, discussions are underway between our two organisations. During the heads of agreement process, we are undertaking due diligence and extensive review into what exactly this opportunity might mean for the Institute and how it could play out for our members.

The Institute has always been, and will always, be built for and by members. Your ideas, questions and feedback are vital to our considerations for our Institute's future. This February, we will be travelling around the country to hold a series of consultative sessions, both in-person and

online, giving every single member ample opportunity to understand the options on the table and raise any key questions you feel should be covered in discussion during this due diligence period.

You should have received an invitation to the session happening closest to you. If you have not and would like to attend, please reach out to our team. You can also raise questions or feedback at any time by emailing [feedback@taxinstitute.com.au](mailto:feedback@taxinstitute.com.au).

We are working through these discussions and considerations of our future with you alongside us. The future of our Institute lies with our members, and I encourage you to be active and engaged in sharing your views as we explore this exciting opportunity.

### The Tax Institute – today, tomorrow, always

As CEO, it is my duty to not only ensure that the Institute is effective in serving members today, but that it will be for years to come. That means looking to our future and exploring every opportunity to find the right way forward – the way that will best enable us to support tax professionals and work for the betterment of the tax system for many years to come, in the most impactful ways possible.

This is one such opportunity. We are confident that this opportunity would bring together two strong associations which share a key guiding principle: that members are at the centre of everything they do.

Rest assured that considerable thought has already gone into this proposal, and that further discussion is being had before any agreement is made. I look forward to hosting you for some of those discussions this month, so please do come along to the consultation sessions and have your say.



## Tax Counsel's Report

by John Storey, ATI

# 50% CGT discount in the spotlight

We assess the impact of the CGT discount on the economy and consider alternative options.

On 4 November 2025, the Senate Select Committee on the Operation of the Capital Gains Tax Discount was established to undertake an inquiry into the current role of the capital gains tax (CGT) discount in the Australian taxation system (the Inquiry). The 50% CGT discount has been a frequent subject of political debate since its introduction in 1999. Its opponents claim that it unduly benefits “the rich” and distorts investment decisions (particularly in respect to housing), while its proponents claim that it stimulates growth and boosts investment (including with respect to housing).

The politicised nature of the debate on the 50% CGT discount is unlikely to change with this new Inquiry; if anything, it appears to have become heightened. The [terms of reference](#) for the Inquiry use quite politically charged language. This includes investigating the “contribution of the capital gains tax discount to inequality”, the “funnelling” of investment into housing, the “distributional effects of the CGT discount”, and whether it encourages investment that is “speculative” and not “productive”. This all implies that the 50% CGT discount is having a highly negative impact on society and appears to seek to confirm preexisting views. Such phrasing risks politicising and polarising the discussion surrounding the issue.

This is unfortunate because Australia urgently needs structural tax reform and simplification. As a significant feature of our current tax system, the 50% CGT discount warrants careful and sober assessment.

One suggestion that the government could adopt to take the heat out of this issue is to announce in advance that any change to the 50% CGT discount, whether its reduction, abolition or reform, will be revenue neutral. This would help to address politicised claims of a “tax grab” or “spending splurge”. Further, any revenue generated could be used to fund beneficial reforms, such as reductions in personal income tax rates.

But that still leaves the question of whether, from a tax design perspective, any changes should be made to the 50% CGT discount at all and what such changes might be.

## Indexation and Inflation

The 50% CGT discount was first introduced following the [Review of business taxation](#) (the Ralph review) as a replacement for the previously existing policy of indexing the cost base of CGT assets. This was seen as a simplification measure to reduce compliance costs.

CGT applies to the appreciation of an asset's value over time, meaning that a portion of the realised gain may be attributable solely to inflation. The former indexation method helped to ensure that CGT was only levied on real gains in value. The 50% CGT discount does this as well, but less precisely. If a capital asset appreciates quickly, the 50% discount may overcompensate the taxpayer for inflation. If an asset appreciates slowly, the 50% CGT discount may not fully compensate for inflation.

Any attempt to scrap the 50% CGT discount entirely without an effective mechanism to address inflationary effects would be deeply unpopular, particularly given the high inflation rates that have persisted in recent years.

One option is to simply revert to the previous indexation method. Although this feels like a retrograde step, the policy behind scrapping indexation needs to be put in context. It was meant to be a simplification measure, but since 1999, our tax system has been saddled with such complex monstrosities as tax consolidation, the taxation of financial arrangements, a global minimum corporate tax rate, and country-by-country reporting (to name but a few). One pines for the day when calculating indexation was considered burdensome, especially given the now ubiquitous use of tax return software.

Another option is a “phased-in” approach to the CGT discount, where the rate of discount increases the longer an asset has been held. As an example (and not an endorsement), the discount might be 10% after one year, 20% after two years and so on until it is 50% after five years or longer. If designed thoughtfully, this might more precisely compensate taxpayers for inflation rather than a “blunt” 50% discount that applies after 12 months.

## The CGT discount and investment

The Ralph review also identified that the 50% CGT discount would encourage greater investment and innovation in Australia. Although it has likely done so, it is also likely true that the relatively narrow base on which it is applied has meant that the 50% CGT discount has had some impact on distorting investment decisions and on fairness.

In respect to distortion, CGT (and therefore the 50% discount) only applies to the appreciation of asset values. A passive investor in an asset that increases in value but generates little income receives a concession, whereas a passive investor in an asset that does not increase in value but does generate income, such as interest or dividends,

does not. Therefore, the 50% CGT discount might encourage investment in one asset class at the expense of others.

This criticism was identified in the [2010 Henry review](#), which recommended that a 40% discount apply to all returns on investment (such as capital gains, rent or interest). As well as differential treatment between investors, the Inquiry is also likely to explore why those who generate taxable income from passive investment receive a discount, and not those who generate income from their labour.

The community would benefit greatly from a genuine and honest analysis as to whether the nearly \$23 billion “cost” to the budget of the 50% CGT discount (based on Treasury’s [2024–25 Tax expenditures and insights statement](#)) would have a more positive economic impact if applied more broadly as a reduction in tax rates for all taxpayers (whether workers, entrepreneurs or investors). This of course assumes that any reforms will be revenue neutral rather than any budgetary savings simply spent.

Alternatively, the “phased-in” approach to the CGT discount described above might also address some of the concerns that the current approach incentivises speculation. If the discount benefit increases over time, this would encourage longer-term investment, rather than short-term speculation.

## Housing and negative gearing

The asset class most commonly identified as being stimulated by the 50% CGT discount is the housing market. This argument is often accompanied by criticism of negative gearing as a cause for high house prices.

As a matter of tax policy, there is little reason why genuinely deductible losses incurred in earning one type of income should be quarantined from use against other types of income. Unlike other foreign jurisdictions that often tax different classes of income (such as dividends, rent or wages) at different rates, our tax system is designed to add all types and sources of income to a taxpayer’s assessable income and then apply the applicable tax rate on the net total.

However, there is an argument that because CGT is taxed concessionally, allowing investment losses to be deductible against other sources of income creates a mismatch. Or put another way, 100% of investment losses are deductible, but only 50% of investment gains may be taxable.

The Henry review proposed that claimable investment losses should be reduced by 40%, so there would be no mismatch with its proposal to provide a 40% discount on investment earnings.

If the concern of the Inquiry is housing affordability, it would be deeply wrong, and potentially counterproductive, to focus solely on the 50% CGT discount and negative gearing. If all other factors remain equal, such changes may reduce investment in housing and could therefore increase rents. There are numerous reforms to consider beyond CGT policy, including the substantial taxes levied by state governments on housing and development, restrictive town planning

and environmental regulations, and foreign investment and immigration rules.

## Conclusion

This segues neatly to a primary criticism of the Inquiry: it focuses on a single tax measure in isolation. The above discussion has not even touched on the effect that the 50% CGT discount has on tax structuring and planning. As it is only available to individuals and trusts (not companies), this generates the need to consider (often complex) tax structuring issues when taxpayers undertake an investment. Addressing this issue realistically requires broader consideration of entity taxation and trust tax reform.

But given this limitation, a “phased-in” approach to the CGT discount would seem to tick all of the following boxes:

- is isolated to the 50% CGT discount;
- addresses the issue of inflation in some way;
- addresses concerns about asset speculation; and
- is relatively simple.

It isn’t the broader reform of the tax system that we might like and truly need, but it would retain (and potentially better target) compensation for inflation, reduce some of the incentives for asset (including housing) speculation while still encouraging longer-term investment, and be relatively simple and therefore politically feasible. If any budgetary savings generated were used to fund broader tax reductions, such a proposal might even garner bipartisan support.

The Inquiry is scheduled to present a final report by 17 March 2026.




# Tax Forum Season

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Institute**

## Tax News – the details

by TaxCounsel Pty Ltd

# December – what happened in tax?

The following points highlight important federal tax developments that occurred during December 2025.

## Government initiatives

### 1. Trust administration systems

The government has released for consultation draft amendments to the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (and explanatory materials) that would streamline how closely-held trusts report beneficiary tax file numbers (TFNs).

The draft amendments would remove reporting on a separate form. Instead, trustees would be required to report TFNs of presently entitled beneficiaries on the trust's income tax return. This will enhance the trust reporting system's pre-filing capabilities and support the ATO's current system changes.

More particularly, the amendments would require trustees to provide a presently entitled beneficiary's TFN to the Commissioner at the same time that the trust return is provided for an income year, if the beneficiary has quoted it to the trustee. This will enhance the ATO's data matching and pre-filing capabilities for beneficiary returns.

The change to the TFN reporting requirements will not change existing TFN withholding rules for closely held trusts. It will ensure that trustees are withholding from beneficiaries' entitlements in line with the existing withholding requirements where the beneficiary has chosen not to quote their TFN.

### 2. Electric car discount review

In a joint media release on 12 December 2025, the Treasurer and the Minister for Climate Change and Energy released the terms of reference for the statutory review of the electric car discount.

The discount has applied since July 2022, providing a fringe benefits tax exemption and tariff exemption to eligible cars to kick-start take-up of electric vehicles and to help reduce transport emissions in the longer term as part of the government's broader climate action agenda.

The ministers said that, when the government came to office, the market for electric vehicles was nascent, with electric vehicles accounting for less than 2% of new vehicle

sales in Australia. Today, industry data show electric vehicles comprise around 10% of new vehicle sales, and Treasury estimates that almost 100,000 vehicles have benefitted from the fringe benefits tax exemption, with this milestone achieved much sooner than expected.

The electric car discount works in concert with the new vehicle efficiency standard and over \$500 million investment in charging infrastructure. Together, these policies are providing easier access to cheaper-to-run cars for the Australian market that consumers around the world have enjoyed for years.

## The Commissioner's perspective

### 3. Personal services businesses: Pt IVA

The Commissioner has released a practical compliance guideline that explains when the ATO will be more likely to have cause to apply compliance resources to consider the potential application of the general anti-avoidance provisions of the income tax law (Pt IVA ITAA36) to an alienation arrangement where personal services income (PSI) of an individual is derived through a personal services entity (PSE) that is conducting a personal services business (PSB) (PCG 2025/5).

For the purposes of PCG 2025/5, alienation of PSI occurs when the services of an individual are provided by an interposed entity (the PSE) controlled by or associated with the individual, rather than directly by the individual who performs the services. Alienation arrangements create a compliance risk when they are used to retain income in the PSE (referred to as "retention of profits" arrangements) or divert income to associates (referred to as "income splitting" arrangements), or both, such that the income is taxed at an overall lower rate.

PCG 2025/5 points out that the ATO has a longstanding view on the treatment of PSI according to ordinary tax rules and the potential application of Pt IVA (and its predecessor, former s 260 ITAA36) to income splitting and retention of profits arrangements. There have been many cases where these provisions have been found to apply to the alienation of PSI. Nevertheless, and despite the note to s 86-10 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (which states that the general anti-avoidance provisions of Pt IVA ITAA36 may still apply to cases of alienation of personal services income that fall outside Div 86 ITAA97), the ATO is aware that some taxpayers incorrectly assume that, where a PSB is being conducted and the provisions of Div 86 do not apply, Pt IVA will also not apply to their income splitting or retention of profits arrangements.

Existing guidance and judicial decisions have made it clear that Pt IVA can apply to alienation arrangements involving income splitting and retention of profits where the dominant purpose of a participant in a scheme was to obtain a tax benefit. In an alienation arrangement, a tax benefit will generally arise because an amount is not included in the assessable income of the individual, being an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the individual if the scheme had not been entered into.

While the introduction of the PSI rules in Pt 2-42 ITAA97 had the practical effect of narrowing the scope for Pt IVA to apply to alienation arrangements (because where the PSI rules apply, no tax benefit is obtained), it did not otherwise affect the continued operation of Pt IVA. At present, where a PSE qualifies as a PSB and therefore the PSI rules do not apply, it remains possible that Pt IVA will apply to the scheme under which the services are provided.

Although PCG 2025/5 addresses the likelihood (risk) that an alienation arrangement will bring Pt IVA into question, it does not provide detailed guidance on when Pt IVA will apply to arrangements involving income splitting or retention of profits.

From an administrative point of view, PCG 2025/5 states that an arrangement will be considered by the ATO to be low risk where the net PSI received through the PSE is assessed in the form of assessable income to the individual whose personal efforts or skills generated that income and tax is not deferred. In contrast, a higher-risk arrangement will include either, or both, an income splitting or retention of profits arrangement which diverts PSI away from the individual or facilitates the deferral of tax. PCG 2025/5 contains a number of examples of low-risk arrangements and of higher-risk arrangements.

PCG 2025/5 also states that, while Pt IVA can apply to any higher-risk arrangement, the materiality of the PSI diverted will always be a relevant factor that the ATO considers when deciding whether to review an arrangement or pursue Pt IVA. The ATO is more likely to target arrangements where there are substantial distributions or payments made to associated lower-tax persons or entities. Further, taxpayers should not be concerned that the ATO will apply compliance resources to pursue Pt IVA where they have made a genuine attempt to move into a low-risk arrangement by 30 June 2027.

PCG 2025/5 is limited to the matters described in it and does not affect the ATO's compliance approach to other tax issues that might arise in connection with PSE arrangements, for example, whether Div 7A ITAA36 applies to an arrangement within the PSE's group. If the ATO considers that an arrangement poses a risk under other tax provisions, the ATO will have cause to apply compliance resources to address those risks.

#### 4. Non-business rental property income and deductions

The Commissioner has released a draft ruling and two draft practical compliance guidelines that provide guidance for individuals who earn non-business income from a rental property (TR 2025/D1; PCG 2025/D6; PCG 2025/D7).

In particular, TR 2025/D1 covers the earning of income from:

- the short-term rental market (such as using online booking or sharing platforms), including renting out a holiday home (as described in TR 2025/D1) or letting a room (or rooms) in a home; or
- the letting out of a property, or part of a property, to long-term tenants.

TR 2025/D1 explains:

- when amounts that are received for the use of a rental property will be assessable income;
- when losses or outgoings that are incurred relating to a rental property can be claimed as deductions;
- how deductions are apportioned when there are both income-producing and non-income-producing uses of a rental property; and
- when certain deductions for a holiday home, that the taxpayer also uses as a rental property, will be denied by s 26-50 ITAA97 because it is a “leisure facility” (as defined).

TR 2025/D1 notes that it is important to be aware that, where a taxpayer rents out some or all of their main residence, the taxpayer's ability to access the CGT main residence exemption in full (on an eventual sale of the dwelling) may be compromised.

An appendix to TR 2025/D1 contains a transitional compliance approach which explains the ATO's practical administrative approach to holiday homes for arrangements entered into before 12 November 2025 (the date of issue of TR 2025/D1).

TR 2025/D1 states that, if a taxpayer rents out a property (including on an online sharing platform), this does not of itself mean that a business is being carried on. There are a range of factors which need to be considered when determining whether a business is being carried on.

TR 2025/D1 does not provide detailed advice on deductions for the following topics:

- rental property travel (s 26-31 ITAA97);
- holding vacant land (s 26-102 ITAA97);
- repairs (s 25-10 ITAA97);
- decline in value (s 40-25 ITAA97); or
- capital works deductions (Div 43 ITAA97).

PCG 2025/D6 explains methods for the apportionment of rental property deductions by individuals that the Commissioner considers fair and reasonable.

PCG 2025/D7 explains the ATO compliance approach to determining whether a taxpayer's holiday home is used (or held for use) mainly to produce assessable income in the nature of rents, lease premiums, licence fees or similar charges.

#### 5. Departure prohibition orders

The ATO is actively using departure prohibition orders (DPOs) as part of a broader shift towards strengthening payment performance and debt collection.

A DPO is an enforcement action available to the ATO to prevent certain persons with tax liabilities from leaving Australia without paying their outstanding tax. Since July 2025, the ATO has issued 21 DPOs, more than the total number issued in the financial year ended 30 June 2025.

Taxpayers who have accumulated significant tax debts that they have the means to pay, and who take deliberate steps to avoid paying, can expect to have overseas travel plans disrupted by the ATO. While the ATO's preference is always to support taxpayers who are willing to comply to pay through early intervention activities, where the ATO has concerns that a taxpayer is seeking to flee the jurisdiction or is spending money on overseas trips in preference to meeting their tax or superannuation obligations, the ATO may issue a DPO to protect the interests of the rest of the community.

The ATO is focused on reducing unpaid tax and bringing down the \$50 billion collectable debt book through its approach to debt management. This includes taking necessary actions on taxpayers who refuse to pay debts, particularly those relating to unpaid employee superannuation, and taxes withheld from employees' wages, or collected from customers as GST but not passed on to the government.

The increased use of DPOs is just one example of the strong and deliberate action that the ATO is taking to deal with taxpayers who are continuing to ignore their obligations and refuse to pay their outstanding amounts. For these taxpayers, the ATO is moving faster to deploy the full powers available to secure payment and prevent the further accumulation of debt. Other examples of firmer actions include director penalty notices, garnishees, referrals to credit reporting bureaus, and wind-up applications.

## 6. Tax Practitioners Board: 2026 compliance priorities

The Tax Practitioners Board (TPB) has announced its 2026 compliance priorities, with a view to providing greater transparency and clarity to the tax profession.

By publishing these priorities for the first time, the TPB is aiming to promote integrity, support voluntary compliance, and strengthen community confidence in the tax profession. The priorities complement the TPB's enduring focus areas, which remain central to its compliance approach.

The TPB said that its priorities highlighted the importance of maintaining community confidence, protecting consumers, and upholding integrity standards. The TPB wants to support tax practitioners who are doing the right thing and provide clarity on where risks exist and the actions the Board is taking.

The TPB's 2026 priorities target both emerging and ongoing risks, with a particular focus on tax practitioner misconduct or unethical behaviour, including tax practitioners who:

- help clients to avoid paying tax debts or engage in illegal phoenix activities, undermining employee entitlements and creditors' rights;
- put clients into schemes designed to avoid tax, such as artificially shifting profits to low-tax jurisdictions, hiding income or assets in secrecy havens illegally, and misusing the research and development concessions;
- facilitate shadow economy activities;

- encourage clients to overclaim work-related expenses;
- engage in activities that exploit vulnerable Australians; or
- fail to meet their personal tax obligations.

## Recent case decision

### 7. CGT: market value issues

In a recent decision, the Full Federal Court (Charlesworth, O'Sullivan and Horan JJ) has unanimously held that, for the purposes of applying the \$6 million maximum net asset value test that applies in the context of the CGT small business concessions, the market value of each of the two minority shareholdings in a company was properly to be determined on a pro rata basis by reference to the consideration received for the whole of the shareholdings (*Kilgour v FCT*).

In October 2016, News Corp Investments Pty Ltd (News Corp) acquired all of the 120,000 issued shares in Punters Paradise Pty Ltd (Punters) from three vendor companies under a share sale agreement. The vendors previously held their respective interests in Punters as trustees of trusts, the Pettett Trust (60%), the Kilgour Trust (20%) and the Reuhl Trust (20%). Pursuant to the share sale agreement, the purchase price of \$31,057,722 was apportioned between the vendors in amounts reflecting the number of shares sold by them. The trustees of the Kilgour and Reuhl Trusts each received \$6,211,544, reflecting their 20% holdings.

The appeal to the Full Federal Court concerned the tax treatment of the proceeds of sale of the 20% holdings in the hands of the appellant taxpayers, Mrs Sarah Alice Kilgour (a beneficiary of the Kilgour Trust) and Mrs Tamara Isterling (a beneficiary of the Reuhl Trust) for the 2017 income year. The Commissioner included a capital gain in each of their assessable incomes, the capital gain being calculated by reference to the distributions that they each received referable to the share sale agreement. That sum was calculated having regard to the "market value" of the shares as "CGT assets" for the purposes of the ITAA97. The Commissioner disallowed the taxpayers' objections to the assessments and each then appealed to the Federal Court against the Commissioner's adverse objection decisions.

The taxpayers contended that, for the purposes of calculating CGT, the focus was on the market value of the 20% parcels considered as discrete transactions, without regard to the simultaneous acquisition by News Corp of 100% of Punters' shares from the three shareholders collectively. In addition, they argued that the value of the assets sold by them did not include advantages to News Corp's overall enterprise arising from the ownership and control of Punters, described in the evidence and submissions as "synergies". It was submitted that the capital gains ought to have been assessed as less than \$6 million, with the result that the taxpayers would each be entitled to the benefit of the CGT small business concessions in Div 152 ITAA97.

The taxpayers relied on expert evidence to the effect that News Corp had paid more than the market value because of matters that they alleged formed no part of the value

of their respective holdings, namely, the willingness of the other shareholders to dispose of their respective parcels, and (relatedly) the synergies. Those factors were said to fall outside of the “market value” of the assets that they disposed of. Logan J at first instance rejected those arguments and the Full Federal Court has now upheld the decision of Logan J. Charlesworth J delivered the Full Court’s reasons and several points from her Honour’s judgment are noted below.

Charlesworth J pointed out that the “net value” of a CGT asset is obtained by subtracting certain sums from the “market values of those assets”: s 152-20 ITAA97. The words “market value” are not defined in this context of the ITAA97. At first instance (as on appeal), it was common ground that market value was to be assessed in accordance with the principles discussed by the High Court in *Spencer v Commonwealth*,<sup>2</sup> a matter involving the valuation of land compulsorily acquired by the Commonwealth.

The prescription that the CGT event occurs “just before” the execution of an agreement for the transfer of the CGT asset does not in terms carry with it a requirement that an actual transaction must be ignored for all purposes when ascertaining the market value of the CGT asset at the immediately preceding moment in time. Whether an actual transaction may permissibly inform the valuation task must depend on the facts and circumstances of the particular case.

Charlesworth J said that there may be cases in which evidence of the negotiation and terms of an actual sale may well provide a reliable indication of the opinion as to price that both the hypothetical vendor and the hypothetical purchaser would form at the valuation time. Indeed, there may be cases where an actual transaction supplies the most informative answer to the hypothetical question. That would be especially so where the actual sale occurs between parties at arms’ length and at a time proximate to the date on which the value of the asset is to be assessed, and where the subject matter of the sale is otherwise comparable to (or identical to) the asset to be valued.

Taking the Kilgour shares, Charlesworth J said that, for the purposes of resolving the temporal question, Charlesworth J rejected the submission that the prescription of the “just before” time in the ITAA97 in and of itself required Logan J to ignore, for all purposes, the facts and circumstances surrounding the actual transaction in which the Kilgour shares were transferred in fact.

Her Honour said that, on the uncontested facts in the present case, at the valuation time prescribed in the ITAA97, there existed an unexecuted agreement which was capable of immediate execution by the Kilgour trustee for the sale of the Kilgour shares on the terms set out in that document. The state of affairs then existing permissibly informed the question of market value, on the proper application of the principles in *Spencer*. By having regard to the price recorded in the share sale agreement just before its execution (and the history of dealings leading to that point), Logan J at first instance did not deviate from the requirement that the CGT asset be valued at the time immediately before the

share sale agreement was signed by the Kilgour trustee. Rather, Logan J proceeded from a footing that execution of an agreement for a sale price of \$30 million was as good as certain.

It was also submitted that Logan J erred by misidentifying the CGT asset to be valued, specifically by failing to hypothesise a sale of a 20% shareholding in Punters in isolation from any contemporaneous transfer of the remaining 80% by other shareholders. It was submitted that the purchase price specified in the share sale agreement included a premium representing the benefit to News Corp of 100% ownership, necessary for News Corp to enjoy synergies such as the complementary nature of the acquired business to its existing enterprise and associated cost savings. Charlesworth J rejected these submissions.

The circumstance that News Corp acquired 100% of the shares under the share sale agreement was said to be irrelevant because the ITAA97 required the focus to remain on (and only on) the value of (and only of) a minority holding. It was submitted that no purchaser in the hypothetical market would be willing to pay 20% of \$30 million for the infirmities of a minority holding, and that a majority or absolute interest was not an asset that the Kilgour trustee could offer for sale. For those reasons, News Corp was said to be a “special” purchaser such that its opinion on price was not to be equated with that of the *Spencer* hypothetical purchaser. Charlesworth J also rejected these submissions.

### Appeal

The taxpayers in this case are seeking special leave to appeal to the High Court from the decision of the Full Federal Court.

**TaxCounsel Pty Ltd**  
ACN 117 651 420

### References

- 1 [2025] FCAFC 183.
- 2 [1907] HCA 82.



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## Tax Tips

by TaxCounsel Pty Ltd

# Co-ownership: residential premises

Various income tax, CGT and GST issues can potentially arise where residential premises that are co-owned by individuals are rented out.

### Background

Where land is co-owned by individuals, the individuals will hold the land either as tenants in common (in equal or other undivided shares) or as joint tenants.

For the purposes of land law, where the land is held by the individuals as tenants in common, each person has a proportionate interest in the land. On the other hand, if the land is held as joint tenants, the joint tenants do not have a proportionate share in the land but, rather, each joint tenant is seised of the whole, along with the other joint tenants. An inherent incident of a joint tenancy is the right of survivorship, that is, when one joint tenant dies, the whole of the land remains with the surviving joint tenant or joint tenants. For most revenue purposes, joint tenants are treated as tenants in common.

It may be noted that it is possible for joint tenants of land to hold in equity as tenants in common in equal shares. This may be the case where there is a partnership at general law and the land is a partnership asset. This is illustrated by the decision of Windeyer J in *Spence v FCT*.<sup>1</sup>

Apart from statutory modification, it is only possible for natural persons to be joint tenants of land (because of the survivorship rule). This has been altered in some jurisdictions so that a company may hold land as a joint tenant.<sup>2</sup>

This article considers in broad terms the more significant ordinary income tax, CGT and GST issues that can arise for individuals who own residential premises jointly, whether as tenants in common or as joint tenants.

There will, of course, be a variety of other circumstances where jointly owned land will be utilised by joint owners (for instance, land that is used in a business), but these situations are outside the scope of this article and are not considered. It may be noted, however, that in such a case, the CGT issues that may arise include the operation of the CGT small business reliefs.<sup>3</sup>

A reference to a pre-CGT asset is a reference to a CGT asset that was acquired on or before 19 September 1985, and a

reference to a post-CGT asset is a reference to a CGT asset that was acquired after 19 September 1985.

### Ordinary income tax

If joint owners of land (whether tenants in common or joint tenants) are in receipt of assessable income from the land (typically, rent), the owners (if not partners at general law) will be treated as a partnership for ordinary income tax purposes (s 995-1 ITAA97 definition of “partnership”).<sup>4</sup>

The net income of a partnership within the extended statutory definition will be taxed to each owner in accordance with the owner’s proportionate interest in the land; it is not possible for the owners to share the profits otherwise than in accordance with their respective interests in the land (*FCT v McDonald*).<sup>5</sup>

In the *McDonald* case, the taxpayer and his wife invested as joint tenants in two residential units which they leased out. They agreed that, in the event of a net profit from the investments in an income year, the net profit would be shared by the taxpayer (who had the greater non-rental income) as to 75% and his wife as to 25%. In the event of a net loss in an income year, it was agreed that the whole of the loss would be borne by the taxpayer. Beaumont J held that the arrangement between the parties relating to the sharing of profits and losses was not effective for the purposes of income tax.

His Honour said that the relationship between the taxpayer and his wife was one of co-ownership, and even if they were deemed to be partners by reason of the statutory definition of partnership, this circumstance was immaterial for the purposes of the issues in the case. His Honour went on:

“31. ... As has been noted, their notional ‘partnership’ will carry with it the consequence that they are to be treated as a ‘partnership’ for some purposes. It does not follow that the [taxpayer] can deduct the whole of the losses. He may only deduct his individual interest in the ‘partnership’ loss. His ‘individual interest’ is the interest to which a ‘partner’ is solely entitled, as contrasted with his joint interest in the whole ... It is necessary therefore to determine whether the [taxpayer] and [his wife] ... were merely notional ‘partners’ for the purposes of the Act (i.e. merely co-owners) or were ‘true’ partners under the general law.”

Later Beaumont J said:

“38. In the present case, a number of indications point to the conclusion that the parties were not carrying on a business, with the consequence that their relationship was that of co-ownership rather than partnership. Their investment involved little, if any, active participation from either party. This was inevitable because the [taxpayer] was apparently in full-time employment, and Mrs. McDonald was fully committed at home. On the few occasions on which the owners needed to be involved, the [taxpayer] and not Mrs. McDonald attended to the matter. This was not a case of the active joint participation by the parties in a business activity. Rather, it was a case of a renting out of premises without the

provision of other services of the kind discussed in Wertman, supra. In my view, there was here a mere investment in property rather than a partnership in the properties or their profits. This is not, of course, to say that it is not possible for husband and wife to enter into a partnership under the general law with respect to land dealings ...

39. Given the [taxpayer's] minor participation in the affair and given [his wife's] apparent lack of commercial expertise and her passive role, it is, I think, more accurate to describe them as co-owners in investments rather than as partners in a business operation."

If the joint owners were in fact partners under the general law of partnership (that is, if they were carrying on a business), the profits and losses would be distributed in accordance with the partnership agreement.

## Carrying on a business of letting rental properties

As indicated, where the activities of joint owners of land in relation to the land in fact amount to the carrying on of a business, the joint owners will be partners for the purposes of partnership law.

The ATO publication *Rental properties guide 2025*<sup>6</sup> (the 2025 ATO guide) considers when the income from the letting of property to a tenant, or multiple tenants, will amount to the carrying on of a business. The 2025 ATO guide refers in this regard to TR 97/11, which lists eight indicators to determine whether a business is being carried on. These indicators are listed in para 13 of TR 97/11<sup>7</sup> and are:

- whether the activity has a significant commercial purpose or character; this indicator comprises many aspects of the other indicators;
- whether the taxpayer has more than just an intention to engage in business;
- whether the taxpayer has a purpose of profit as well as a prospect of profit from the activity;
- whether there is repetition and regularity of the activity;
- whether the activity is of the same kind and carried on in a similar manner to that of the ordinary trade in that line of business;
- whether the activity is planned, organised and carried on in a businesslike manner such that it is directed at making a profit;
- the size, scale and permanency of the activity; and
- whether the activity is better described as a hobby, a form of recreation or a sporting activity.

The 2025 ATO guide states that, while most rental activities are a form of investment and do not amount to the carrying on of a business, where a business of letting rental properties in partnership with others is carried on, the net rental income or loss must be divided according to the partnership agreement. This must be done even where the legal interests in the rental properties are

different to the partners' entitlements to profits and losses under the partnership agreement. If there is no partnership agreement, the division will be between the partners equally, or if the property is held as tenants in common other than in equal shares, according to the respective tenant in common interests.

The 2025 ATO guide gives the following example:

### "Example 4: co-owners who are carrying on a business of letting rental properties"

Lazlo and Petra own several rental properties either as joint tenants or tenants in common. They own 8 houses and 3 apartment blocks (each apartment block comprising 6 residential units), a total of 26 properties.

Lazlo and Petra actively manage all these properties, devoting an average of 25 hours per week each, to these activities. They:

- do all the financial planning and decision making in relation to the properties
- interview all prospective tenants and collect all the rents
- carry out regular property inspections and attend to all the everyday maintenance and repairs themselves or organise them to be done on their behalf.

Apart from income Lazlo earns from shares, they have no other sources of income.

Lazlo and Petra are carrying on a business of letting rental properties, because of the:

- significant size and scale of the rental property activities
- number of hours they spend on the activities
- extensive personal involvement they have in the activities
- business-like manner in which they plan, organise and carry on these activities.

Lazlo and Petra have a written partnership agreement where they agree to carry on a business of letting rental properties. They have an agreement that shows:

- Lazlo is entitled to a 75% share of the partnership profits or losses
- Petra is entitled to a 25% share of the partnership profits or losses.

Because Lazlo and Petra are carrying on a business of letting rental properties, they divide the net profit or loss it generates between them according to their partnership agreement (in proportions of 75% and 25%), even if their legal interests in the rental properties are equal, that is, they each own 50%."

## No carrying on of a business

The 2025 ATO guide gives the following example where the co-owners of land are not carrying on a business:

### “Example 3: co-owners who are not carrying on a business of letting rental properties

Claudio and Judith own, as joint tenants, 2 units and a house from which they derive rental income. Claudio and Judith occasionally inspect the properties and also interview prospective tenants.

Claudio performs most repairs and maintenance on the properties himself, although he generally relies on the tenants to let him know about issues. Claudio and Judith do any cleaning or maintenance when tenants move out.

The tenants of the 2 units and the house pay the weekly rent into Claudio and Judith’s account. Although Claudio and Judith devote some of their time to rental income activities, their main sources of income are their respective full-time jobs.

Claudio and Judith are not partners carrying on a business of letting rental properties. They are only co-owners of several rental properties.

As joint tenants, they must each include half of the total income and expenses for the rental properties in their tax returns, in line with their legal interest in the properties.”

## CGT

Individuals who own a CGT asset as joint tenants are treated for CGT purposes as if they each owned a separate CGT asset constituted by an equal interest in the asset and as if each of them held that interest as a tenant in common (s 108-7 ITAA97).

This CGT rule for joint tenants only applies in the case of a CGT asset that is owned by individuals as joint tenants. As pointed out above, in some jurisdictions at least, it is now possible for a company to hold an interest as a joint tenant in land. It is considered likely that a court would adopt a purposive approach to the application of the CGT provisions in such a case that would result in the severing of a joint tenancy (when one or more joint tenants are companies) having no CGT consequences.

## GST

For the purposes of GST, an activity, or a series of activities, done on a regular or continuous basis, in the form of a lease, licence or other grant of an interest in property constitutes an enterprise.<sup>8</sup>

However, it is unlikely that there would be a GST liability in the kinds of case considered in this article. This is because of s 40-35 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) which provides to the effect that a supply of premises that is by way of lease, hire or licence (including a renewal or an extension of a lease, hire or licence) is input taxed<sup>9</sup> if (so far as is relevant) the supply is of residential premises.<sup>10</sup>

For this purpose, “residential premises” means (so far as is relevant) land or a building that is occupied as a residence or for residential accommodation or is intended to be

occupied, and is capable of being occupied, as a residence or for residential accommodation (regardless of the term of the occupation or intended occupation).<sup>11</sup>

This GST input taxed category of supply is relevant in the case of jointly owned premises even if the activities in relation to the jointly owned premises in fact amount to the carrying on of a business.

## Severance of a joint tenancy

If a joint tenancy of land between individuals is merely severed (so that the joint tenants become tenants in common in equal shares), this will have no CGT consequences. As already noted, individuals who own a CGT asset as joint tenants are treated, for CGT purposes, as if they each owned a separate CGT asset constituted by an equal interest in the asset and as if each of them held that interest as a tenant in common (s 108-7 ITAA97).

## Partition

If there is a partition of land that is jointly owned (whether as tenants in common or as joint tenants), each co-owner becomes the sole owner of a particular part of the land. A partition may be voluntary or, where there is an absence of agreement, by court order under a statutory provision.

In some cases, a particular part of the land which a co-owner becomes the owner of is equal in value to the interest that the co-owner had as a joint owner. In other cases, it may not be the same and, in such cases, monetary consideration is usually provided by way of adjustment. This may give rise to CGT issues.

From a CGT perspective, where there is a partition of land, the consequences will be that each owner will:

- acquire from the other joint owner(s) an interest in the land that the other joint owner(s) ceased to have; and/or
- dispose to the other or each other joint owner an interest in the land to which the other joint owner(s) becomes entitled to.

Accordingly, for an owner who or which acquired their interest in the jointly owned land post-CGT, a capital gain or capital loss will be potentially made from the happening of CGT event A1. A joint owner will, of course, have a further interest or interests in the land (acquired from the other joint owner(s)) which will be a separate CGT asset.

## Death of joint owner

Where land is owned by individuals as tenants in common or as joint tenants and one dies, the normal CGT deceased estate rules will apply. This will (broadly) mean that no capital gain or capital loss is recognised at the time of death, and the legal personal representative, a beneficiary to whom the deceased’s interest passes or a surviving joint tenant is treated as having acquired the interest for a consideration equal to the deceased’s cost base (or reduced cost base) or, if the deceased acquired their interest pre-CGT, at the market value of the interest at the date of death.<sup>12</sup>

## Discount capital gain concession

In the case of an inherited asset, for the purposes of applying the 12-month qualifying period that is relevant for the CGT discount concession to apply, a beneficiary can treat the asset as though the beneficiary had owned it since:

- the deceased acquired the asset, if they acquired it on or after 20 September 1985; or
- the deceased died, if they acquired the asset before 20 September 1985 (s 115-30 ITAA97).

## CGT main residence exemption

A dwelling that is used as a main residence is often co-owned by individuals and this will raise issues as to whether the CGT main residence exemption may apply.<sup>13</sup> The operation of the exemption will need to be considered in relation to each co-owner.

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## References

- 1 [1967] HCA 32.
- 2 See, for example, s 25 of the *Conveyancing Act 1919* (NSW). Under that section, where a body corporate is a joint tenant of any property and the body corporate is dissolved, the property is taken to devolve on the other joint tenant or joint tenants.
- 3 See Div 152 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 4 A company cannot be a partner under this provision.
- 5 [1987] FCA 200. See also TR 93/32.
- 6 Available at [www.ato.gov.au/forms-and-instructions/rental-properties-2025/how-to-get-the-rental-properties-guide-2025](http://www.ato.gov.au/forms-and-instructions/rental-properties-2025/how-to-get-the-rental-properties-guide-2025).
- 7 Although TR 97/11 refers to primary production, the ATO document treats the indicators as being equally relevant to non-primary production activities.
- 8 S 9-20 GSTA99.
- 9 Being an input taxed supply, no GST is payable and input tax credits are not claimable.
- 10 This input taxed category of supply does not apply to a supply of commercial residential premises or a supply of accommodation in commercial residential premises provided to an individual by the entity that owns or controls the commercial residential premises. The supply is not input taxed if the lease, hire or licence, or the renewal or extension of a lease, hire or licence, is a long-term (50 years or more) lease.
- 11 S 195-1 GSTA99.
- 12 S 128-50(1), (2) and (3) ITAA97.
- 13 The CGT main residence exemption is provided for in Subdiv 118-B ITAA97.



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### Michelle Hunt, FTI

Chartered Accountant  
Lorkin Delper Harris Pty Ltd, Hobart



### From Tasmania to New Zealand and back again

Michelle's interest in working in tax started while studying business in high school.

She began her tax journey with Lorkin Delper Harris Pty Ltd in 2007, while studying for her Bachelor of Commerce at the University of Tasmania. By 2015, ready for a new challenge, she made the bold move and relocated to New Zealand where she gained exposure to international tax issues.

"I value the knowledge I gained from experiencing international taxation from another country's perspective."

Returning to Australia in 2021, Michelle joined a sole practitioner as a senior accountant. The role offered something precious: flexibility to study the CTA2B Advanced subject while raising two young children.

"The combination of the complexities of the tax system and the important role of tax contributed to shaping my sense of purpose in my career."

By 2022, she'd progressed to a director role and then, in 2024, came a full-circle moment. She reconnected with the team at Lorkin Delper Harris Pty Ltd in pursuit of building client relationships and gaining further expertise in superannuation.

### When theory transforms into practice

For Michelle, superannuation isn't just another tax specialty. It's where theory meets some of the most consequential financial decisions Australians make.

"Given that superannuation is a significant asset for many Australians, the knowledge I have gained in superannuation and estate planning is invaluable," she says. "I've learned

strategies for discussing matters for consideration with clients and the implications around control of their superannuation."

**The ATL007 Advanced Superannuation course pushed Michelle to master the intricacies of superannuation and estate planning at a level that immediately elevated her practice.**

"This subject increased my knowledge in superannuation law, strategy and compliance rapidly," Michelle notes. "Working through the intricacies of superannuation and estate planning within this subject has helped me develop the skills of applying strategies for the management of tax liabilities in superannuation funds and that of beneficiaries. In return, it has completely changed how I approach these conversations."

### The path forward

Michelle isn't resting on her current achievements. She's already planning her next move and plans to pursue the CTA designation, with a focus on GST. "The ability to dive deeper into the intricacies of tax law and work out how the different pieces fit together makes it truly fascinating," she says.

### Achieving excellence without the sacrifice

Her advice for other tax professionals who are considering further study comes from hard-won experience.

When Michelle became Dux of [ATL007 Advanced Superannuation](#), she proved that excellence doesn't require choosing between professional ambition and family life. It requires strategy, determination and knowing when to pursue knowledge that matters.

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# Taxation of trusts: common issues in preparing trust deeds

by Philip Bender, ATI, Barrister,  
Victorian Bar

This article analyses the legal and practical issues that arise when trust deeds contain defects, ambiguities or unintended outcomes, with an outline of the types of problems that can arise and solutions to those problems including rectification and court-approved variations. The article considers the practical measures for using these solutions to drafting issues, including when amendment powers can be exercised, the principles underpinning applications for rectification, and the use of the rule in *Saunders v Vautier* to amend. It also considers the role of revenue authorities in these processes and the implications for duty and tax concessions. Finally, the article provides a detailed overview of statutory powers enabling court approval of trust variations, together with practical guidance on evidentiary requirements, beneficiary representation, appointment of a contradictor, and key considerations when seeking judicial advice or approval.

## Overview

This article is aimed at examining some issues in drafting trust deeds and problems that can arise therein. The objective of the article is not to comprehensively outline all possible issues, but to give some examples and then to outline potential methods of dealing with drafting problems that arise. The focus of the article is on discretionary trust issues, although some other examples are also covered.

One of the most common problems that I see in practice is clients being given stock standard trust deeds that are not tailored to meet their particular circumstances and objectives. They may contain clauses that are not appropriate for a particular client or their situation. Unfortunately, that seems to be a difficult problem to deal with due to the rise of companies that specialise in selling “cookie-cutter” trust deeds for rock-bottom prices, with little ability to customise the deed for a client’s own situation. Often discretionary trusts are established with, or become enriched with, significant assets, so placing faith

in a cheap, cookie-cutter deed is not advisable given the potential consequences of the drafting not being suited to the circumstances.

The biggest problems are ambiguous drafting or poorly worded clauses in trust deeds (for example, undefined terms that are ambiguous), a lack of foresight about circumstances that might arise in the future, and an absence of power to do something.

Older trust deeds will often use a drafting style that makes them difficult to understand and interpret, including:

- archaic language;
- the never-ending sentence;
- very little structure and minimal use of clause numbering; and
- poor and sometimes inconsistent use of definitions.

A good modern trust deed might, in contrast, have:

- a table of contents of clauses;
- numbering of paragraphs and sub-paragraphs;
- good use of definitions;
- clauses organised by topic area; and
- short, easy to understand sentences using plain language.

Other problems I have seen on occasion are:

- a law firm without a good precedent trust deed might obtain an ancient or poorly drafted deed from a colleague and then tinker with that around the edges to use for a one-off client; and
- “adding to the beast” – having a precedent trust deed that has been added to with new clauses year on year without thinking about whether the deed as a whole works and the clauses interact appropriately.

## Appointor and guardian-related issues

### Choice of appointors and guardians

Appointors and guardians are officeholders or donees of powers under a trust who can play an important role in safeguarding the trust. They can provide a check on the power of a trustee. The appointor would usually be given the power to remove and appoint trustees, so they play a critical role in controlling a trust.

A guardian is often given an additional protective role in respect of a trust by, for example, requiring their consent before particular acts or exercises of power can be carried out. Sometimes the roles of appointor and guardian are combined.

The critical role of these officeholders makes it vital to choose an appropriate person to hold the role. Usually, that will not be a problem during the life of the patriarch or matriarch of the family who caused the trust to be settled – generally, those persons will want to hold the controlling role. That may not always be the case, though, as there may

be asset protection reasons why a person does not want to hold the appointor/guardian role.

## Fiduciary powers

One issue which can arise with appointor and guardian powers is whether the powers are fiduciary in nature. Why does that matter? It matters because, if they are not fiduciary in nature, the donee of the power can exercise the powers in their own personal interests. If the powers are fiduciary, the donee must exercise them for the benefit of the trust/beneficiaries as a whole, not in their personal interest, and they have a duty of undivided loyalty to the beneficiaries. That does not mean that a donee who is not a fiduciary is absolved of all restrictions – they must still exercise the power in good faith and not for an improper person. However, the level of protection for beneficiaries is much less if an appointor or a guardian is not a fiduciary.

There is no single answer to the question of whether an appointor/guardian is a fiduciary. In *Blenkinsop v Herbert*,<sup>1</sup> the Western Australian Court of Appeal considered whether a guardian's power to consent to the appointment of income and capital and the advancement of capital to beneficiaries was a fiduciary power.

The court held that simply being a guardian under a trust deed does not automatically mean that the guardian is a fiduciary. Determining whether they are a fiduciary depends on a construction of the trust deed and whether the particular power(s) are fiduciary in nature. In that particular case, the guardian did not occupy a fiduciary position as, among other things, they were entitled to act in their own interests when deciding whether to consent. They did not have any obligation to the other objects of the trust when considering whether to grant consent.

One way of dealing with this issue may be to include a specific provision in the deed to make it clear that a guardian or an appointor is intended to occupy a fiduciary role and/or act in the best interests of the beneficiaries as a whole, rather than solely in their own interests. As the Court of Appeal found the matter to be one of construction, that would arguably deal with the issue because it would explicitly set out the settlor's intent in the deed.

### Example

Thaddeus P Thylacine is the primary beneficiary of a family trust, the Tas Tigers Trust, that he has caused to be settled by his accountant. His instructions to the lawyer who drafts the trust deed are that his wife, Thelma Thylacine, and his son, Terry Tiger, should be joint appointors of the trust. The lawyer uses a precedent deed which names Terry Tiger and Thelma as joint appointors, but there is no express clause in the trust deed which makes it clear if the office of appointor is a fiduciary one.

Thaddeus acts as the initial trustee of the trust. He also has a daughter, Patricia Possum, from a previous relationship. The class of beneficiaries includes, among others, Thaddeus, his spouse and his lineal descendants.

### Example (cont)

Thelma dies leaving Terry Tiger as the sole appointor of the trust. Terry Tiger does not care about his father or his sister. He thinks it would be in his own best interests to appoint his friend, Bobo the Bandicoot, as trustee of the trust. He exercises his power as appointor to remove Thaddeus as trustee and to replace him with Bobo. Whether this is an appropriate exercise of power will depend, in part, on whether the office/powers of appointor should be properly construed as fiduciary in nature.

## Joint appointors or guardians

Sometimes two or more individuals are named in a trust deed as appointors or guardians. It is preferable to make it clear when drafting a deed as to what happens when one of those persons dies. That is, it should be made clear whether the surviving person can exercise the powers alone, or whether the intent is that the powers can only be exercised by both persons acting together (or by, for example, a legal personal representative of the deceased person together with the surviving appointor/guardian).

Ambiguous drafting in this regard can lead to possible problems.

This issue has recently been explored in *Mak v Juventus Pty Ltd*.<sup>2</sup> An appointor usually fulfils a key role in the control of a trust by having the power to appoint or remove trustees. An appointor can also be given a role in respect of reserved powers, such as the trustee needing their approval in order to exercise named powers, like powers of appointment. Sometimes a guardian is also named and may take on this protective role. This means that the roles are crucial to control over a trust.

If there is a bare power that has been given to two or more people jointly in their own right as individuals, the survivor will not be able to exercise the power alone. When a power is annexed to a particular office (for example, the office of guardian), it may be exercisable by the survivor of the persons holding that office. That will not always be the case, though, if the power was really given only to the persons officially named. In other words, if the donor of the power intended that it be donated to those persons together (despite being annexed to a particular office), and exercised by those persons only in their joint capacity, a survivor will not be able to exercise the power. In that scenario, one would need to look to the trust deed to determine who, if anyone, has the right to exercise the powers as appointor or guardian on death of one of the joint persons. Sometimes, for example, a trust deed will permit the trustee to exercise the power if there is no occupant of the office of appointor or guardian.

*Mak's* case illustrates these principles. The court went through a process of construing the trust deed and concluded in that particular case that the objective intention was that the survivor of joint persons was to continue with the powers of the office of guardian.

**Example**

Thaddeus P Thylacine and his wife, Thelma Thylacine, are originally named as joint appointors of the Tas Tiger Trust. There is no office of guardian under the deed. Thaddeus and Thelma later get divorced, but the trust deed is not updated so Thelma remains named as one of the joint appointors. The class of beneficiaries is wide enough to include any lineal descendants of Thaddeus, as well as those of Thelma. After the divorce, Thaddeus has two children with a new spouse and runs a successful business through the trust for decades. Thelma also has two children with a new spouse.

Decades after the divorce, Thaddeus dies. His new spouse takes over control of the corporate trustee of the Tas Tiger Trust. Thelma's lawyers discover that she is still named as an appointor in the trust deed. It is unclear under the trust whether a surviving appointor can exercise the powers alone. Thelma assumes that she can exercise the powers and appoints her best friend as substitute trustee for the corporate trustee. She then influences her friend to exercise their discretion to distribute income and capital to Thelma's children with her new spouse, to the exclusion of Thaddeus' widow and her children.

**Limited succession**

One problem I have seen on a number of occasions are dead-end succession clauses for guardians and appointors that can leave the trust without an officeholder. What do I mean by that? Suppose a trust deed has an appointor/guardian clause which:

- names a specific guardian/appointor;
- names a specific successor guardian/appointor, but no successor after that person;
- gives a power to a current guardian/appointor to name a successor while alive by deed, or in their will; and
- does not otherwise contain provisions to deal with succession to the guardian/appointor offices, and does not otherwise contain a power to change the identity of the guardian/appointor or to appoint a new one.

If the current guardian/appointor and the successor both die without naming their own successors, there will be no guardian/appointor and no mechanism to appoint a new one.

If such a scenario arises, unless there is a power of amendment in the deed which allows a new guardian or appointor to be named, the trustee may need to make an application to the court to seek to fill the offices.

The above scenario can be remedied by including failsafe clauses in the deed, such as a clause allowing the legal personal representative of the last surviving appointor or guardian to assume the office or appoint a new officeholder (or even, as a last resort, allowing the trustee to exercise such a power).

**Example**

Thaddeus is the named appointor/guardian of the Tas Tiger Trust. The schedule to the trust deed also names Thelma as his successor appointor/guardian. No other successor is named in the schedule. The current appointor/guardian has a power to appoint a new appointor/guardian while they live, or name one in their will on their death, but the trust deed does not contain any other provisions to name successor appointors/guardians or to appoint a new one if the offices are vacant. Thelma dies before Thaddeus without naming a successor to her office. Thaddeus then dies. He also fails to name a successor. The trust is left with no appointor/guardian and, as the trust has no power of amendment, there is no mechanism in the trust deed by which a new appointor/guardian can be named. A court application is the only option.

**Reserved/restricted powers: succession issues**

Where a guardian is included in a deed, it is common to require their consent to exercise key powers under the deed, such as a power of appointment. Sometimes this mechanism is drafted simply by including a clause in the relevant power which requires guardian consent to the exercise of the power. Other times, the drafter will use a concept of a reserved or restricted power that may require guardian consent, or for the guardian to be informed in writing before it is exercised (which allows them an opportunity to consider the proposal and to raise any complaints with the trustee beforehand, or, in the case of an appointor, to potentially remove the trustee if there is a major concern). That typically involves the trust deed including a list of reserved/restricted powers. These powers could be very narrow in scope, such as being limited to the power of amendment and the discretion as to which beneficiaries receive trust capital on vesting of the trust. The list could also be very wide and include, for example, all powers to distribute capital. I have seen some trust deeds in which this has even been extended to a power to distribute income.

Dead-end succession of guardians can create some real difficulties if these sorts of clauses are used. That can be heightened when even more controls are placed on the exercise of reserved/restricted powers by trustees. Some trust deeds include specific provisions which prevent the trustee from exercising reserved/restricted powers when the office of guardian is vacant. That can create enormous practical difficulties for a trustee if there is no mechanism that can be used to appoint a new guardian, for example, if powers to distribute income and capital are reserved powers.

**Example**

Assume the facts in the previous example, except that the trust deed does contain a power of amendment. The power of amendment is a broad one that, on the face of

**Example (cont)**

it, could be used to change the identity of the guardian/appointor. The power of amendment is, however, listed as a reserved power in the trust deed that cannot be exercised without guardian consent. The power to distribute income and the power to distribute capital are also reserved powers. The trust deed also contains a clause stating that the trustee cannot exercise reserved powers while the office of guardian is vacant. Due to the dead-end succession described in the previous example, there is currently no guardian. However, the trustee is unable to use the power of amendment to appoint a new guardian because of the restriction in the deed that prevents reserved powers from being exercised when the office of guardian is vacant. The trustee is left with a huge practical problem because the powers to distribute income and capital are also reserved powers which cannot be exercised without guardian consent and while there is no guardian in office.

### The non-existent clause or wrong clause reference

One common drafting error I have seen is where the drafter has made changes to a cookie-cutter deed and has not updated and checked the clause cross references. That can have serious consequences for the proper operation of a deed and can cause all sorts of interpretational issues.

**Example**

The Tas Tiger Trust deed names a guardian without whose consent reserved powers cannot be exercised by the trustee. The deed includes a list of reserved powers by reference to clause numbers. The reserved powers include cls 20, 25 and 30. There is, however, no cl 30 of the trust deed. The trust deed ends at clause 29. Clause 29 is the power of amendment. Clause 29 is not included in the list of reserved powers. This was due to a drafting error – the previous trust deed precedent used by the firm included the power of amendment with a clause number of 30, but the power became included in cl 29 after another clause was deleted from the deed. Prima facie, without some kind of constructional gymnastics, this error means that the trustee could exercise the power of amendment without guardian consent.

### Do I need to consider mental incapacity?

It may be prudent for a drafter to consider what happens to the appointor or guardian role in the event that the person currently fulfilling that role is permanently or temporarily incapacitated. Without an effective mechanism, that situation could leave a trust dangerously exposed to risk.

The recent Western Australian case of *Dryandra Investments Pty Ltd as Trustee of the Dryandra Trust v Hardie by her guardian ad litem Ian Torrington Blatchford*<sup>3</sup> illustrates the problems that can arise in this type of scenario. Isobel Hardie was the named appointor and guardian of a trust, but

she had dementia so was incapable of fulfilling her duties in those roles. The trust deed required guardian consent before reserved or restricted powers could be exercised by the trustee, so the trustee was constrained due to Isobel's incapacity. There was a serious problem because one of the reserved/restricted powers was the power to distribute income so, without guardian consent, the trustee could not distribute and was left with a tax issue.

The trustee made a court application under s 90 of the *Trustees Act 1962* (WA) seeking approval of variations of the trust deed as follows:

- “(a) The definition of ‘Guardian’ in the Schedule to the Trust Deed be varied by adding the following words:
- and in the default of appointment, the second named person’s legal personal representative.
- (b) That the following clause be inserted after clause 14.1 of the Trust Deed:

14.1A In the event that either the Appointor or Guardian by reason of mental disability, however occasioned, is declared by the Supreme Court of Western Australia or the State Administrative Tribunal of Western Australia to no longer have capacity to manage his or her own affairs, then any attorney of the Appointor or Guardian under a subsisting and valid enduring power of attorney may exercise the powers of Appointor and Guardian under this Deed in the place of the Appointor and Guardian for such period as the loss of capacity subsists.”

The first variation was sought to ensure that there was a guardian after Isobel's death, and the second amendment was sought to deal with her mental incapacity.

The court accepted that, despite the incapacity, Isobel was still validly appointed as guardian and appointor. However, her incapacity meant that she could not exercise her powers.

The court refused to make the variations on the basis that, to invoke the jurisdiction under s 90, the court had to be satisfied that the person seeking the variation had an interest in the trust. Isobel was a beneficiary, but the variation was sought in her capacity as guardian.

The court did, however, find that it had inherent jurisdiction to change the guardian and appointor and it changed them to Isobel's legal personal representative.

The case highlights, though, why it would be prudent to have a clause dealing with the incapacity of an appointor and guardian – it can potentially lead to real problems in practice if there is no such clause.

In Victoria, in the absence of a specific clause, the situation could become more complicated if there is an administrator appointed for a person by the Victorian Civil and Administrative Tribunal, or there is a power of attorney in place. Practitioners would need to consider s 50 of the *Guardianship and Administration Act 2019* (Vic) and the *Powers of Attorney Act 2014* (Vic). A consideration of situations of that nature is beyond the scope of this article.

## Beneficiary and trustee issues

### Too narrow a class of beneficiaries

Practitioners need to be careful with old trust deeds to ensure that they do not make assumptions when organising year-end distributions. Not all deeds are drafted to allow distributions to companies and trusts. Many old trust deeds restrict the classes of beneficiaries to individuals only from a particular family. I have seen a number of situations in which practitioners have picked up a trust client with an old deed and have prepared distribution resolutions distributing funds to companies or trusts without reading the deed and where the trust deed only had individual beneficiaries.

That can cause all sorts of problems including:

- a potential breach of trust by the trustee which might result in personal liability;
- a question of whether there is an obligation on the trustee to seek the return of the trust funds improperly distributed (for example, by relying on a cause of action based on money had and received) and whether there are defences to such a claim (for example, laches or reliance by the beneficiary);
- an issue as to whether the purported beneficiary's income tax returns need to be amended as they had no present entitlement to the income; and
- an issue as to whether the trustee will be assessed on any income if there was no default distribution clause in the trust deed, or whether the trust resolution was drafted such that some other beneficiary is entitled to the income and should have been taxed on it.

There are obviously good tax reasons for wanting to be able to distribute to corporate and trust beneficiaries. If a deed is restricted to individuals, the methods discussed below to amend the deed to expand the class of beneficiaries need to be considered (see under the heading "Dealing with drafting issues after the deed is executed").

### Breadth of the class of beneficiaries

#### Challenges to discretion

Too broad a class of beneficiaries can be just as dangerous as too narrow a class. One often sees cookie-cutter deeds being used which define the class of beneficiaries to include every possible relative of the primary beneficiaries under the sun, including cousins (not restricted to first cousins), aunts, uncles, nieces, nephews, siblings, and all of their spouses as well, and sometimes even all of their lineal descendants.

While flexibility to distribute is good, too wide a class of beneficiaries can also lead to potential disputes or risks for the primary family for whom the discretionary trust was set up. That is particularly the case in light of *Owies v JJE Nominees Pty Ltd*.<sup>4</sup>

A trustee of a discretionary family trust generally has a wide and unfettered discretion as to which beneficiaries they distribute income and capital to. In most cases, depending on the trust deed, they would not even be required to give

reasons for their decisions. That does not mean there are no limits on the discretion. Further, if a trustee does not keep records as to why they exercised the discretion in a particular manner, then, if the decision is subsequently challenged, it may be more difficult to justify the decision.

As has been made clear in *Karger v Paul*,<sup>5</sup> such a power can be impugned by a court on the following grounds:<sup>6</sup>

- a failure to exercise the discretion in good faith;
- a failure to give real and genuine consideration to the exercise of the discretion. One aspect of the duty to give real and genuine consideration is that there must be an exercise of an "active discretion". That is, the person must apply their own mind to the exercise of the discretion.<sup>7</sup> They cannot simply do nothing or act under the instructions of another. Further, a breach of this duty can occur where a person did not really apply their mind to the exercise of the discretion or they shut their eyes to the facts;<sup>8</sup>
- a failure to exercise the discretion for the purposes for which it was conferred; and
- if the trustee does give reasons, the court is able to review them.

There are some overlapping duties which will not be discussed in this article.

In the *Owies* case, a challenge to the exercise of a trustee's discretion was upheld on the basis that the trustee had not given real and genuine consideration to the exercise of the discretion. That was because they had failed to make inquiries about the relevant beneficiary's circumstances, including their financial position.

Although a trustee may not necessarily need to inquire about every possible beneficiary's situation every year before exercising a discretion to distribute, the wider the class of beneficiaries, the greater the risk there is and the greater the possibility that a family member outside the core immediate family may attempt to challenge the trustee's actions. That makes an extremely wide class of beneficiaries something that is not always going to be desirable.

#### Example

Mr Thylacine is the primary beneficiary of the Tas Tiger Trust. He has two little tiger cubs and a spouse, Thelma Thylacine. His discretionary family trust, the Tas Tiger Trust, has a corporate trustee in which Mr Thylacine holds all of the shares. The class of beneficiaries is wide and includes all kinds of relatives of Mr Thylacine, including his siblings, and cousins and nephews and nieces, and their spouses. He names his brother, Thucydide Thylacine, as the sole executor named in his will. Mr Thylacine then dies. As executor, Thucydide, takes over control of the corporate trustee and becomes its sole director. He decides to distribute large amounts of income to Thelma and Mr Thylacine's tiger cubs. He also, however, distributes a large amount of income to himself and his own children.

**Example (cont)**

Thelma challenges the exercise of the discretion. In addition, a destitute cousin, Timmy, also challenges the exercise of discretion on the basis that no inquiries were made of him about his financial situation and so there was no genuine consideration in exercising the discretion.

**Foreign beneficiaries**

Another danger of having a wide class of beneficiaries is that one might unintentionally sweep up some foreign resident beneficiaries in that class. That may cause problems because it can potentially lead to the foreign purchaser duty surcharge, or the foreign person land tax surcharge, being imposed. Older deeds might need to be amended to avoid this problem by excluding persons who fall within the definition of “foreign persons” in the various state duties/land tax legislation. One needs to be careful when drafting such an exclusion because the definitions of foreign persons/purchasers are not uniform across jurisdictions.

**Step-children, adopted children and widows/widowers**

One common issue that can arise with beneficiaries is a lack of clarity on when children and spouses are meant to be beneficiaries. That can often occur when those concepts are either not defined or they are defined ambiguously. Advisers need to also consider very carefully with their clients whether their clients actually *want* those persons to be beneficiaries in all circumstances. That can be one of the dangers of a standard trust deed without modification.

Take “children” to start with. If the term is not defined, it leaves a potential construction issue as to whether step-children and adopted children are supposed to be included within the term. Defining the term makes it clear what the intention is. References to step-children can also create problems if it is not clear whether those persons are to remain beneficiaries if the parents divorce, or if one parent dies but they are still married as at death. It is far better to make it clear in the deed the circumstances in which step-children should remain beneficiaries. This is something that should also be discussed with the client – some people, due to their close relationship with the step-child, may want them to remain beneficiaries regardless of any divorce or death of the spouse, others may not.

A similar situation arises with spouses. One problem that can arise is where spouses are specifically named as beneficiaries in a trust deed. That makes it much more difficult to sever the relationship with the trust after divorce. It is far better to include a general reference to “spouses”, rather than specifically naming a person (and to include a definition of what a “spouse” is). If the person ceases to be a spouse due to divorce, they will no longer be a beneficiary. One other ambiguity that can arise when there is merely a reference to a “spouse” is whether that

person remains a beneficiary after the death of the primary beneficiary. For example, the class of beneficiaries might include a primary beneficiary and their spouse and certain relatives and their spouses. It is better to make the deed clear and to specifically reference widows/widowers if the intention is for such persons to remain beneficiaries after the death of their partner.

**Unadministered estates as beneficiaries**

I am occasionally informed about some practitioners assuming that a discretionary trust can make distributions to a deceased estate merely because the trust deed includes other trusts in which at least one beneficiary has an interest or potential or contingent interest. Such an assumption misapprehends the nature of an unadministered deceased estate. Until the administration is complete, the estate is *not* a trust and the executor is *not* a trustee. No beneficiary of the estate has any interest in the underlying assets of the estate while the estate remains unadministered.<sup>9</sup> That means that one cannot simply treat an unadministered estate as just another trust and distribute to it under a class of eligible trusts in the trust deed. It has recently been confirmed in *Re Estate of Stagliano*<sup>10</sup> that this is not the correct approach and an unadministered estate would not fall within the usual type of “eligible trusts” beneficiary class that one sees in discretionary trust deeds.

**No power to exclude beneficiaries or to change beneficiaries**

It is common for trust deeds to give a trustee the power to exclude beneficiaries. Sometimes that requires the beneficiary’s consent. It is a useful power to have to deal with a troublesome beneficiary or to deal with a settlement of a family dispute, but subject still to potential challenges based on bad faith or fraud on a power by a trustee. In a trust deed, it is rare to see a specific power allowing wholesale changes to the beneficiary class. Broad powers of amendment can usually allow the beneficiary class to be changed.<sup>11</sup>

**Streaming, income and related matters****Income definitions**

The High Court’s decision in *FCT v Bamford*<sup>12</sup> confirmed the proportionate approach to the taxation of trust income. That means that a presently entitled beneficiary is required to include in their assessable income, under s 97(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), a share of the net income (the taxable income) of the trust. That share is determined by ascertaining the beneficiary’s percentage share of *trust* income (that is, income as determined under the trust deed) and applying that percentage share to the net income (taxable income) of the trust.

While the High Court’s decision in *Bamford* was handed down quite some time ago, the need to make amendments to old trust deeds to accommodate *Bamford* is still something that advisers need to be mindful of.

The most common problem with old trust deeds is that they may not contain a definition of “income” or “net income”. In that situation, the term refers to income according to ordinary concepts and accounting principles.<sup>13</sup> That excludes capital gains. That can result in beneficiaries who do not receive capital gains being taxed on them, or the trustee sometimes being taxed on them.

#### Example

Tas Tiger Trust makes \$30,000 of losses as its ordinary income is less than its expenses. It made a resolution to distribute all of its income to Mr Thylacine during the 30 June 2024 income year under the income distribution clause in the trust deed. There is no definition of “income” in the trust deed. It has a capital gain of \$60,000 which, if it had been included in distributable income, would have been distributed to Mr Thylacine and he could have been taxed on it. The capital gain is not ordinary income and so is not distributed effectively by the distribution resolution. The trustee is taxed on the capital gain.

Common methods of dealing with these types of issues in old deeds include:

- keeping income undefined but specifically including capital gains as income;
- making net income equivalent to taxable income under s 95 ITAA36, or a similar definition. Sometimes adjustments may be necessary in this regard to, for example, strip out notional assessable amounts which cannot be distributed. This sort of clause will not allow the non-assessable capital gains discount portion of a capital gain to be distributed under the income distribution clause (although, if the distribution resolution is drafted appropriately, it might still be possible to distribute that capital under another power in a trust deed allowing distribution of trust capital). That might create a problem for streaming capital gains as, for streaming purposes, a beneficiary needs to receive the financial benefit referable to the capital gain in order to be specifically entitled to it;
- giving the trustee the discretion to determine what is included in net income; and/or
- having a default mechanism as to what constitutes income if the trustee does not exercise such a discretion.

If there is an old deed, it may be necessary to consider updating the income definition using one of the methods set out below under the heading “Dealing with drafting issues after the deed is executed”.

### Default income or capital beneficiary clauses

Often trust deeds will contain a default distribution clause to deal with income where the trustee does not exercise their discretion as to how income is distributed. This is important because, if no beneficiary is presently entitled to the trust income, the trustee will be taxed at the penal

tax rate. Usually trust deeds will also give the trustee a discretion as to how capital is distributed on vesting of a trust. A default clause that operates on vesting is also advisable so that capital is effectively dealt with in the event that the trustee does not exercise their discretion prior to vesting.

Such default distribution clauses can be effective if they are drafted appropriately.

In *FCT v Carter*,<sup>14</sup> the trust deed contained the following default clause on vesting:

“As from the Vesting Day, the Trustee shall hold the Trust Fund:

4.1 in trust for such one or more of the *General Beneficiaries* for such interests and in such proportions and for one to the exclusion of the others as the Trustee may subject to clause 16 appoint by deed before the Vesting Day and the appointment may be either revocable or irrevocable (but if revocable shall be revocable only until the end of the day preceding the Vesting Day when it shall become irrevocable);

4.2 in default of appointment and subject to any partial appointment under the preceding paragraph, in trust for such of the *Primary Beneficiaries* as shall be living at the Vesting Day as tenants in common in equal shares BUT if any Primary Beneficiary dies before the Vesting Day leaving issue living at the Vesting Day, that issue shall take as tenants in common in equal shares per stirpes the share which the deceased Primary Beneficiary would have received had he or she survived to the Vesting Day ...”

The trust deed also contained the following effective default clause for income distributions:

“If in relation to any Accounting Period, the Trustee has made no *effective determination* pursuant to the preceding provisions of this clause in respect to any part of the income of that Accounting Period *immediately prior to the end of the last day of that Accounting Period*, then the Trustee shall hold that income in trust successively for the persons who are living or existing on the last day of that Accounting Period and who are successively described in clauses 4.1 to 4.5 (inclusive) as though that last day of the relevant Accounting Period were the Vesting Day.”

Present entitlement of a beneficiary to income for tax purposes must exist as at the end of the income year.<sup>15</sup> The key to drafting an effective default clause in respect of income distributions is to ensure that the present entitlement arises by the end of the income year and not after.

*BRK (Bris) v FCT*<sup>16</sup> provides an illustration of an ineffective default distribution clause. The clause referred to the trustee, on default of exercising their discretion to distribute income, being required to “divide the Fund equally among the beneficiaries named in the Schedule hereto” on a date after the income year had ended. The court found that there was no present entitlement for tax purposes as at the end of the income year due to the trustee not making the

distribution to default beneficiaries until after the income year had ended. The trustee was then taxed on the income. In other words, the default distribution clause was not effective because it did not result in a present entitlement arising for beneficiaries by the end of the income year.

#### Example

The Tas Tiger Trust has a default income distribution clause in it that provides that, in default of the trustee exercising their discretion to distribute income within a reasonable time after the end of the income year, the income is set aside for the primary beneficiaries in equal shares. The default clause is ineffective for tax purposes as it does not give the primary beneficiaries a present entitlement to the income by the end of the income year.

### Classification and streaming powers

Historically, the courts applied the conduit theory of trust income as per *Charles v FCT*.<sup>17</sup> That is, it was considered that the trust acted as a conduit through which different types of income could flow and retain their characteristics in the hands of the beneficiaries. That approach allowed streaming of different types of income and capital for tax purposes, provided that the trust deed had appropriate clauses in it.

The Full Federal Court in *FCT v Greenhatch*<sup>18</sup> found that the proportionate method endorsed by *Bamford's* case meant that a beneficiary received a proportionate share of trust income that had no single character (that is, it was an undissected sum). That meant that, when applying the proportionate approach under s 97 ITAA36, a beneficiary included in their assessable income a mixed amount of all different types of income and capital gains that had been included in the trust's net taxable income. That meant that streaming was not possible from a tax perspective.

Legislation has now ameliorated that outcome, but only to some extent. It is now possible to stream franked distributions and capital gains in accordance with legislation.<sup>19</sup> For capital gains, a beneficiary needs to be specifically entitled to the capital gain or part of it. That, broadly, involves them receiving, or they can be reasonably expected to receive, an amount equal to a share of the net financial benefit referable to the capital gain.<sup>20</sup> They must have that entitlement in accordance with the terms of the trust.

The legislative provisions for streaming franked distributions also rely on the concept of a beneficiary being specifically entitled to the franked distribution.<sup>21</sup> Once again, that concept relies on the share of the net financial benefit of the beneficiary, being the financial benefit in accordance with the trust that the beneficiary receives, or can reasonably be expected to receive, that is referable to the franked distribution.<sup>22</sup>

To be able to stream under these statutory provisions, the trustee needs to have an appropriate streaming power under the trust deed. While it may be possible to imply such a power in some circumstances when a trustee has a very

broad discretion to distribute and apply income and capital, it is preferable for the trust deed to contain an express streaming power. The most typical form is to have a power that allows the trustee to classify different types of income and capital based on tax and other attributes, and then to allocate those different classes among beneficiaries and make them entitled to those separate amounts.

Although streaming is only possible for tax purposes for franked distributions and capital gains, it is desirable to have a broader clause that allows broader classification and streaming of other amounts in case there is further legislative change in the future. Older trust deeds may not have such express clauses, which then requires a drafter to look at options for amending the trust deed (see below under the heading "Dealing with drafting issues after the deed is executed").

### Administrative power issues

Trustees cannot simply assume that they have power to do something under a trust deed. Their ability to do an act is confined by the scope of the powers and discretions granted under the trust deed, as well as any statutory powers which supplement the trust deed (for example, there are statutory powers granted to trustees under the *Trustee Act 1958* (Vic)).

Drafters need to be careful to ensure that sufficiently wide powers are given to the trustees under the trust deed so that they can carry out their role effectively. This does not necessarily mean that every single possible thing that a trustee might ever do needs to be named as a power in the trust deed. Sometimes one sees trust deeds which contain an inordinately long and detailed list of powers, where broader powers might accomplish the same end.

One common area where the scope of administrative powers often arises is when a trustee wishes to borrow money from a bank or financier, or wishes to give a guarantee. Before lending funds, a financier will usually conduct a review of the trust deed to ensure that acceptable powers are included in it. Sometimes it will be necessary to amend a trust deed to accommodate a financier's requirements, so it is important to have an appropriate power of amendment to allow that to happen (see below under the heading "Powers of amendment") otherwise an expensive court application may be necessary (see below under the heading "Dealing with drafting issues after the deed is executed").

### Powers of amendment

Powers of amendment can provide a useful mechanism to allow a trust deed to be changed in response to changing circumstances, or even changes in trust or tax law. That does not, however, mean that all trust deeds contain a power of amendment, or that they should contain one. Some older trust deeds do not. Generally, it would be preferable to include some form of power of amendment for flexibility. Clients will not always want this though. I have seen examples of clients who want to "rule beyond the grave" and do not wish to give their descendants power to change the deed – they want to protect their intent in the trust terms as much as possible.

## Careful use of language

When drafting powers of amendment, it is important to be very precise as to the language being used and to understand the effect of particular language. Two examples illustrate this point.

### “Hereinbefore”

Often one will see powers of amendment that refer to being able to amend provisions “hereinbefore” contained. The use of that word can have very real effects if a drafter is not careful. For a power of amendment contained at the very end of a trust deed, all other provisions would be contained before it. Sometimes, though, there might be a schedule after the power of amendment, or the power of amendment might have other clauses after it. In such a case, a court would generally give effect to the word “hereinbefore” and effectively place a limitation on the scope of the power of amendment. That could have very real consequences if one needs to, for example, amend a schedule.

“Practitioners need to be careful with old trust deeds to ensure that they do not make assumptions when organising year-end distributions.”

*Mercanti v Mercanti*<sup>23</sup> is an illustration of the problems that such wording can potentially cause. In that case, the power of amendment used the word “hereinbefore”. The definitions of appointor/guardian were contained in a clause at the start of the trust deed, but the named appointor/guardian was set out in the schedule to the trust deed. The schedule was after the power of amendment, so there was an issue as to whether the identity of the appointor/guardian could be changed using the power of amendment (that is, because the schedule was not “hereinbefore” contained). The power of amendment could be used to change the identity of the appointor/guardian, but only because the definitions of those offices were “hereinbefore” the power of amendment and those definitions were linked to the schedule. That may not always be the case and situations might arise when something in the schedule is independent of a definition in the main trust deed and needs amending. Inclusion of the word “hereinbefore” in a power of amendment could cause problems in that sort of situation.

### “Trusts” versus “provisions”, “powers” or “terms and conditions”

*Mercanti*’s case also provides a second illustration of problems that can arise from the use of language in a power of amendment. Some older trust deeds contain powers of amendment that refer to being only able to amend the “trusts” in the deed. One of the trust deeds in *Mercanti*’s case had such a provision. The court essentially adopted a technical meaning of “trusts”, such that it did not cover all of the terms of the trust deed, only the core trust provisions, which included the actual declaration of trust,

the power to deal with profits of the trust, the provision operating on vesting of the trust, and certain trustee’s powers. The power of amendment could not be used to alter the identity of the appointor/guardian because it was not part of the “trusts”.

Contrast that result with broader wording in a power of amendment such as one that allows alteration of any “provisions and powers” or “terms and conditions”, which would ostensibly cover most, if not all, clauses of a trust deed.

Drafters need to be careful of these differences in language in a power of amendment. A broader power, though, will not always be appropriate – there may be situations in which particular clients want a more narrow power of amendment that may not allow, for example, changes to the identity of officeholders other than through the specific provisions of the deed that allow such changes.

## Administrative powers only

Sometimes trust deeds contain restrictions on a power of amendment which only allow them to be used to change administrative powers in the deed. Drafters need to be careful of wording which, for example, refers to only exercising the power in the “administration” of the trust if such a restriction is not intended.

## Restrictions on particular powers versus power of amendment itself

There are other restrictions that are common on a power of amendment, such as not being able to amend to benefit a settlor, or not being able to amend to take away benefits that have already accrued to beneficiaries.

An important consideration for drafters to consider is whether the power of amendment can be used to amend itself. There are cases in which courts have implied a restriction on a power of amendment, such that it cannot be used to amend itself.<sup>24</sup> That will not always be the case. In *Re McGowan & Valentini Trusts*,<sup>25</sup> the court accepted that a widely drafted power of amendment could be used to amend itself. Accordingly, if a drafter wishes to prevent the power of amendment being used to amend itself, it is better to include an *express* prohibition in the power. There are reasons why that sort of control is appropriate – without it, the power of amendment could be used to negate other restrictions in the power (subject to any argument that exercising the power in that manner would be a fraud on a power, that is, would be exercising the power for an improper purpose or in bad faith).

Another strategy to restrict the use of a power of amendment is to make it a reserved power that can only be exercised with appointor or guardian consent. That strategy is discussed above under the heading “Appointor and guardian-related issues”.

Finally, sometimes it may be appropriate to place restrictions on the power of amendment to prevent it from being used to amend specified powers within the deed (for example, guardian powers).

## Self-managed superannuation funds: death benefits

This section of the article considers a common dispute that arises with self-managed superannuation funds (SMSFs) – the distribution of death benefits. With the rise of SMSFs and the gradual inter-generational wealth transfer from baby boomers, this sort of issue is likely to continue to give rise to many disputes in the future.

Usually, SMSF trust deeds will give the trustee a discretion to distribute death benefits to dependants of the deceased or to the deceased's estate (in line with regulatory requirements in the superannuation law). Often, there will also be provision for a member of the fund to make a binding death benefit nomination (BDBN) that will bind the trustee as to how they distribute the death benefits.

There are various requirements that must be met to cash funds out of a superannuation fund under the *Superannuation Industry (Supervision) Act 1993* (Cth) and under the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).

Regulation 6.17A SISR, among other things, requires a trustee to pay a death benefit in respect of a fund member to a person mentioned in a binding death benefit notice. There are, however, conditions for that rule to apply. Those include:

- the person(s) mentioned in the notice have to be the legal personal representative or a dependant of the fund member;
- the proportion of the benefit that will be paid to the person(s) has to be certain or readily ascertainable from the notice;
- the notice has to be in writing;
- the notice has to be signed and dated by the fund member in the presence of two witnesses;
- the two witnesses have to be 18 and not a person mentioned in the notice; and
- there must be a declaration signed and dated by the witnesses stating that the notice was signed by the fund member in their presence.

The High Court in *Hill v Zuda*<sup>26</sup> confirmed that members of SMSFs do not, as a general proposition, need to abide by these requirements to have a valid BDBN. That is not to say, however, that members will *never* need to meet these requirements. Although it is not compulsory, as a general proposition, for members to comply with these requirements, that is still subject to the trust deed.

A particular trust deed might import these requirements for a death benefit nomination to be binding, and, in that event, a member would need to comply. If there were no compliance in that situation, a member risks the BDBN being invalid and being challenged by a potential beneficiary of the trustee's discretion.

That makes it important when drafting the trust deed to be clear as to whether these requirements need to be met for a valid BDBN. Prior to *Hill v Zuda*, there was uncertainty

for quite some time as to whether these requirements in reg 6.17A applied to SMSFs. Some older deeds from that era may contain some ambiguity as to whether the reg 6.17A requirements apply in all circumstances, or only if reg 6.17A actually was a mandatory rule that applied to SMSFs. Such ambiguity can create future problems if there are challenges to the validity of BDBNs.

Although the requirements in reg 6.17A do not have to be applied, advisers should also be considering with their clients whether it is *desirable* anyway to mandate in the trust deed compliance with any of those requirements for a BDBN to be binding. On the one hand, it can be easy to make mistakes resulting in non-compliance with such technical requirements that can create disputes about validity. On the other hand, the greater danger may be the potential risks that removing such guardrails creates. Often when BDBNs are made, a fund member may be suffering from cognitive decline or a degenerative disease, or be in an end of life situation. That creates a risk that an unscrupulous family member may attempt to influence the fund member into making a BDBN in their favour.

While it may be possible to challenge a BDBN based on undue influence or unconscionability or similar grounds, that is very difficult from an evidentiary perspective. If there are no witnesses to what has occurred, a family member who wished to challenge a BDBN might be left with attempting to draw inferences from a course of conduct or surrounding circumstances and medical evidence about the fund member's health at the time of signing the BDBN. Even medical evidence is not always easy to obtain if the family member who wishes to challenge the BDBN is not the executor of the deceased's will.

The requirements in reg 6.17A provide an additional safeguard. If they are mandatory under the trust deed, they must be complied with for the BDBN to be valid and binding. The requirement for two witnesses to sign, as well as to sign a declaration that they have seen the fund member signing, can, for example, provide a safeguard against a family member exerting pressure on a fund member to sign a BDBN while they are in ill health.

### Example

Mr Thylacine is on his death bed in Chauncey Vale Caves in rural Tasmania. His tiger stripes have faded to grey, and his brown fur is mottled and falling out. His end is fast approaching. He is a member of the Tiger SMSF and has \$2 million in his account. The trust deed of that fund allows BDBNs to be made in respect of death benefits, but it has requirements that must be met for a valid BDBN and those requirements mirror reg 6.17A. Mr Thylacine's nephew, Terrible Timmy, slips into his cave as Mr Thylacine lies in a foggy stupor. Terrible Timmy has drafted a BDBN which names him as the sole beneficiary of Mr Thylacine's superannuation benefits. He aggressively pressures Mr Thylacine to sign the BDBN and Mr Thylacine, in pain and doped up with possum juice, complies. Terrible Timmy has, however,

**Example (cont)**

forgotten about the requirement to have two witnesses sign and the BDBN lacks a witness declaration. The BDBN does not comply with the requirements under the trust deed and is invalid.

**Charitable trusts**

A detailed consideration of drafting issues with charitable trusts is beyond the scope of this article. Charitable gifts/trusts are common in wills. The danger is if those gifts/trusts fail. That can happen immediately when the gift/trust is supposed to take effect on the death of the testator, or at some future point in time after the death of the testator and after the gift/trust has taken effect. This part of the article will briefly consider drafting issues that can result in initial impossibility of a gift.

**Initial impossibility of gifts**

The drafting of a will can result in a charitable gift/trust being impossible to implement on the death of the testator. One common scenario where this can happen is if a gift is left to a particular charitable institution but that institution does not exist, or no longer exists, or there is ambiguity as to which institution is being referred to.

**Example**

Mr Thylacine leaves money in his will to the Aged and Invalid Tasmanian Tiger Fund of Queensland of 55 Striped Tail Road. Consider the following scenarios which may result in a gift that is impossible to fulfil:

- there is no such fund and no fund by that name has ever existed;
- there was previously such a fund at the time the will was drafted but it was wound up prior to Mr Thylacine's death;
- there is only an Aged and Invalid Tasmanian Tiger Fund of Tasmania; and
- there is an Aged and Invalid Tasmanian Tiger Fund of Queensland, but it has never had the address of 55 Striped Tail Road. There is also an Aged and Invalid Tasmanian Tiger Fund of Victoria which does have an address of 55 Striped Tail Road.

Another common scenario is where there are conditions placed on a gift, but it may be impossible or impractical to fulfil those conditions.

**Example**

Mr Thylacine drafts his own will. He leaves a gift of \$200,000 to the Tasmanian Devil Facial Tumour Foundation, but only if they also establish a library for books about Tasmanian Tigers and about the Western Tasmanian wilderness. The gift is too small to establish and maintain a library. The condition cannot be met and the gift fails.

Drafters need to keep these sorts of problems in mind, and consider:

- checking that the correct name and address of the charitable organisation is used;
- checking whether the organisation exists and advising clients of the need to update the will in case charities cease or merge;
- the possibility of a partial intestacy if a gift is ineffective;
- whether the testator still wants the gift to go to charity if the gift to the particular organisation fails for any reason; and
- how practically the charitable gift might work. For example:
  - whether the gift is large enough to achieve the objective;
  - whether there are sufficient details to enable the gift to work practically. For example, if a physical place was to be established to carry out a charitable gift, there may need to be details as to how that is to practically operate; and
  - whether there are conditions which it is practically difficult to comply with or impossible to comply with. I have, for example, seen scenarios in which a testator has wanted a family member to work for a charitable donee for a period as a condition of a gift, or the gift is cumbersome because it would require the executor to monitor its terms over a long period of time.

**Gift over clauses and successor institutions**

It is prudent to consider whether a gift over clause is appropriate in a will to specify an alternative destination for a charitable gift if it fails. That allows the gift to still take effect in an alternative manner, assuming that the gift over clause itself is not impossible to perform.

In some scenarios, a charitable institution may have been named in a will and may no longer exist, but there may be a successor institution. In that scenario, a gift can potentially take effect if the new institution is truly a successor to the old one. A change in legal structure from, for example, an incorporated association to a company limited by guarantee will not necessarily prevent the new organisation from being a successor. An analysis of the similarity of the charitable objects of the organisations, the activities of both, and what happened to the assets/liabilities after the change is necessary. For example, *Re Estate of Henry Brough Smith; Perpetual Trustee Co Ltd v Uniting (Victoria and Tasmania) Ltd*<sup>27</sup> involved a gift to the Burwood Boys' Home, an organisation which previously existed but no longer existed at the time of the deceased's death. The court considered whether an incorporated entity, Child & Family Care Network Inc, was the successor institution to the Burwood Boys' Home. The court found that there was significant practical identity between their charitable activities and that Child & Family Care Network Inc was the successor institution.

## Cy près and general charitable intent

If a charitable gift is initially impossible to perform on the death of a testator and there is no gift over clause, there is a question as to whether the gift can be applied cy près. Cy près is a doctrine that allows, usually with court approval,<sup>28</sup> a gift to be applied for purposes as near as possible as the original purposes. Where a gift is impossible to perform from the outset (that is, on the death of the testator), the cy près doctrine can only be relied on if there is a general charitable intent expressed by the testator in the will. In other words, the issue is whether the testator intended the gift *just* for that specific donee organisation for particular purposes, or whether there was a general intent to benefit charity.

Courts will usually be quite ready to find a general charitable intent so that a failed gift can be applied cy près. *Re Coghlan; Merriman v Attorney-General (No. 2)*<sup>29</sup> is one example of this lenient approach to interpretation. In that case, there was a gift of one-third of the estate's residue to "Diabetes Australia of 26 Arundal Street, Glebe, New South Wales". The problem was that there was a Diabetes Australia, a Diabetes NSW, and a Diabetes Australia – Victoria. The address used in the will was not that of Diabetes Australia, it was the address of Diabetes NSW. It was impossible to tell which organisation the gift was intended for.

The will did not refer to any charitable purpose, nor did it refer to there being a "general charitable intent". The court found that the absence of a reference to any charitable purpose, or the absence of express terms of a general charitable intent, was not necessary in every case and that did not preclude a finding that there was a general charitable intent. The reference to the name of one charitable organisation in the gift clause, and the address of a separate charitable organisation as well, suggested that the deceased intended the gift to benefit *an* organisation which supported people with diabetes. There was a general charitable intent.

## Dealing with drafting issues after the deed is executed

If a trust deed has already been executed and a drafting error or problem has emerged, there are limited mechanisms that can be used to deal with the issue. This section of the article examines some potential avenues for fixing a problem:

- use of a power of amendment in the trust deed;
- use of the rule in *Saunders v Vautier*;<sup>30</sup>
- rectification of the trust deed; and
- a court application seeking judicial advice on the correct interpretation of the trust deed, or seeking the court's approval to vary the trust deed.

### Powers of amendment

The simplest way in which to amend a trust is by exercise of a power of amendment in the trust deed. Not all trust deeds

contain a power of amendment though. Further, one needs to be careful to *read* any power of amendment carefully to ensure that it is actually broad enough to permit the required drafting change. Some powers of amendment may specifically prohibit certain types of changes to the deed. For example, a deed might prohibit changes to the class of beneficiaries, or to the vesting date, or to other specific clauses of the deed.

Other powers of amendment, while not specifically prohibiting alterations to particular clauses, might either limit the types of changes that can be made, or place general limitations on the changes that can be made. For example, some deeds limit the changes that can be made to those in the management or administration of trust property (which would not cover every clause of the deed), and some deeds limit the changes that can be made to the "trusts" in the deed.

### Rule in *Saunders v Vautier*

The rule in *Saunders v Vautier* allows beneficiaries of full capacity with an absolute, vested and indefeasible interest in the trust capital/income to call for that fund.<sup>31</sup> The court has accepted that the rule in *Saunders v Vautier* can extend to amendments of a trust deed by beneficiaries of full capacity who have an infeasible entitlement to the trust fund.<sup>32</sup> Accordingly, it is highly likely that the rule in *Saunders v Vautier* can be used to extend the vesting date of a trust *if* all beneficiaries are of full capacity. This will not, ordinarily, be of much use with a discretionary trust as there would usually be minor beneficiaries, or potential future beneficiaries (for example, unborn descendants), in which case, the rule could not operate. One strategy that is sometimes used to prevent beneficiaries utilising the rule in *Saunders v Vautier* is to include a charitable purpose in the trust deed (for example, as a default beneficiary on vesting of the trust, or even as part of the general class of beneficiaries).

### Rectification

Rectification is an equitable remedy available to fix documents if there has been a mistake that has caused the document not to operate as intended by the parties. A trust deed may need to contain particular provisions to comply with the provisions of a duty concession or exemption. There might be situations in which the drafter makes an error in the trust deed such that the requirements of a duty exemption could not be met. Rectification of the trust deed is a possible solution to such a problem. An application could generally be made to a superior court to seek orders for rectification of a trust deed.

Rectification is available to reform documents, but not to reform the bargain or arrangement between the parties.<sup>33</sup> The following principles apply in respect of rectification of trust deeds:<sup>34</sup>

- rectification is available where there is a mistaken expression of the true intention of the maker or makers of a document. In the case of a trust deed, the mistake must be on the part of the settlor;

- rectification is generally not available where the mistake is only as to the legal effect of the document. However, it is no bar to rectification that the rectification is sought to avoid stamp duty or that a fiscal benefit will result from the order;
- it is no bar to an order for rectification that the parties have previously entered into a deed of rectification in an attempt to record the true state of affairs;
- it is no bar to rectification that the mistake was due to negligence; and
- what is required is convincing proof justifying the making of an order permitting the correction of a mistake in the relevant document; and
- an order for rectification takes effect retrospectively so that the document is rectified with effect from the date of its making.<sup>35</sup>

In a trust deed rectification case, the relevant subjective intent may not always be that of the settlor. Where the settlor is acting on instructions and has no independent intention in respect of the trust, it may be the intention of the person who provides the instructions to the settlor to set up the trust that may be relevant.<sup>36</sup> A court application for rectification of a trust deed that may have an impact on a tax or duty provision may have a revenue authority joined as an appropriate contradictor,<sup>37</sup> although there may be cases in which that may not be necessary.<sup>38</sup>

*Holloway v Commissioner of State Revenue*<sup>39</sup> illustrates how rectification of a trust deed can be a vital tool to ensure that duty or other tax concessions or exemptions can be properly applied. In *Holloway*, a Tasmanian solicitor had been instructed to draft and be the settlor of a family discretionary trust. The purpose of the trust was to purchase farming land from the executor of the estate of a relative of two individuals and, in doing so, to qualify for the family farming duty exemption in s 225 of the *Duties Act 2001* (Tas). That exemption applied, among other things, if there was a transfer of property used solely or principally in connection with the business of primary production. Where the transfer was from a natural person to a trustee of a trust, that trust's beneficiaries had to all be individually named and be relatives of the transferor, and the trust could not be varied other than by the addition of a relative individually named in any deed of variation.

The solicitor had received instructions that: the two individuals intended to rely on the exemption for the purchase of the farming land; the solicitor was to create a trust that would qualify for the exemption; and it was the intention of the two individuals that they would be the only beneficiaries of the trust. The solicitor did not update a template discretionary trust deed of her firm to comply with the clients' instructions. After the Commissioner assessed duty on the transfer, a deed of rectification was prepared and executed by the settlor and the clients. The Commissioner took the view that the deed was not binding on him. The deed of rectification was still defective, though, because it did not limit the beneficiaries such as to comply with the exemption.

The individuals brought an application to rectify the trust deed so that it complied with the requirements of the exemption, and also to seek a declaration that the deed of rectification was of no legal effect because it did not record their true intention. The court granted the application for rectification of the trust deed. The court was somewhat hesitant to declare the deed of rectification as being of no effect but, nonetheless, did so. The court also commented that, if it were wrong to make such orders, rectification orders could still be made to rectify the trust deed to exclude or reverse the attempt at rectification made by way of the deed of rectification.

#### Example

Harry Hobart is a bumbling Bicheno barrister. Mr Thylacine approaches him to draft a discretionary trust deed for his family (Mr Thylacine is to be the settlor, but not a beneficiary, of the trust). Mr Thylacine gives him specific written instructions to name Mr Thylacine's wife, Thelma Thylacine, as the appointor in the trust deed and to include a power for the trustee to amend the trust deed. Harry Hobart names Thelma as appointor and includes the power in his draft trust deed. Being his usual bumbling self, he accidentally deletes those clauses from the final version of the deed without realising his mistake. The trust deed is executed and real property of significant value is settled on the trust. Mr Thylacine is furious when he realises the mistake and is advised to seek rectification of the deed in a court application to reflect his intention as settlor.

### Court applications: judicial advice on deed interpretation

In each Australian jurisdiction, a court can give judicial advice on matters relating to a trust to, among others, the trustee. In Victoria, the Supreme Court can give judicial advice pursuant to r 54.02 of the *Supreme Court (General Civil Procedure) Rules 2025*. If there is an error in drafting, an amendment may not always be critical. If the trust deed could be construed in a manner which gets around the drafting issue, that could be sufficient to avoid having to amend the deed. The court can give judicial advice on such trust deed construction issues. For example, an ambiguous phrase may have been used in the trust deed and it might be possible to construe that phrase in a favourable way in the context of the whole deed.

### Court applications: approval for trust deed variation

In Victoria, it is possible to have the court approve a variation to a trust deed under s 63A of the *Trustee Act 1958* (Vic) on behalf of those who cannot approve a variation themselves. It is the agreement between the beneficiaries, combined with the court's approval, that effects the variation.<sup>40</sup> That is, the court's order does not, of itself, vary the trust deed. That means the consent of all adult beneficiaries with capacity is required to give effect to the variation.

The power in s 63A cannot be applied if the variation results in a resettlement of the trust. A consideration of trust resettlement is beyond the scope of this article.

### Classes of beneficiaries on whose behalf approval can be sought

In Victoria, s 63A(1) prescribes the following classes of beneficiaries on whose behalf the court can approve a trust variation:

- “(a) any person having, directly or indirectly, an interest, whether vested or contingent, under the trusts who by reason of minority or other incapacity is incapable of assenting; or
- (b) any person (whether ascertained or not) who may become entitled, directly or indirectly, to an interest under the trusts as being at a future date or on the happening of a future event a person of any specified description or a member of any specified class of persons, so however that this paragraph shall not include any person who would be of that description, or a member of that class (as the case may be) if the said date had fallen or the said event had happened at the date of the application to the Court; or
- (c) any person unborn; or
- (d) any person in respect of any discretionary interest of his under protective trusts where the interest of the principal beneficiary has not failed or determined ...”

The courts have approved many applications involving minor beneficiaries or others without the capacity to consent, and unborn beneficiaries. There has, however, been little judicial consideration of the second category of persons on whose behalf the court can approve an arrangement (category (b) above).

In *In the Application of Nyasa No. 19 Pty Ltd*,<sup>41</sup> the court accepted that a class of discretionary objects of a discretionary trust could come within the New South Wales equivalent of category (b) above. The case involved a lost trust deed. Neither the original deed, nor a copy of it, could be found. There were deeds of other trusts that were settled at the same time that were available. The court accepted that it could approve an arrangement that the trust be administered in accordance with the amended terms of a trust deed.

The decision in *Nyasa* could potentially be significant in other cases in which there are wide classes of discretionary objects, and where it may be difficult to identify all of the beneficiaries such as to obtain their consents. In that scenario, there may be a possible argument that the court could consent on the beneficiaries' behalf, although the bounds of the court's consent in respect of this category is yet to be fully tested. It may also be the case that there are some possible members of a discretionary class whose interests are so remote as to be negligible such that consent was not required,<sup>42</sup> although that proposition does not appear to have been tested in Australia.

### The test to be applied

The statute in each jurisdiction should be considered on its own terms to determine the relevant matters that the court has to consider in approving a variation. In Tasmania, for example, the statute sets out specific matters that must be considered by the court. In Victoria, there is a two-stage test that the court applies when deciding whether to approve an arrangement:<sup>43</sup>

1. whether the arrangement would be for the benefit of the beneficiaries who are unable to consent. This is not restricted to financial benefit and can include other non-financial benefits, such as social, familial, moral or educational benefits; and
2. whether the arrangement is by its nature a fair and proper one overall, taking into account the particular advantages which the various parties will gain from the arrangement and their respective bargaining strength. Relevant to this consideration is whether the arrangement is consistent with the purpose of the trust and the intention in establishing it.

There has been a possible additional question raised in *George v Kollias*<sup>44</sup> and in *Re Alan Synman Family Trust*,<sup>45</sup> based on *Re Cohen's Will Trusts*.<sup>46</sup> The question has been said to arise where there is a risk from the arrangement from the point of view of a beneficiary lacking capacity, or an unborn or minor beneficiary. The additional question is whether the proposed arrangement involves a risk that an adult, well-advised, would be prepared to take.

In *Re The Pickering Family Trusts*,<sup>47</sup> the court has recently expressed reservations about the appropriateness of this question regarding whether an adult would be willing to take a particular risk. The court, at para 21, criticises the question as being of limited application beyond its particular circumstances, in part, because of the difficulty of identifying, with any certainty, the relevant circumstances or characteristics of an underage child or an unborn child which would inform an answer to be given to this question on their behalf.

**Example 1. Situations court has allowed – extending vesting dates.** In *Re Plator Nominees Pty Ltd*,<sup>48</sup> the trustee of a family trust successfully applied under s 63A of the *Trustee Act 1958 (Vic)* to extend the vesting date of the trust to a date not later than 21 years after the death of the last living relative of a particular family member. The court approved the extension of the vesting date for the following reasons:

- the trust was established as a property investment vehicle for two parents who intended the trust to continue after their deaths for the benefit of the children under their control. The vesting of the trust would not give effect to that intention, but extending the vesting date would;
- all the sui juris beneficiaries wanted the trust to continue;
- there was no specific reason why the original trust deed specified a particular vesting date and why the powers of variation in that deed specifically excluded the ability to

vary the trust to extend the vesting date. If there was any specific reason, it had no relevance; and

- there would be significant CGT liabilities incurred on post-CGT assets of the trust on vesting (by their disposal or in specie distribution to beneficiaries). For the assets of the trust that were pre-CGT assets, the benefit of the pre-CGT status would be lost if the trust vested and they were distributed to beneficiaries.

An extension of the vesting date of a discretionary trust was also approved for similar reasons in *Application by Perenna Nominees Pty Ltd*.<sup>49</sup>

**Example 2. Situations court has allowed – expanding classes of beneficiaries.** In *Thomas Hare Investments Ltd v Hare*,<sup>50</sup> an amendment to a trust deed which added trusts to the class of beneficial objects was approved by the court under s 63A of the *Trustee Act 1958* (Vic). It was approved on the basis that it would allow greater flexibility in distributing the benefit and tax burden of the trust's income because, before the amendment, the income had to be distributed to the individuals only.

In *Re EM McPherson Settlement*,<sup>51</sup> the court approved the expansion of a class of beneficiaries from individuals only to also include companies and trusts in which other beneficiaries had an interest (although there were restrictions placed on the companies to limit them to private companies only).

**Example 3. Situations court has allowed – inclusion of a streaming power and income definition.** In NSW, the court in *Re Dion Investments Pty Ltd*<sup>52</sup> approved an amendment to include a streaming clause in a trust deed under its trust legislation.<sup>53</sup>

Similarly, in *Re EM McPherson Settlement*,<sup>54</sup> the court approved inclusion of both a streaming clause and a new definition of “income” in a trust deed.

### Practical aspects of making a court application

This section of the article will deal with some of the practical matters when making an application to court for approval of a trust variation. The focus is on Victoria.

**Commencing an application.** In Victoria, an application is commenced by an originating motion which should include a brief summary of the relief sought. This would usually be a brief summary of the changes to the trust deed for which approval is sought. The originating motion is accompanied by affidavit evidence which should generally include:

- background of the trust and family and any reasons personal to the family as to why the amendments are sought;
- drafts of the proposed amendments (this could, for example, be in the form of a draft deed of amendment);
- beneficiary consents to the proposed variation (see below);
- trust deed, and any existing variations, to the trust, including changes in trustees and appointors;

- financial information regarding the trust; and
- any advice received on the benefits of the proposed amendments (including tax and other financial benefits), and the tax consequences of the amendments.

In some jurisdictions, for example, in NSW and Victoria, notice of an application must be given to any persons as the court directs.<sup>55</sup>

Ordinarily, the appropriate person to commence this type of application would be the trustee. Typically, though, the potential applicants are not so limited. You should check the legislation in your home jurisdiction. In Victoria, for example, the persons who can put forward an arrangement to the court are extremely broad: “by whomsoever proposed and whether or not there is any other person beneficially interested who is capable of assenting thereto.”<sup>56</sup>

**Beneficiary consents and joinder.** As explained above, unless the relevant statute provides that the court by order can actually vary the trust, the court's order will not effect a variation. It is the court's order, together with the consent of the adult beneficiaries with full capacity, that effects the variation.

There is a question as to whether the consent of all beneficiaries is needed prior to commencing an application. Where there is a specific statutory provision requiring consent, that may be the case. In Tasmania, for example, a proposed arrangement cannot be submitted to the court for approval until an applicant has the consent in writing of any person who is beneficially interested under the trusts and who is capable of consenting to the arrangement.<sup>57</sup>

In other jurisdictions, such as Victoria, there is no specific requirement that consent be obtained by *all* adult beneficiaries prior to bringing an application. The Victorian Court of Appeal has indicated that an absence of consent by a particular beneficiary will not be a barrier to the court giving its approval on behalf of those who cannot consent.<sup>58</sup> The consent would, however, need to be obtained at some stage for the arrangement to be effective. It would be prudent to obtain consent from all adult beneficiaries with capacity prior to commencing an application.

The next question is the appropriate form of that consent. Adult beneficiaries should be given an opportunity to seek legal advice on the proposed amendments. They should be given full information about them, including a draft originating motion, a draft of the proposed amendments, a copy of any advice obtained regarding the merits of the amendments, and possibly draft affidavit material as well if that is available.

There is no prescribed form of consent. A formal consent which can be executed by each beneficiary should be drafted and included in the affidavit evidence. That consent should be fairly detailed in terms of describing the amendments and the material that has been made available to the beneficiary, it should state that each beneficiary has had the opportunity to seek independent legal advice, and it should make it clear that they consent and do not wish to be joined to the proceeding. Joinder of beneficiaries is not

preferable given the additional time and expense that can be added to the proceeding.

**Form of relief.** The form of relief will depend on your particular statute (that is, whether a court order actually varies the trust, or the court is merely giving approval). In Victoria, the relief should be framed in terms of the court giving approval for the variation arrangement on behalf of the particular categories of beneficiaries who are unable to consent.

In states like Victoria where the court's order does not vary the trust, the next issue is, if the court gives approval, what further thing needs to be done to give effect to the arrangement. Technically, it is the court's order, together with the consent of the adult beneficiaries, that effects the variation. Ordinarily, it would be prudent for a deed of amendment to be executed by the trustee to document the arrangement. The written consents of the beneficiaries and the court's order should be enough to give effect to the arrangement. Prudent practitioners may also wish to have all of the adult beneficiaries with capacity execute the deed of amendment.

Practitioners should also be mindful of the potential operation of the Australian versions of the statute of frauds in each case. For example, in Victoria, s 53(1)(c) of the *Property Law Act 1958* (Vic) requires a disposition of an equitable interest or trust subsisting at the time of the disposition to be in writing, signed by the person disposing of the same, or their agent lawfully authorised in writing or by will. Those requirements may be relevant to the manner in which an arrangement to vary a trust is effected if, for example, the amendment caused the disposition of an equitable interest under the trust. The requirements do not, however, affect the creation or operation of a resulting, implied or constructive trust.

**A contradictor.** The legislation in some states, such as South Australia and Tasmania, specifically requires the interests of all actual and potential beneficiaries to be represented.<sup>59</sup> In jurisdictions in which there is no specific requirement, as a matter of good practice, an applicant should also seek the appointment of a contradictor to represent those beneficiaries who are unable to consent (it may not *always* be necessary for this to be done – see further discussion below regarding *Cisera v Cisera*<sup>60</sup>). That could be a member of counsel only or, in particularly complex cases, it may require counsel and an instructing solicitor. An applicant can put forward names of potential contradictors to the court for consideration, but a court may also appoint its own preferred contradictor and may order that their costs be paid out of the assets of the trust.

**Revenue authorities.** There is no requirement that the federal or state/territory Commissioners of Taxation be joined to this sort of proceeding. My experience is that they would, generally, not be interested in joinder because these sorts of matters are private and do not directly involve the application of a revenue statute. It is good practice, however, to notify the revenue authorities of the proceeding and ask them whether they wish to be joined and then to file evidence of the same. This is because there is the

*potential* for amendments to a trust deed to have revenue consequences.

In my experience, the revenue authorities are likely to be more interested in an application where an applicant is seeking declarations about particular matters regarding a trust. There is a complex issue as to when revenue authorities are bound by decisions of state/territory courts regarding trust and other legal matters. A consideration of that issue is beyond the scope of this article.

Differing views have been expressed by the courts as to the need for revenue authorities to be invited to be joined if they so choose. Compare *Cisera v Cisera* (see below),<sup>61</sup> with the following comments of the court in *Application of Walker Corporation Pty Ltd*<sup>62</sup> in the context of an application to rectify a trust deed's vesting clause which would have resulted in an extended vesting date:

"126. In cases such as the present, the amendments are often sought for taxation purposes. In some of the cases, the taxation authorities have been joined as parties, or at least notified and invited to appear. In *Carlenka*,<sup>63</sup> the Commissioner for Stamp Duties was joined as a defendant at first instance to resist the claim and then appealed (unsuccessfully) against the rectification order that was made.

127. In the present case, no enquiry was made of the taxation authorities to see whether they wished to be heard. Mr Bannan suggested in his written submissions that the hearing should not proceed until this enquiry had at least been made.

128. Counsel for the Trustee pointed out that, upon vesting, the Trust will be converted from a discretionary trust to a fixed trust. This will not itself have any capital gains tax consequences. That may be so, but, once the assets are vested in individuals, the likelihood of their sale or transfer will increase. The longer the Trust continues, the longer that vesting will be deferred, and the longer the Trustee may be able to distribute its income among the beneficiaries so as to minimise the tax burden on that income.

129. The problem is, however, that the future tax consequences of extending the Trust's vesting date are unknown and unquantifiable. Counsel submitted that the tax authorities' interest in the current issue is so remote and speculative that it would have been pointless to invite them to join the proceedings, and I agreed."

**Costs.** Ordinarily, a trustee would have general law and statutory rights of indemnity for their costs of the application out of the trust funds.<sup>64</sup> A prudent trustee might seek a specific indemnification order from the court.

## Conclusion

Practitioners need to be wary of using cookie-cutter trust deeds without giving appropriate attention to the needs of the particular family and the drafting changes that may be required to address those needs. Purchasing cheap off-the-shelf trust deeds may cost significant money in the

long-term when family disputes or disputes with revenue authorities arise, particularly if there are ambiguities or errors in drafting. Errors or ambiguities in trust deeds need not be fatal if practitioners deploy appropriate remedial tools, including powers of amendment, rectification, or court-approved variations to the trust deed. As the great Thaddeus P Thylacine would say: “My dear Verity, one simply cannot fathom the depths of such an egregious oversight – surely even the most incompetent solicitor ought to grasp the gravity of a missing appointor!”

**Dr Philip Bender, ATI**  
Barrister  
Victorian Bar

This article is an edited version of “Taxation of trusts – common issues in preparing trust deeds and how to deal with them” presented at The Tax Institute’s VIC Tax Forum in Melbourne on 20 to 21 March 2025.

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- 19 Div 6E ITAA36 and Subdiv 207-B and Subdiv 115-C of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).
- 20 S 115-228 ITAA97. The amount must also be recorded in its character as referable to the capital gain in the accounts or records of the trust no later than two months after the end of the income year.
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- 22 It must also be recorded in its character as referable to the franked distribution in the accounts or records of the trust no later than the end of the income year.
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# Fringe benefits tax: is there a better way?

by Sam Gathercole, Senior Manager – Workforce Advisory, KPMG

In 1986, Australia introduced fringe benefits tax to prevent high net worth individuals from avoiding personal income tax by receiving non-cash benefits in lieu of taxable salary and wages. The FBT regime provided a framework for valuation by introducing fringe benefit categories that are connected to specific valuation methodologies. It also introduced concessions in the form of exemptions and reductions. Despite these reforms, the FBT regime still does not meet the “good tax” criteria. It imposes a high compliance burden on taxpayers while generating relatively low tax revenue. The complexity of benefit identification, valuation methodologies, and the exemption and reduction framework, along with the reporting requirements for individual income tax purposes, highlight the inefficiency and lack of simplicity in the current FBT system. This article will explore the complexities of the current FBT framework and discuss ongoing equity and efficiency issues that challenge its classification as a “good tax”. The article recommends simplifying benefit categories, harmonising valuation methodologies, and taxing fringe benefits through the pay as you go withholding framework.

## Introduction

Prior to the introduction of fringe benefits tax, the provision of non-cash benefits to employees was subject to tax in Australia via the former s 26(e) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). Non-cash benefits were treated as assessable income and employees paid tax at their marginal tax rate via normal individual income tax processes. However, the methodology by which these benefits were valued was vague and led to instances of tax avoidance (purportedly by high net worth individuals).

The “good tax” design criteria are the framework against which a tax is evaluated as fit-for-purpose. While the design criteria have evolved over the years, there are three main criteria that have emerged as key to determining whether a tax is a “good tax”, ie equity, efficiency and simplicity. Due to the obscurity of identifying non-cash benefits and the

vagueness around their valuation, the pre-1986 taxation of non-cash benefits was not equitable or efficient.<sup>1</sup> This was the impetus for reforming how non-cash benefits were taxed in Australia.

In 1986, Australia introduced FBT as an anti-avoidance measure to ensure that high net worth individuals were not able to circumvent their personal income tax obligations by receiving non-cash benefits (open to subjective valuation) in lieu of taxable salary and wages. At the time of introduction, the FBT framework clarified the benefit valuation process by introducing: (1) non-cash benefit (ie fringe benefit) categories; and (2) valuation methodologies specific to these categories. Also available were FBT concessions in the form of specific exemptions and reductions that either exempted the fringe benefit from taxation altogether or reduced its taxable value.

Despite reform targeted at addressing issues of equity and efficiency, the FBT regime still does not meet the criteria of “good tax” design. FBT imposes the highest compliance burden on taxpayers for the lowest tax revenue when compared to other Australian taxes. This is driven by the complexity of the benefit identification process, the valuation methodology, the exemption and reduction framework, and the subsequent reporting of fringe benefits on employees’ payment summaries for individual income tax purposes. The complexity of the current FBT framework best showcases how it cannot be categorised as a “good tax”, and how it cannot be said that the taxation of fringe benefits is *simple*.

This article will showcase the complexity of the current FBT framework, while also making comments on persisting equity and efficiency issues that challenge the idea that FBT is a “good tax”. International benefits-in-kind frameworks will be critically evaluated to draw insights for potential reform in Australia. Specifically, analysis of the comparable New Zealand, India and United Kingdom tax systems has been included. This article will recommend that the benefit categories are simplified, the valuation methodologies harmonised, and fringe benefits taxed in the hands of the employee through the pay-as-you-go (PAYG) withholding framework. It will be argued that recent reforms in the payroll space (ie the introduction of single touch payroll (STP) and Payday Super) suggest that Australia is now better positioned to implement these recommendations.

## How has the “good tax” framework evolved in Australia?

Contrary to popular belief, the impost of tax can be good. The collection of tax is intended to raise revenue for government spending. Political parties campaign to spend this revenue on chosen items which (in their view) produce the best outcomes for their citizens. In most modern societies, the people elect their preferred political party, effectively choosing what their taxes fund:<sup>2</sup>

“Taxes are the price we pay for civilised society.”

To understand what constitutes a “good tax”, it is important to understand the context surrounding the Australian tax

system. Prior to the 1970s, the legislature was focused on expanding the revenue base.<sup>3</sup> However, following growing equity concerns, reform from this point was focused on improving equity, efficiency and reducing complexity.<sup>4</sup> Table 1 summarises the criteria proposed within various Commonwealth reports for what constitutes a “good tax” in the Australian tax system.<sup>5</sup>

The criteria for equity, efficiency and simplicity are well-established. The following provides a useful summary of these criteria:<sup>6</sup>

- **equity:** individuals with similar economic capacity should be treated in the same way, while those with greater capacity should bear a greater tax burden;
- **efficiency:** tax revenue should be raised and redistributed at the least possible cost, and should not affect choices made by the taxpayer; and
- **simplicity:** the tax framework should be easy to understand and comply with. This should lead to a lower compliance cost for taxpayers.

### Analysis of Australian FBT in the context of the “good tax” framework

Prior to the introduction of the modern FBT regime in 1986, fringe benefits were taxed via income tax law, specifically the former s 26(e) ITAA36. This was a relatively broad section that captured all:

“... allowances, gratuities, compensations, benefits, bonuses and premiums allowed, given or granted to him in respect of, or for or in relation directly or indirectly to, any employment of or services rendered by him, whether so allowed, given or granted in money, goods, land, meals, sustenance, the use of premises or quarters or otherwise ...”

The problem with taxing fringe benefits through s 26(e) was that there was no clear method for identifying and valuing fringe benefits for inclusion in an employee’s assessable income. The introduction of the *Fringe Benefits Tax Assessment Act 1986* (Cth) addressed this issue, providing a comprehensive framework for benefit identification and valuation. Consequently, the updated *Income Tax*

*Assessment Act 1997* (Cth) (ITAA97) excludes fringe benefits as assessable income for employees.<sup>11</sup> A key feature of the Australian FBT regime is that FBT is levied on the *employer*.

A summary of the benefit identification and valuation methodologies, the application of exemptions and reductions, and the process by which fringe benefits are disclosed on employees’ payment summaries is set out below. A discussion on recent reforms has also been included. This section will also provide commentary on how these processes should be evaluated against the “good tax” design criteria.

### Benefit identification and valuation

All non-cash benefits provided to employees are prima facie subject to FBT, unless they are specifically excluded under the definition of a “fringe benefit” in the legislation.<sup>12</sup> Each benefit must be classified into one of the following 12 fringe benefit categories:

- car benefits;
- debt waiver benefits;
- loan benefits;
- expense payment benefits;
- housing benefits;
- living-away-from-home allowance benefits;
- board benefits;
- meal entertainment benefits;
- tax-exempt body entertainment benefits;
- car parking benefits;
- property benefits; and
- residual benefits.

The residual benefits category acts as a “catch-all” provision, whereby any fringe benefit that does not fall into another category is still prima facie subject to FBT.

It should be noted that the classification of fringe benefits can be burdensome due to the complexity of the rules. For example, to be categorised as a car fringe benefit, the motor vehicle provided to an employee must be designed to carry a load of less than 1 tonne and fewer than nine passengers.<sup>13</sup>

Table 1. Good tax criteria

Asprey report (1975) <sup>7</sup>	Draft white paper (1985) <sup>8</sup>	Tax reform: not a new tax, a new tax system (1998) <sup>9</sup>	Henry review (2009) <sup>10</sup>
Fairness	Equity	Fairness	Equity
Simplicity	Efficiency	Incentives	Efficiency
Efficiency	Simplicity	Revenue security	Simplicity
Others: 1. Stabilisation 2. Growth	Others: 1. Prevent tax avoidance and evasion 2. Interaction of tax with social welfare systems 3. Tax expenditures 4. Federal/state issues	Consistency in treatment of economic activity	Sustainability
		Simplicity	Policy consistency

Otherwise the motor vehicle would be considered a residual fringe benefit.

To calculate whether the motor vehicle is designed to carry a load of less than 1 tonne, the employer must locate, read and understand the interpretive guidance provided by the ATO in MT 2024, and collect the required vehicle specifications (including gross vehicle weight, basic kerb weight, and passenger capacity information) for each vehicle. This analysis will need to be replicated over the entire fleet of vehicles. By failing to undertake this analysis, an employer may misclassify a motor vehicle and apply a concessional valuation method which would result in an underpayment of FBT.

To complicate matters, there are further sub-categories for benefits that must be considered. For example, when a benefit is provided “in-house”, it can become an in-house expense payment, in-house property and in-house property fringe benefit. A further variation requires consideration of whether the benefit is provided under a salary packaging arrangement – which results in 14 possible outcomes, as demonstrated in Table 2. This complexity supports the argument that the FBT framework is not simplistic.

### Exemptions and reductions

Once the taxable value is determined, there is a patchwork of exemptions and reductions that taxpayers may consider. If a benefit meets an exemption, it is an “exempt benefit” and it should not be disclosed on the FBT return or be subject to FBT. Should a reduction apply, the fringe benefit should still be disclosed on the FBT return, but a reduction recorded. Hence, additional administration is involved where a reduction is relied on. Most exemptions can be located between ss 58 and 58ZE of the *Fringe Benefits Tax Assessment Act 1986* (reflecting the sheer number

of additional exemptions added post-enactment of the legislation), while most reductions can be found between ss 59 and 65A of the Act. Of course, additional exemptions and reductions scattered throughout the legislation that are specific to each benefit type must also be considered. Typically, the application of exemptions and reductions requires significant record-keeping.

### Disclosure

Following the disclosure of fringe benefits on the return and payment of tax, certain benefits must be disclosed on the employee’s payment summary as a reportable fringe benefits amount (RFBA). An employee does not pay personal income tax on their RFBA (this would be economic double taxation). However, the RFBA is used to determine entitlements to certain government benefits or obligations (eg Medicare levy surcharge, higher education loan program repayments, child support obligations). While tax is still levied on the employer, the disclosure of RFBA ensures that the way in which employees are remunerated (ie via salary or fringe benefits) is neutral with respect to government benefits or obligations and therefore increases equity in the tax system.

To reflect what an employee would have needed to earn as their pre-tax salary or wages to purchase the benefit, an RFBA is calculated as the grossed-up value of the reportable fringe benefit. The benefit is grossed up at the type 2 rate, being the highest marginal tax rate exclusive of GST (despite most benefits being subject to GST). A wide range of specific benefits are not reportable, but the most common non-reportable benefits are meal entertainment and car parking benefits.<sup>14</sup> These benefits were likely classified as non-reportable within the legislative framework due to the practical difficulty in assigning these benefits to an employee. For similar reasons, an employee will have an RFBA disclosed on their payment summary only where the taxable value of the benefits exceeds \$2,000. These are clear examples of policymakers opting for a decrease in equity for an increase in efficiency and simplicity.

**Table 2. Gym membership benefit classification**

Benefit	Category	In-house?	Salary packaged?
Gym membership	Expense payment	Y	Y
			N
		N	Y
			N
	Residual	Y	Y
			N
		N	Y
			N
			Y
			N
	Property	Y	Y
			N
			Y
			N
N		Y	
		N	
		Y	
		N	

### Recent updates to the FBT regime

As with all taxes, there have been some reforms to the FBT regime since its introduction over 35 years ago. These have been targeted measures that are aimed at achieving a better balance between the “good tax” criteria and/or a specific policy intent. The 2011 updates to the valuation of car fringe benefits are a felicitous example of this.

Prior to the introduction of these updates, car fringe benefits valued using the statutory method required the use of a statutory fraction that was assigned based on the number of kilometres travelled throughout the FBT year (1 April to 31 March).<sup>15</sup> A higher number of kilometres would impose a statutory fraction, meaning more kilometres driven resulted in a lower tax liability. It was noted that the concessionary treatment of this valuation method resulted in perverse incentives for more car use and ultimately encouraged car use during peak hour commuting.<sup>16</sup> It was recommended that the statutory formula method be amended to remove the incentive to

drive excessively to reach the next threshold.<sup>17</sup> It was noted that the policy intent behind the concessional treatment was different to the broader tax policy of minimising compliance costs (ie increasing efficiency and simplicity).<sup>18</sup> Ultimately, a standard statutory rate of 20% was adopted, which removed the incentive to drive a higher number of kilometres and the evidentiary burden to support the use of a concessional rate. This example showcases that updates to the FBT regime have been due to a mix of policy intent (in this case, transport fuel consumption) and “good tax” design criteria.

More recent updates also confirm that FBT amendments are a mix of supporting specific policy intent and increasing alignment with the “good tax” design criteria. As noted above, preparing an FBT return requires employers to maintain extensive records to support their disclosures. To reduce compliance costs, the Commissioner of Taxation was granted powers to approve alternative records to be kept for certain benefits.<sup>19</sup> These alternative records are less burdensome to maintain, and this welcome amendment is an obvious attempt to increase the efficiency and simplicity of the FBT system.

Also obvious in terms of discerning the rationale behind an amendment, is the introduction of the electric car exemption.<sup>20</sup> Clearly intended to increase the adoption of electric vehicles by employees (for environmental reasons), interestingly, policymakers “underestimated the lure of the generous tax break”, originally budgeting for \$55 million but now forecasted to cost \$564 million.<sup>21</sup> This is clear evidence that FBT amendments sometimes support policy initiatives at the expense of the “good tax” design criteria (in this case, equity and efficiency).

## Recent discussion of FBT in Australian literature

In the 2008–09 Budget, a comprehensive “root and branch” review of the Australian tax system (the Henry review) was announced to deal with the social, economic and environmental challenges that Australia was facing.<sup>22</sup> In this review, the objective was stated to be:<sup>23</sup>

“Raising revenue should be done so as to do least harm to economic efficiency, provide equity (horizontal, vertical and intergenerational), and minimise complexity for taxpayers and the community.”

The Henry review recommended significant reform to Australia’s FBT framework. It was suggested that FBT had a significant compliance cost for employers (ie it was not efficient), was not progressive (ie not equitable), and required simplification.<sup>24</sup> The Henry review recommended that fringe benefits which are readily valued and attributable to individual employees should be taxed in the hands of the employees through the PAYG system.<sup>25</sup> Further, it was recommended that other fringe benefits remain taxed to employers at the top marginal rate, with the scope of fringe benefits that are subject to tax simplified.<sup>26</sup>

These recommendations have industry support. The Tax Institute supported these recommendations, but included

additional questions around whether fringe benefits should be taxable if they are not part of an employee’s remuneration.<sup>27</sup> It was suggested that an alternative to taxing non-remunerative benefits as fringe benefits would be to simply deny a tax deduction for non-remunerative benefits such as meal entertainment (effectively levying tax at the employer’s corporate tax rate).<sup>28</sup> The final recommendation was that the “otherwise deductible” rule be abolished such that the employee would bear the onus to substantiate any tax deductions that may be available. While these changes were initially put forward in 2021, they were again recommended in 2024.<sup>29</sup>

## International discussion

International FBT frameworks support the recommendations made in Australian literature. This section will discuss the approaches to taxing fringe benefits in India, the UK and New Zealand. Undertaking a full review of each FBT regime is not in scope for this article. Rather, the analysis has been limited to key features that are intended to draw out potential opportunities for reform in Australia.

### India

Fringe benefits tax was introduced into the Indian tax framework in 2005 through the *Finance Act, 2005*. Following significant challenges, the Finance Minister announced its abolishment in the 2009 Union Budget.<sup>30</sup> Despite being short-lived, a comparison between the original framework (and challenges) and the new framework is a useful reference point for Australia.

Originally, the Indian FBT framework was similar to Australia in that the tax was levied on employers and there were “heads of fringe benefits”.<sup>31</sup> However, there was no “catch-all” provision, and if a benefit did not fall into one of the heads of fringe benefits, it was not subject to tax. Further, the taxable value of fringe benefits was calculated as a specified rate for each head of expenses, and a flat rate of 30% was applied to calculate the FBT liability (with concessional tax treatment for specific industries).

FBT was introduced as a way to increase equity within the Indian tax system.<sup>32</sup> It was recognised that the concessional taxation of fringe benefits contradicted both horizontal and vertical equity principles on the grounds that employees would pay different amounts of income tax based on their remuneration mix, and typically higher-income employees received non-cash benefits.<sup>33</sup>

“The FBT has been quite a controversial tax since its introduction. It has been criticised on many grounds – on the method of its valuation, deeming provisions – all leading to increased compliance costs for taxpayers, on its absurd logic of taxing expense, etc. On the contrary, the government has argued that there is no additional burden in terms of cost of compliance, the deeming provisions have been introduced to make it simple and for making its collection and administration efficient.”

With the abolishment of FBT, India still levies a tax on fringe benefits. Income tax is levied on “perquisites” (ie employee benefits), and these are taxed in the hands of

the employee according to ordinary income tax laws. Some perquisites are tax-exempt, some are taxable, and some are taxable only for specified employees. If captured by the income tax legislation, benefits are subject to complex valuation rules, depending on the specific benefit type.<sup>34</sup> While the current Indian system is very similar to Australia, there are a few exceptions, ie the tax is levied on the employer, there is a tax-free threshold before perquisites need to be reported, and there is no catch-all provision for fringe benefits.

### United Kingdom

In the UK, “specified benefits” are taxed in the hands of the employee (noting that employers are still liable for contributions to the employee’s pension fund).<sup>35</sup> “Specified benefits” are broadly defined as:<sup>36</sup>

- non-cash vouchers;
- credit-tokens;
- cars;
- car fuel;
- vans;
- van fuel; and
- employment-related benefits (meaning any benefit or facility of any kind, other than an excluded benefit, provided to an employee, or their family, by reason of employment).<sup>37</sup>

Importantly, there were amendments to capture “optional remuneration arrangements” to ensure that salary sacrifice arrangements could not be entered into to reduce the tax base on which the equivalent PAYG withholding and pension contributions were calculated.<sup>38</sup>

From April 2026, benefits-in-kind will need to be reported via payroll, and withholding taxes deducted via normal processes.<sup>39</sup> Currently, a P11D form is lodged by employers to inform the revenue authority of the perks and expenses that they have provided to their employees.

### New Zealand

The FBT regime in New Zealand is similar to Australia. FBT is payable on fringe benefits and levied on the employer.<sup>40</sup> There are specific categories of fringe benefits (eg vehicles, loans etc), and a catch-all provision where benefits are provided that do not fall into these categories,<sup>41</sup> albeit less categories than in Australia. Non-remunerative benefits are not taxable as fringe benefits and the costs are not tax deductible for employers.

### Single touch payroll and Payday Super

There is evidence that Australia is trending towards real-time payroll reporting of employee remuneration. Single touch payroll (STP) is the reporting framework through which the Australian Government is provided details on payments to employees that are processed through payroll.<sup>42</sup> While this information is used for a

variety of purposes, the most notable purpose is to provide information to the revenue authority (which assists with practicalities like pre-populating an employee’s taxable income within their yearly personal income tax return). Other uses include providing information to Services Australia (the entity responsible for social security payments and services),<sup>43</sup> and more recently, targeting employers that may have failed to meet their superannuation guarantee obligations.<sup>44</sup>

The most important reporting obligation under the STP reporting framework is that an employee’s gross income must be disaggregated.<sup>45</sup> Each payroll code needs to be mapped to an income type, which includes:

- gross;
- paid leave;
- allowances;
- overtime;
- bonuses and commissions;
- director’s fees; and
- salary sacrifice.

Each of these payment types contains sub-categories that need to be considered during the mapping process.

“FBT imposes the highest compliance burden on taxpayers for the lowest tax revenue ...”

An employer’s STP report is due on or before the pay day.<sup>46</sup> Interestingly, there is a concession for inbound assignees (employees of multinational employers who are exchanged between tax jurisdictions) who are seconded to Australia, paid by an offshore entity, and are on a shadow payroll arrangement.<sup>47</sup> It was recognised that a concession was needed for payments made to these employees for the following reasons:<sup>48</sup>

- delays in receiving information from an overseas payroll;
- currency conversion of payment amounts; and
- a requirement for additional calculations to report liabilities and implement tax equalisation.

As a result of the introduction of STP, there is close to real-time reporting of an employee’s taxable income (and the actual components) to the Australian Government.

In the 2023–24 Budget, the Australian Government announced the largest reform to the superannuation guarantee system since its introduction in 1992. That is, from 1 July 2026, employers will be required to contribute superannuation to an employee’s superannuation fund on pay day.<sup>49</sup>

The Payday Super regime will require superannuation to be contributed within seven calendar days of payments of qualified earnings (as opposed to quarterly under the current regime). The exposure draft currently provides that concessional treatment will be provided to “out-of-cycle” payments. However, there is industry support for alignment with STP reporting concessions that are available for expatriate employees.<sup>50</sup>

## Recommendations

This article has reviewed the current FBT framework, analysed international FBT frameworks, and discussed the recent Australian trends in real-time reporting of employee remuneration. The recommendations made in current Australian literature are aligned with the analysis of international FBT frameworks. This article suggests that the following recommendations are required to reform the FBT regime:

1. the fringe benefits categories (and the consequent valuation methodologies) should be reduced. It is suggested that, at a minimum, the meal entertainment and car parking fringe benefit categories should be removed. These benefits are already not reportable due to the practical difficulty in identifying which employees received these benefits. Should the decision be made that these remain part of the tax base, it may be more appropriate to simply deny a corporate tax deduction for these benefits (effectively levying tax at the corporate tax rate); and
2. fringe benefits should be taxed in the hands of the employee through the PAYG withholding system. There is no support from the “good tax” design criteria that the taxpayer for an employee’s salary or wages and fringe benefits should be different. Making this change will not only increase the equity of the FBT regime, but it will also increase efficiency for employers deciding between remuneration offerings and increase the simplicity of reporting requirements.

In addition to the above, this article makes the ambitious recommendation that fringe benefits be subject to real-time reporting requirements (similar to the UK regime which starts in April 2026). The STP and Payday Super payroll reporting requirements have established a framework through which fringe benefits should be able to be disclosed. This would ensure that employees do not have an unexpected tax liability at year-end and increase the data available to the revenue authorities.<sup>51</sup> Similar to STP and Payday Super, concessional treatment should be considered for expatriate employees or other employment arrangements that make it difficult to comply. It may be appropriate to instead ensure that fringe benefits are reported seven business days after pay day, which would align with the Payday Super reporting obligations.

## Conclusion

It is overwhelmingly apparent that the Australian FBT regime is not aligned with the “good tax” design criteria. The benefit identification and valuation methodology processes

are complex, especially when considering the application of exemptions and reductions, and the specific reporting rules around RFBAAs. This results in a tax system that is non-simplistic, inequitable and inefficient.

To reduce the compliance burden, the identification and valuation of fringe benefits should be streamlined, and the taxation of fringe benefits should be harmonised with other employee remuneration. Australia has laid the groundwork for the real-time reporting of fringe benefits with STP reporting and Payday Super. By moving to a real-time reporting framework, employees will not receive an unexpected tax liability when they lodge their personal income tax return. Further, the government would not need to wait until lodgment of the FBT return and payment due date to collect its tax revenue. Care needs to be taken to ensure that concessional treatments for STP, Payday Super and fringe benefits reporting are harmonised, particularly for employers with expatriate employees on their payroll.

### Sam Gathercole

Senior Manager – Workforce Advisory  
KPMG

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# Reimagining land use: sustainability and tax

by Courtney van Zyl, FTI, Associate Partner (Tax Advisory), and David Hall, CTA, Partner (Tax Advisory), Findex

Landowners are capitalising on alternative land use opportunities to generate income, or achieve more philanthropic goals around environment conservation and species protection. While lawyers are generally quickly consulted given contracts are in play, getting the right tax advice can be critical to ensuring that the landowner is aware ahead of time of the associated tax implications for their particular set of circumstances. These tax implications can be complex and long-lasting, impacting everything from immediate cashflow to long-term succession planning. This article focuses on biodiversity conservation covenant arrangements. It delves into the New South Wales Biodiversity Offsets Scheme, looking at some of the technicalities of the associated tax calculations and highlighting some of the longer-term considerations in a tax, practical and commercial sense for landowners entering into these agreements. A real-world case study is included to highlight how these factors can intertwine.

## Overview

It is becoming increasingly common for landowners, in particular primary producers, to diversify their income stream with alternative land use opportunities to supplement their on-farm income. Many see themselves as custodians of the land and are quick to identify, take advantage of, and even champion environmental and sustainability initiatives. Concurrently, external businesses, organisations and authorities (mining, coal seam gas, transport and electricity authorities, philanthropic organisations) want access to land and the associated biodiversity or carbon credits that may be created.

While the revenue generated by these activities is valuable, they can also create significant tax issues, some of which extend beyond the immediate or direct tax consequences of the arrangement itself. The less direct and longer-term consequences must also be considered to ensure that the landowner is fully apprised of the true cost of entering into

one of these arrangements. To that end, this article focuses on biodiversity conservation covenant arrangements. It delves into the New South Wales Biodiversity Offsets Scheme, looking at some of the technicalities of the associated tax calculations and highlighting some of the longer-term considerations in a tax, practical and commercial sense for landowners entering into these agreements. A real-world case study is included to highlight how these factors can intertwine.

## Conservation covenants

Many property owners have large tracts of land that they recognise have unique or special native flora and fauna or cultural significance that they wish to protect. In a lot of cases, the owner of the land sees themselves as a multi-generational custodian. Permanent protection can be achieved by entering into a conservation covenant over the land. As well as achieving environmental benefits, a conservation covenant may provide a tax deduction but it may also trigger a capital gain or loss.

To obtain a deduction, it is not only a matter of creating the covenant – it must also meet certain criteria and be under a program approved by the Environment Minister. These covenants can be entered into directly by the landowner with the government or with organisations under a program which the organisation (including deductible gift recipients) has successfully applied for approval in writing by the Environment Minister.

### Step 1: Div 31 tax deduction

The tax consequences for entering into a conservation covenant start at Div 31 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97):

“You can deduct an amount if you enter into a conservation covenant over land that you own and you satisfy certain conditions.

The amount you can deduct is the difference between the market value of the land just before and after you enter into the covenant.”

Section 31-5(5) ITAA97 defines “conservation covenant” as:

“... a covenant that:

- (a) restricts or prohibits certain activities on the land that could degrade the environmental value of the land; and
- (b) is permanent and registered on the title to the land (if registration is possible); and
- (c) is approved in writing by, or is entered into under a program approved in writing by, the Environment Minister.”

### Eligibility for Div 31 tax deduction

Section 31-5(1) to (4) cover the eligibility conditions to access a Div 31 deduction:

- you enter into the conservation covenant (that meets the definition above) with a fund, authority or institution that

satisfies Subdiv 30-B ITAA97 “deductible gifts” or the Commonwealth, state, territory or local governing body, or an authority of the Commonwealth, state or territory; and *you own that land* (this excludes leaseholds); and

- the covenant must be:
  - perpetual, and registered on the title to the land if possible; and
  - you must not receive any money, property or material benefit *for entering into the covenant*; and
  - the market value of the land must decrease as a result of entering into the covenant (which must be supported by a valuation of the change in market value by the Commissioner of Taxation – the Commissioner provides a valuation certificate<sup>1</sup> and the cost of the valuation is passed onto the applicant<sup>2</sup>); and
  - the change in market value of the land must be more than \$5,000 *or* you have entered into a contract not more than 12 months before you entered the covenant.

The above conditions are “and” conditions; therefore, if *any one* of the above conditions is failed, a Div 31 tax deduction is not available.

**Example 1**

Bill and Mathilda own a cattle property that they purchased for \$5 million and which currently has a market value of \$10 million. They apply for a conservation covenanting program<sup>3</sup> and receive approval. They enter into a conservation covenant directly with the Australian Government, the Environment Minister approves the covenant, and Bill and Mathilda lodge a request for valuation (a conservation covenant program form<sup>4</sup>) with the ATO and pay a non-refundable application fee of \$241.

The Commissioner provides a valuation certificate to them outlining the loss in value as a result of the covenant as being \$1 million.

Providing all requirements are met, under s 31-5, they can claim the \$1 million deduction in the current year or elect<sup>5</sup> to spread the deduction over five years.

**Claiming the deduction**

The election to spread the deduction must be lodged with the ATO *before you lodge your tax return for the year you entered into the covenant*.<sup>6</sup> The election does not require you to spread the deduction equally over the five years, but does require you to stipulate the deduction for each year.<sup>7</sup> This is important as the deduction cannot result in a loss for the year.<sup>8</sup> You can vary the election<sup>9</sup> at any time, but only in relation to income years not yet lodged.

**Eligibility for Div 31 tax deduction**

To obtain the deduction, you must not receive any money, property or material benefit for entering into the covenant. The first two are obvious, but material benefit is a subjective term. The other important aspect is that these payments etc must be in relation to “entering into the covenant”.

Therefore, at face value, you may be able to receive funds to maintain that conservation area without falling foul.

Landowners who enter into a covenant under a biodiversity scheme (discussed later in this article), and in return received biodiversity credits, will be considered to have received a material benefit and will be denied the Div 31 deduction. This may differ for situations where a covenant is entered into, and a separate arrangement is entered into for a carbon credit scheme on the same land. As the carbon credits were not provided for entering into the conservation covenant, it arguably would not be considered a material benefit for entering into the conservation covenant.

The ATO does provide some guidance in ATO ID 2002/678 on “material benefit” (where it was concluded, based on the facts at hand, that the meeting or reimbursing of legal and administrative costs is not considered to preclude deduction under Div 31), and TR 2005/13. Private binding ruling 1051903212989 provides a more recent indication of the Commissioner’s thinking in relation to this.

Consistent with comments in ATO ID 2002/678, there may be other benefits that arise for the landowner that have some connection to the covenant, but this is not necessarily a material benefit for entering into the covenant. As such, receipt of some kind of benefit does not automatically mean a Div 31 deduction is not available.

**Step 2: Application of CGT provisions**

Separate from the tax deduction under Div 31, entering into a conservation covenant may trigger CGT event D4 or CGT event D1.

To determine whether it is CGT event D4 or D1 that applies, the differentiating factors are whether capital proceeds are received for entering into the conservation covenant and whether a Div 31 deduction applies. With the context that CGT event D4 applies unless an exception in s 104-47(6) ITAA97 applies (in which case, CGT event D1 is the relevant CGT event), all possible scenarios are:

Capital proceeds received	Division 31 deduction available	Relevant CGT event triggered
No	No	D1
No	Yes	D4
Yes	No	D4
Yes	Yes	Not possible: the Div 31 deduction can only be allowed if no material benefit is received

**CGT event D4**

The requirements for CGT event D4 are found in s 104-47(1) and (2):

- “(1) **CGT event D4** happens if you enter into a conservation covenant over land you own.
- (2) The time of the event is when you enter into the covenant.”

While CGT event D4 has a broad reach, there are exceptions, in which case a CGT D1 event will result. These exceptions are found in s 104-47(6):

- “(6) CGT event D4 does not happen if:
- (a) you did not receive any capital proceeds for entering into the covenant; and
  - (b) you cannot deduct an amount under Division 31 for entering into the covenant.

Note: In this case, CGT event D1 will apply.”

Section 104-47(7) also confirms that the normal pre-CGT exception for land acquired prior to 20 September 1985 applies to CGT event D1.

In other words, subs (6) above means that CGT event D4 does not happen where the landowner did not receive any capital proceeds for entering into the covenant *and* is denied a deduction under s 31-5. That is, the landowner must meet the requirements of both paragraphs for the exception to apply. In understanding the reasoning for this exemption, if you have no capital proceeds and are denied a s 31-5 deduction, then you have no capital gain to deal with under CGT event D4.

The supplementary explanatory memorandum to the Bill that became the *Taxation Laws Amendment Act (No. 2) 2001* (Cth) provides some clarity on this:

“1.29 ... CGT event D4 applies where a conservation covenant is entered into for capital proceeds, or for nil capital proceeds if a deduction is available;”

The explanatory memorandum also provides a useful diagram (see Diagram 1).

**Calculating the capital gain for CGT event D4.** Once it has been determined that CGT event D4 has occurred, the

resulting capital gain needs to be calculated. Therefore, it is essential to determine what the proceeds are and the cost base, along with any basis for apportionment. A CGT event D4 capital gain or loss is calculated according to the normal CGT calculation premise (capital proceeds less the cost base). However, s 104-47 specifically prescribes how the capital proceeds and cost base must be determined or adjusted:

“(4) The part of the cost base of the land that is apportioned to the covenant is worked out in this way:

$$\text{Cost base of land} \times \frac{\text{Capital proceeds from entering into the covenant}}{\text{Those capital proceeds plus the market value of the land just after you enter into the covenant}}$$

The part of the reduced cost base of the land that is apportioned to the covenant is worked out similarly.

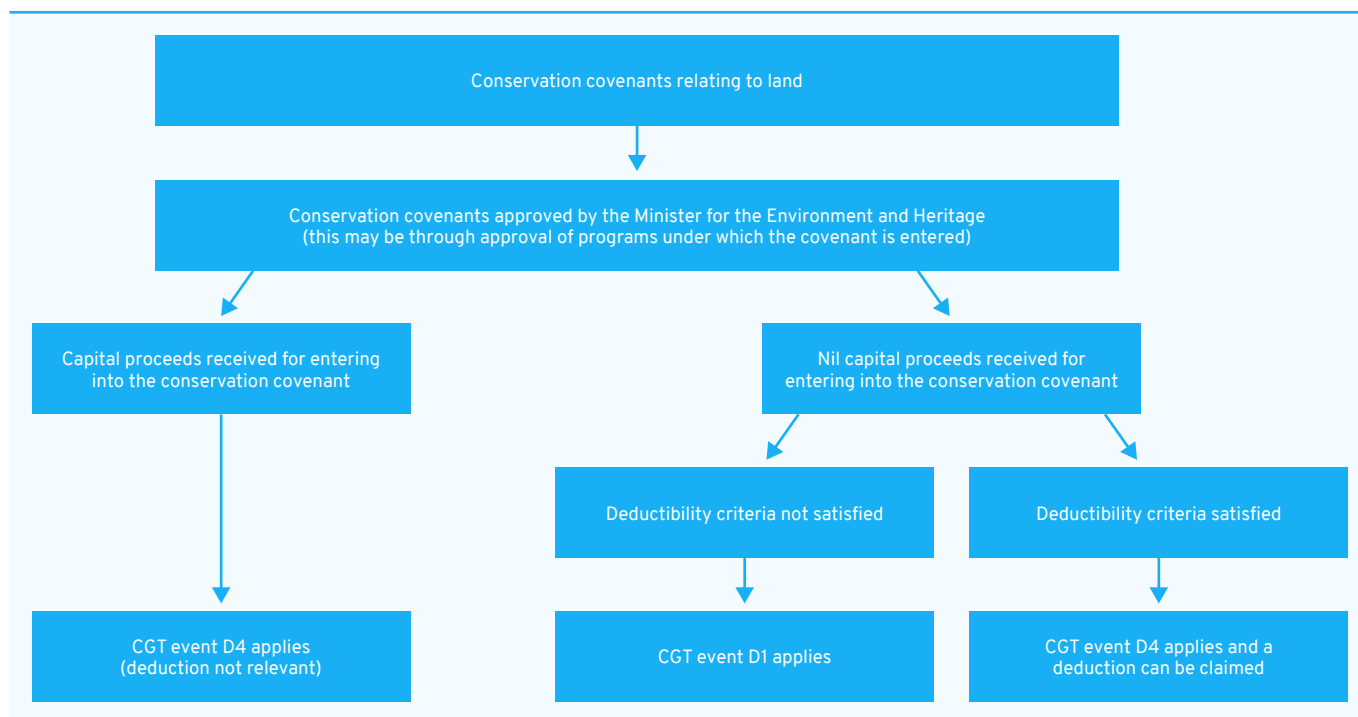
(5) The cost base and reduced cost base of the land are reduced by the part of the cost base or reduced cost base of the land that is apportioned to the covenant.”

Section 116-105 ITAA97 provides specific comment in relation to the calculation of capital proceeds for CGT event D4:

“If CGT event D4 happens because you enter into a conservation covenant over land you own and you can deduct an amount under Division 31 because you enter into the covenant, the capital proceeds from the event are the amount you can deduct.

Note: To get a deduction under Division 31, you must not receive money, property or other material benefit for entering into the covenant.”

**Diagram 1. Decision tree for CGT event D1 versus CGT event D4**



In other words, s 116-105 prescribes that, if CGT event D4 has occurred and you also have a Div 31 deduction, the proceeds for your CGT event D4 calculation are equal to your Div 31 deduction.

**Example 2**

In simple terms and using Bill and Mathilda’s example:

- the original cost base of the property is \$5 million;
- the Div 31 deduction is \$1 million;
- the market value of the property after the covenant is granted is \$9 million; and
- the market value of the property before the covenant is granted is \$10 million.

The CGT calculation becomes:

Capital proceeds (modified proceeds rule, ie Div 31 deduction)	\$1m
Less: (capital proceeds from entering covenant/(those capital proceeds + value of land after entering covenant))	(\$5m/(\$1m + \$9m))
<b>Capital gain</b>	<b>\$500,000</b>

Because the gain is from CGT event D4, the general 50% discount may apply.

**Example 3**

Example 2 is varied such that Bill and Mathilda received capital proceeds of \$500,000. As a result of receiving the capital proceeds, they would be denied a Div 31 deduction.

Furthermore, the modification to capital proceeds under s 116-105 does not apply.

CGT event D4 would still happen, and the capital gain would be worked out as follows:

Capital proceeds (modified proceeds rule does not apply)	\$500,000
Less: (capital proceeds from entering covenant/(those capital proceeds + value of land after entering covenant))	(\$5m/(\$500,000 + \$9m))
<b>Capital gain</b>	<b>\$236,842</b>

Because the gain is from CGT event D4, the general 50% discount may apply.

**CGT event D1**

If you fail the CGT event D4 requirements, GCT event D1 may apply.<sup>10</sup> For CGT event D1, the capital gain will equal the capital proceeds from creating the right, less the incidental costs of creating the right.<sup>11</sup> The time of the event is when the right is created.<sup>12</sup>

There is no general 50% discount as the right is a newly created asset and specifically excluded as a discount capital gain.<sup>13</sup>

**Small business CGT concessions**

**CGT event D4.** Providing the landowner meets the normal eligibility conditions to access the small business CGT

concessions, the landowner can apply these concessions to reduce or eliminate their capital gain.

**CGT event D1.** The small business CGT concessions may apply pending satisfaction of the eligibility conditions, noting the modifications in s 152-12 ITAA97 whereby s 152-10(1)(a) ITAA97 is not required to be passed (ie the CGT event does not have to happen in relation to an asset), and s 152-10(1)(d) is not required to be passed (ie the active asset ownership requirements under s 152-35 ITAA97 do not need to meet).

**Other payments received in relation to conservation covenants**

Other amounts may be received by the landowner that relate to the ongoing covenant, such as for ongoing maintenance and management of the covenanted area (fencing requirements, spraying, planting etc). These receipts maybe treated as s 6-5 ITAA97 ordinary income, or s 20-20(2) ITAA97 indemnity or other assessable recoupment, and the associated costs incurred (maintenance and management of the covenanted area) could be potentially deductible under s 8-1 ITAA97.

**Biodiversity agreements and credits**

Several states, including Queensland, NSW, Victoria and Western Australia, have established biodiversity schemes. These schemes operate on the same basic premise of a landowner being paid to undertake agreed management actions to maintain or improve the condition of specific environmental values on their land, and/or landowners being paid for the use of their land for biodiversity credits or offset delivery by another person. The exact structure of the relevant scheme differs between the states.

A federal scheme known as the Nature Repair Market (NRM) scheme received royal assent on 14 December 2023.<sup>14</sup> A key element of the NRM scheme is that only one biodiversity certificate will be issued per project: it will be considered personal property that is transferrable and contain the details of the project to allow the market to value the certificate based on the project’s attributes. The carbon credit system is intended to operate in tandem with this scheme. Following initial pilot programs in late 2024 and early 2025, it is now formally established and operational in a basic form, with further development underway including expansion of additional methods for different types of nature repair activities, and continued consultation and review of the underpinning legislation and guidance etc. Given this scheme is still in its early period and the taxation outcomes would not be dissimilar to those schemes that are established, this article does not delve further into this particular scheme.

To demonstrate the tax nuances that arise when dealing with a biodiversity scheme, the next sections of this article specifically consider the NSW Biodiversity Offsets Scheme.

**NSW Biodiversity Offsets Scheme**

The NSW Biodiversity Offsets Scheme allows landowners to enter into a biodiversity stewardship agreement (BSA) with the NSW Biodiversity Conservation Trust (BCT), in

return for receiving biodiversity credits (previously known as biobanking agreements<sup>15</sup>). The scheme involves entering into in-perpetuity agreements to permanently protect and manage an area of land.

It can be accepted as fact that a BSA meets the definition of a “conservation covenant” under s 31-5(5).

Before considering the relevant CGT provisions, it is useful here to give a general explanation of how this scheme works and the resulting tax outcomes. To that end, the flowchart in Diagram 2 displays the mechanisms of a BSA using numbered arrows.

To explain Diagram 2 (as per the numbered arrows):

1. the landowner enters into a BSA with the BCT, which includes provision by the landowner of:
  - a. details of the specific actions that the landowner agrees to take to protect and manage the biodiversity values of the site, including restricting certain activities;
  - b. the number of biodiversity credits created for the management actions; and
  - c. the amount of the total fund deposit (TFD), which is the present value of the total of all detailed scheduled managements payments in the agreement. It is important to note that this is not a cash transfer or transaction – it is simply the agreement of the value of the TFD;
2. the landowner receives the agreed biodiversity credits under the BSA from the BCT. These are now assets of the landowner to hold or sell as they wish.

The relevance of selling the biodiversity credits becomes important here because only on sale of the credits (or other cash deposit) does the TFD start to have a cash balance. Why does this matter? Because only on reaching 80% of the agreed total TFD balance does the TFD commence paying agreed amounts to the

landowner to cover the agreed conservation activities under the BSA.

Generally, “passive” management is required from the date of signing the BSA, and the “active” management actions are required only once the TFD reaches at least 80%;

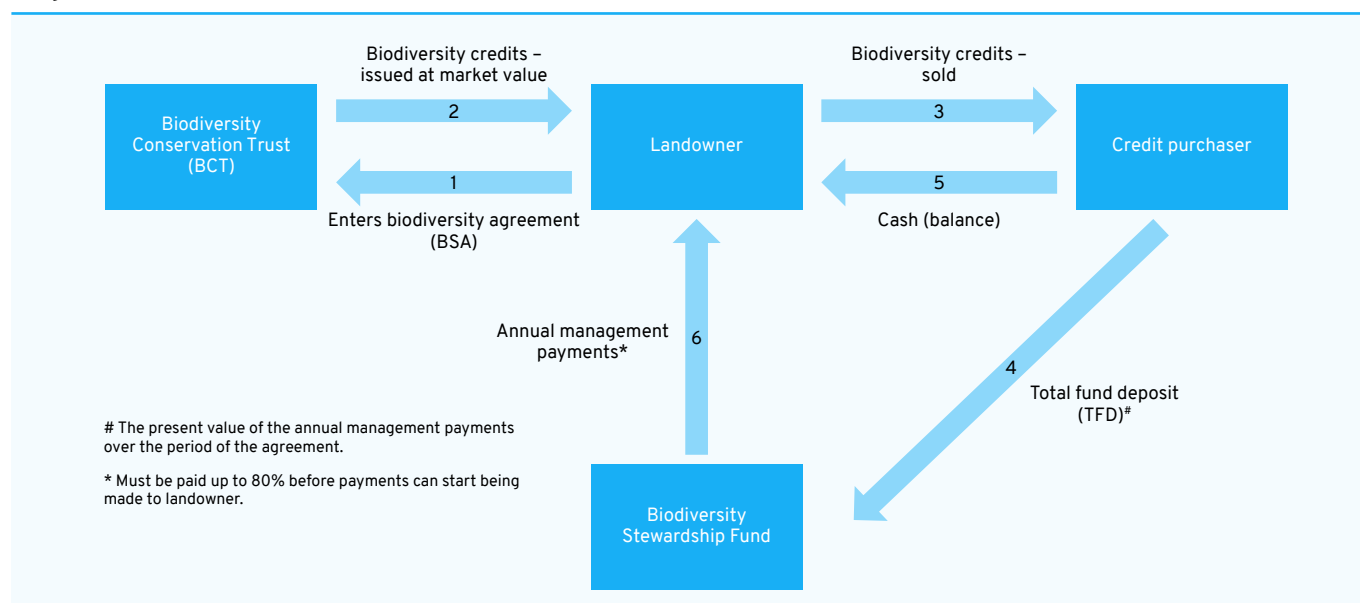
3. the landowner decides to sell the credits to the credit purchaser. There are various public platforms/markets facilitating these transactions, and the seller and the buyer can negotiate the selling price;
4. on payment of the proceeds, the first “claim” on those proceeds is the TFD. Before the credits can be transferred to the buyer, an amount is required to be deposited into the TFD. The amount required to be deposited into the TFD can depend on the proportion of credits sold and may be less than 100% if not all credits are sold at once;<sup>16</sup>
5. once the requirement in (4) is met, any remaining proceeds can be paid to the landowner directly as unencumbered cash; and
6. now the TFD has reached at least 80% of the agreed balance under the BSA, the management actions (both passive and active) are required to be done as per the agreed schedule in the BSA. An annual report is submitted by the landowner and a schedule payment under the agreement is made to the landowner. Annual management payments are paid to the landowner to cover the agreed conservation activities.

**CGT event D4**

As noted above, CGT event D4 is considered as being the relevant CGT event. When considering the requirements for CGT event D4:

- the landowner enters into the conservation covenant (the BSA) on land they own; and
- the time of the CGT event is when the BSA is entered into (signed).

**Diagram 2. The mechanisms of a BSA**



Next, we consider whether the CGT event D4 exception in s 104-47(6) applies (remembering that both conditions must be “no” in order for the exception to apply and the relevant CGT event instead be CGT event D1):

- Has the landowner received any capital proceeds for entering into the BSA?

Yes: the landowner received biodiversity credits, which are tradeable assets and would be considered property.<sup>17</sup> The market value of those credits on initial issue would be counted towards determining the capital proceeds.<sup>18</sup>

Consequently, the exception in s 104-47(6) does not apply, and CGT event D4 is the applicable event. However, for technical discussion purposes, we include the comment below on the Div 31 limb.

- Can the landowner deduct an amount under Div 31 for entering into the BSA?

No, the landowner would not have a Div 31 deduction: s 31-5(2)(b) requires that the landowner not receive any material benefit for entering into the BSA. Receipt of the biodiversity credits is a material benefit, and therefore the conditions to apply a Div 31 deduction are failed.

In a number of private rulings,<sup>19</sup> the ATO has accepted that entering into a biodiversity scheme triggers CGT event D4. This is also confirmed in CR 2009/77.

Any resulting capital gain from CGT event D4 arising as a result of entering into a BSA may be eligible for the 50% discount and potentially the small business CGT concessions.

**Proceeds.** The capital proceeds for CGT event D4 arising as a result of entering into a BSA are the value of the biodiversity credits at issue time. It is important to understand that this is not necessarily simply the market value of the biodiversity credits as they may be advertised at the time on one of the selling platforms/marketplaces. Instead, there are multiple potential approaches to determining the “value” of the biodiversity credits, including: current value on platforms/marketplaces; the agreed value in a credit sale agreement signed or being negotiated at the time the BSA is signed; or a “costing” approach, taking into account establishment costs to set up the BSA, management costs at the stewardship site (the TFD) required to improve biodiversity and generate credits, opportunity or land costs, and profit and risk calculations.<sup>20</sup> This must all be assessed and considered on a case-by-case basis as the specific facts of each client’s situation will be unique.

**Cost base.** The cost base of land is that part of the cost base that is attributed to the covenant. This is a prescribed formula in s 104-47(4):

“(4) The part of the cost base of the land that is apportioned to the covenant is worked out in this way:

$$\text{Cost base of land} \times \frac{\text{Capital proceeds from entering into the covenant}}{\text{Those capital proceeds plus the market value of the land just after you enter into the covenant}}$$

The result of the above is that, where the land value is negatively impacted as a result of entering into the BSA, the denominator is smaller and the resulting cost base of CGT event D4 is higher. In the (less likely) event that the value of the land increases as a result of entering into the BSA, the resulting CGT event D4 capital gain increases.

**Division 31 deduction**

As noted above, the receipt of the biodiversity credits is in exchange for entering into the covenant on the land (the BSA) and therefore a deduction would be denied under Div 31.

**Sale of biodiversity credits**

Biodiversity credits are a CGT asset,<sup>21</sup> and are treated accordingly under the CGT provisions on their sale. When selling the credits, CGT event A1<sup>22</sup> (or a more relevant event, if applicable) occurs for the landowner/owner of the credits, with a potential capital gain or loss occurring depending on the capital proceeds received<sup>23</sup> and the cost base of the credits.<sup>24</sup>

**Proceeds.** Fortunately, the calculation for the sale of biodiversity credits is far simpler than for CGT event D4. The proceeds are simply the consideration received from the sale, taking into account typical considerations such as any uncertainty or contingencies within the sale contract, adjustments for time, the value of money for contracts and payments to occur over an extended time period etc.

**Cost base of credits.** For determining the cost base of a CGT asset, s 110-25(2) ITAA97 provides that the:

“first element is the total of:

- (a) the money you paid, or are required to pay, in respect of acquiring it; and
- (b) the market value of any other property you gave, or are required to give, in respect of acquiring it (worked out at the time of the acquisition).”

The CGT asset being dealt with at this stage is the biodiversity credits, which have an already established cost base (ie the CGT event D4 proceeds). There are generally also incidental costs incurred to acquire the credits, including application, consultant and legal fees,<sup>25</sup> which form part of the cost base of the credits (if not already taken into account in the CGT event D4 calculation).

**Recognition of the TFD.** In zooming out and looking at the whole picture thus far of the taxation of a BSA, you may ask whether double taxation is occurring: entering into a BSA triggers CGT event D4 on which a capital gain is likely to result; the sale of the biodiversity credits triggers CGT event A1 and likely a taxable capital gain of which a significant portion must be paid into the TFD; and then payments out of the TFD to the landowner are taxable to the landowner.

How does the TFD get taken into account in the CGT outcomes and ensure that the landowner is not being taxed more than once on the same income?

The answer is that the TFD is taken into account in the CGT calculation on the sale of the biodiversity credits. The ATO’s preferred method for doing so is not entirely clear: while the

Commissioner's view in CR 2009/77 makes no allowance in CGT event D4 for the liability to pay the TFD amount, the actual payment to the TFD is taken into account when determining the proceeds on the sale of the credits.

Conversely, in a number of private rulings,<sup>26</sup> the Commissioner has indicated the opposite view that the payment of the TFD is an incidental cost to register the transfer and therefore is considered part of the cost base of the biodiversity credits.

Either way, the value of the TFD (*paid* amount, not the agreed value, although these are generally ultimately the same) is taken into account in the CGT calculation for the sale of biodiversity credits, and irrespective of whether it reduces proceeds or increases the cost base, the outcome is the same.

### Small business CGT concessions

The sale of biodiversity credits is not specifically precluded from eligibility for the small business CGT concessions. However, a common issue is meeting the active asset test. As an intangible asset, a biodiversity credit would need to be "inherently connected with the business that is carried on". If the credits are immediately sold, there is an argument that this connection exists (which is supported by a number of ATO private rulings<sup>27</sup> that are consistent with biodiversity credits being active assets, by meeting the alternative test for intangibles).

Extract from PBR 1051976577326

"It must be demonstrated that, under paragraph 152-40(1)(b) of the ITAA 1997, the credits, as an intangible asset, are inherently connected with the farming business that is carried on (whether alone or in partnership) by you, your affiliate, or another entity that is connected with you.

The conservation covenant is a permanent burden on the land, that would also burden the purchaser should the land be sold at a future point in time.

The credits would not be received but for the conservation covenant on the land, which is used in the farming business. The credits are therefore inherently connected with that business and the land it uses to undertake that business. As the land is used in the farming, it is an active asset for the purposes of Section 152-40 of the ITAA 1997.

As a result, the credits will be active assets under paragraph 152-40(1)(b) of the ITAA 1997 for the purpose of the small business CGT concessions."

Further, the Commissioner has not claimed that biodiversity credits would fail the active asset requirement as financial instruments.

However, if the biodiversity credits are held for a period of time and the conservation covenant does not permit the business activities on that portion of land (particularly where the covenanted land represents a not insignificant portion of the land title in question), issues may arise with meeting the active asset test in the future.

### Could the biodiversity credits be revenue?

The assumption thus far is that the creation of the credits and ownership of the property were all on capital account.

Should the property have been acquired to enter into a scheme to acquire the credits for sale (for example), then potentially s 6-5 ITAA97 applies, whether that is from carrying on a business<sup>28</sup> or profit from isolated transactions.<sup>29</sup> As the credits are a tradeable asset and can be readily convertible to cash, ss 21 and 21A of the *Income Tax Assessment Act 1936* (Cth) would apply.

Section 118-20 ITAA97 would also apply to reduce any capital gain under CGT event D4 or A1 to the extent that it has been included as income under s 6-5.

### Other payments under the agreement

Biodiversity stewardship payments made from the BCT are generally for the performance of services (being the conservation and management actions agreed to under the BSA) and would normally be ordinary income of the landowner.<sup>30</sup> Any expenses incurred in performing those services would generally be deductible under s 8-1 ITAA97.

GST applies to these payments as they do for the sale of the credits.

### Beyond CGT events D4 and A1

The direct taxation of a biodiversity scheme is not the only relevant consideration. The authors have seen in practice a number of tax and non-tax issues arise that require examination and discussion with landowners before they sign on the dotted line. Some of these issues are:

- If the biodiversity credits are not sold at the time of (or immediately after) entering into the BSA, or are partially sold, how does this impact the landowner? Payments will not commence from the TFD until it reaches 80%, and in the meantime, what benefit is the landowner actually getting from having signed the BSA?  
Further, in the event that a contract is signed to sell X number of credits now and Y number in the future, the contract structure may actually mean that 100% of the capital gain on the credits is crystallised "today", but the landowner is not getting the cash for the sale until a number of months, or even years, down the track. This can mean a big out-of-pocket cost to the landowner to cover tax bills before they receive that cash.
- How will entering into the BSA impact future use and taxation of the land? What is its current use, and will this have an impact on carrying on the existing activities? Will this impact the future sale value and/or future saleability (conservation covenants on land can be a deal-breaker for many buyers), and how might restriction on land use impact future ability to satisfy the "active asset test" for the purposes of the Div 152 concessions etc?
- How will entering into a BSA impact succession planning and the passing of the property to the next generation? Is that next generation willing and capable of taking on those conservation activities and obligations?
- Could the activity be considered ordinary income from an isolated profit-making venture (not CGT)?

- Who is actually the landowner, and what are the specific considerations for that legal structure? For example:
  - partnerships are a very common farming business structure, but the land is generally not owned by the partnership; and
  - property ownership by a self-managed superannuation fund (SMSF) is also very common: how does a BSA impact cashflow for pensions if the property is leased and that is a key revenue source for the SMSF; how does the holding of credits and/or maintenance of the land under the BSA once the credits are sold impact the sole purpose test (especially if lease payments reduce due to reduced useability of the land); is the SMSF in accumulation phase and therefore consideration is required for additional concessional tax treatment on particular types of income, including that sourced from conservation activities?
- Who will practically undertake the required conservation activities, and is this realistic given the age, capacity, time etc of the landowner or relevant party/ies?
- Landowners selling biodiversity credits are expected to register for GST where the credit sales tip the landowner over the \$75,000 threshold. What does this mean for other activities that the landowner may have underway, such as leasing other land to a related party as part of the family group structure etc?
- The consequences for breaching a BSA can be severe. The relevant law<sup>31</sup> provides for various outcomes, from cancelling the biodiversity credits and/or the BSA itself and/or remediation orders, through to civil/criminal proceedings in extreme cases.
- A BSA cannot be easily terminated. Section 5.10 of *Biodiversity Conservation Act 2016* (NSW) states that it “has effect in perpetuity, unless it is terminated by the Minister either in agreement with the owners, or by the Minister without owner consent and in accordance with certain conditions in the Act”. Voluntary termination is possible but within strict time periods (and noting that the template BSA itself states that, by signing a BSA, the landowner waives any right to voluntary termination of the agreement<sup>32</sup>).
- On a positive note, an additional land tax concession exists in many states for land under a conservation covenant. For farming land, this may not make much difference as there are generally land tax exemptions for primary production land. However, for non-primary production land this would certainly be of benefit.

## Case study

It should be noted that, while this case study is based on a real-world scenario, all details have been changed to protect the privacy of the relevant parties. Further, GST and Div 152 have not been specifically commented on here.

### Case study 1: the Newmans

Alex and Jemma Newman, both in their mid-40s, jointly own 700 hectares in NSW on which they operate a beef cattle

business. This property was purchased 12 years ago for \$950,000 and is now worth \$2,450,000.

Alex and Jemma start discussions with the BCT about entering into a BSA over 300 hectares of their property (42.8% of the property). Assessments and negotiations come back with the following figures:

- the following credits would be issued: 700 PCT-26, 180 PCT-55 and 25 PCT-244; and
- passive management would involve ensuring that cattle do not graze or otherwise impede or impact the 300 hectares under the covenant, and no significant landscape changes occur during the passive management period. Once the active management period starts, new fencing is required to be installed along with various other actions, such as spraying and planting new trees; and
- the TFD will be \$1,650,000.

A valuer advises Alex and Jemma that their property value will likely drop approximately 18% to \$2,000,000 as such a significant portion of the land will be permanently covenanted, ie an opportunity cost of \$450,000 as a result of entering the conservation covenant.

The Newmans sign the BSA on 1 July 2024.

About six months later, the mining company Castle Mining (CM) approaches the Newmans. CM has a staged mining project underway and wants to lock the Newmans into selling all of their biodiversity credits to CM, but CM doesn't want to actually have to pay for the credits until they progress to each stage and can use the credits at that time. As such, CM proposes the following to the Newmans:

- sign a contract agreeing to the purchase of 100% of the biodiversity credits by CM;
- the first tranche of credits will be 14% of the total credits available for \$550,000. This will be paid (and the credit transfer form lodged) within 30 days of the contract being signed (expected to be sometime in January 2025);
- the second tranche will be in July 2026, for a further 52% of credits for \$2,230,000; and
- the third and final tranche will be in July 2027 for the final 34% of credits for \$1,490,000.

Alex and Jemma are keen conservationists and they figure the overall benefit to them of the credit sale proceeds less the TFD (which they will get back over time anyway) means significant cash in their pocket – to the tune of \$2,620,000 over the two-year period, less a little bit of tax, right? They sign the CM contract on 31 January 2025.

They book a meeting with their tax adviser to talk it all through.

**The first CGT event.** Entering into the BSA immediately triggers CGT event D4, ie on 1 July 2024 when the BSA was signed.

Given the Newman's had not at that time contemplated immediate sale of the credits and had not entered into any discussions or agreements in this respect, they must

determine the value of the credits at the time of the BSA being entered into. Using a “costing method”, they therefore calculate the price of the credits and thus the proceeds for CGT event D4 as follows:

Element 1	Preliminary advice	\$5,000	
	Site assessment fees		<i>Covered by CM</i>
	Expected adviser fees (tax, solicitor)	\$15,000	
Element 2	Management costs of stewardship site (taken to be equivalent to the TFD)	\$1,650,000	
Element 3	Opportunity or land costs (taken to be equivalent to the value loss of the land)	\$450,000	
Element 4	Profit/risk calculation discount (suggested to be between 5% and 25%)		<i>Chosen not to be included by the Newmans</i>
<b>Proceeds for CGT event D4</b>		<b>\$2,120,000</b>	

The cost base of the land is that part of the cost base that is attributed to the covenant:

Cost base of the land (full value)	\$950,000
× (capital proceeds from entering the covenant/(those capital proceeds + market value of land after entering covenant))	$(\$2,120,000/(\$2,120,000 + \$2,000,000))$
<b>Cost base for CGT event D4</b>	<b>\$488,836</b>

The capital gain for CGT event D4 is therefore:

Proceeds	\$2,120,000
Less: cost base	(\$488,836)
<b>Prima facie CGT event D4 capital gain</b>	<b>\$1,631,165</b>
Less: CGT 50% general discount	(\$815,583)
<b>Post-discount CGT event D4 capital gain</b>	<b>\$815,583</b>

Tax on this at the highest marginal rate is approximately \$383,324.

As the BSA was signed on 1 July 2024, this is the CGT event date and this tax liability will be due and payable by Alex and Gemma in May 2026 on lodgment of their FY25 tax returns.

**The second CGT event.** Signing of the credit sale contract with CM on 31 January 2025 triggers CGT event A1 on the sale of the biodiversity credits.

In reviewing the signed CM contract, it is determined that 100% of the biodiversity credits are taken into account for CGT event A1 on “day 1” (being 31 January 2025). The “staged” acquisition of the credits is effectively just deferred settlement dates.

The total value of the contract with CM is \$4,270,000, which is therefore the CGT event A1 proceeds. The cost base is the proceeds figure from CGT event D4, ie \$2,120,000 plus the value of the TFD.

The CGT event A1 capital gain is therefore:

Proceeds	\$4,270,000
Less: cost base (\$2,120,000 + \$1,650,000)	(\$3,770,000)
<b>Prima facie CGT event A1 capital gain</b>	<b>\$500,000</b>
Less: CGT 50% general discount	N/A
<b>Post-discount CGT event D4 capital gain</b>	<b>\$500,000</b>

As the credits were acquired by Alex and Gemma on 1 July 2024 and then sold on 31 January 2025, they do not satisfy the 12-month holding requirement to apply the 50% general discount. Tax on this at the highest marginal rate is approximately \$235,000.

As this contract was signed on 31 January 2025, this is the CGT event date and this tax liability will be due and payable by Alex and Gemma in May 2026 on lodgment of their FY25 tax returns (in addition to the BSA CGT event D4 liability).

Overall, this means a tax bill in May 2026 of around \$618,324.

**Cashflow.** Alex and Gemma intended to deposit only the minimum necessary amount into the TFD, expecting that this would mean they would receive a portion of cash on each transfer of credits to CM. However, as they have actually sold 100% of their credits in the CM contract signed on 31 January 2025 (irrespective of only 14% actually being transferred to CM at that time), this means that 100% of all cash proceeds must go into the TFD until it reaches its balance, which will be in July 2026.

Consequently, Alex and Gemma are not entitled to receive any cash from CM into their own bank account until the July 2026 tranche. However, the CGT liability of \$618,324 is due to the ATO in May 2026. This means that Alex and Gemma will need to somehow fund the tax liability and carry that until the first cash lands in their pocket in July 2026.

### Case study 2: immediate sale of credits by the Newmans

If CM approached the Newmans prior to the BSA being signed and the CM contract was signed the same day as the BSA, how does this change the CGT outcome?

As the value of the credits would quite clearly be known at the time of signing the BSA and triggering CGT event D4, ie being per the \$4,270,000 in the CM contract, this is the figure used for the CGT event D4 proceeds and cost base calculations.

Consequently, the cost base of CGT event D4 is calculated as being:

Cost base of land (full value)	\$950,000
× (capital proceeds from entering the covenant/(those capital proceeds + market value of land after entering covenant))	$(\$4,270,000/(\$4,270,000 + \$2,000,000))$
Add: other associated costs (professional fees etc)	\$20,000
<b>Cost base for CGT event D4</b>	<b>\$666,970</b>

The capital gain for CGT event D4 is therefore:

Proceeds	\$4,270,000
Less: cost base	(\$666,970)
<b>Prima facie CGT event D4 capital gain (before the general discount)</b>	<b>\$3,603,030</b>

As the Newmans are triggering CGT event A1 at the same time (due to the sale of the credits), the capital gain for CGT event A1 is therefore:

Proceeds	\$4,270,000
Less: cost base (\$4,270,000 + \$1,650,000)	(\$5,920,000)
<b>Prima facie CGT event A1 capital loss</b>	<b>(\$1,650,000)</b>

This means that the net capital gain position for FY25 is \$1,953,030. Reducing this amount by the CGT general 50% discount results in a taxable net capital gain of \$976,515, and a tax liability of \$458,962 due in May 2026. Similar to case study 1, this is a liability that the Newmans need to pay prior to the receipt of any cash directly into their bank account.

**Case study 3: change of inclusion of TFD in CGT calculation**

While the ATO’s view is clearly that the TFD is recognised in the CGT event A1 calculation (the conflicting guidance from the ATO is in regard to whether the TFD reduces the CGT event A1 proceeds or increases the CGT event A1 cost base), it is an interesting theoretical exercise to consider the impact on the overall CGT outcome if the TFD is taken into account in the CGT event D4 calculation. Ultimately, the obligation to pay into the TFD initially arises when the BSA is signed, and therefore it could be arguable that the TFD should be taken into account in the cost of the credits on the credits being issued (ie the signing of the BSA), rather than “held over” until the credits are sold and CGT event A1 event is triggered.

The below takes the facts from case study 2 and “relocates” the TFD from CGT event A1 to instead reduce the proceeds of CGT event D4.

The cost base of CGT event D4 is therefore calculated as being:

Cost base of land (full value)	\$950,000
× ((capital proceeds from entering the covenant – TFD)/(those capital proceeds + market value of land after entering covenant))	(\$2,620,000/(\$2,620,000 + \$2,000,000))
Add: other associated costs (professional fees etc)	\$20,000
<b>Cost base for CGT event D4</b>	<b>\$558,745</b>

The capital gain for CGT event D4 is therefore:

Proceeds including TFD (ie \$4,270,000 – \$1,650,000)	\$2,620,000
Less: cost base	(\$558,745)
<b>Prima facie CGT event D4 capital gain (before the general discount)</b>	<b>\$2,061,255</b>
Less: CGT 50% general discount	(\$1,030,628)
<b>Post-discount CGT event D4 capital gain</b>	<b>\$1,030,628</b>

The CGT event A1 capital gain is therefore:

Proceeds	\$4,270,000
Less: cost base	(\$2,620,000)
<b>Prima facie CGT event A1 capital gain (no general discount)</b>	<b>\$1,650,000</b>

This means that the net capital gain position for FY25 is \$2,680,628. This results in a tax liability of \$1,259,895 due in May 2026.

**Table 1. Summary of case study calculations and tax outcomes**

	Case study 1 (costing method for pricing credits)	Case study 2 (market value for pricing credits)	Case study 3 (market value for pricing credits, TFD reduces CGT event D4 proceeds)
CGT event D4 proceeds	\$2,120,000	\$4,720,000	\$2,620,000
CGT event D4 cost base	(\$488,836)	(\$666,970)	(\$558,745)
<b>CGT event D4 gain (pre-discount)/(loss)</b>	<b>\$1,631,165</b>	<b>\$3,603,030</b>	<b>\$2,061,255</b>
CGT event A1 proceeds	\$4,270,000	\$4,270,000	\$4,270,000
CGT event A1 cost base	(\$3,770,000)	(\$5,920,000)	(\$2,620,000)
<b>CGT event A1 gain (non-discountable)/(loss)</b>	<b>\$500,000</b>	<b>(\$1,650,000)</b>	<b>\$1,650,000</b>
Net capital gain (post-discount)	\$1,315,583	\$976,515	\$2,680,628
<b>Tax liability</b>	<b>\$618,324</b>	<b>\$458,962</b>	<b>\$1,259,895</b>

## Comparison of case study outcomes

Clearly, as shown in Table 1, there can be a significant impact on the CGT calculation and resulting tax liability outcome for the landowner depending on the facts of the scenario and the resulting methodology employed for the CGT calculation.

As noted above, case study 3 is purely a theoretical exercise and does not reflect an ATO-accepted CGT calculation methodology for these circumstances.

## Food for thought

**Land value and opportunity cost.** The following highlights the complexities of the CGT calculations for BSAs, specifically in regard to the CGT event D4 calculation.

It has been suggested by some industry participants that land may actually go up in value in some circumstances as a result of entering into the covenant. As a result, the CGT event D4 cost base could drop, potentially significantly, if the value of the land goes up, not down (ie in case study 1, \$450,000 is removed from the denominator in the CGT event D4 cost base calculation, which results in a decreased cost base and increasing the overall CGT event D4 capital gain). If using the costing method of pricing credits (the CGT event D4 proceeds), the associated opportunity cost of entering the BSA (being the drop in land value) is now \$nil, and the CGT event D4 proceeds number would decrease.

While this would appear to be a good thing (the CGT event D4 capital gain may be lower), it also means that the cost base of CGT event A1 (being the CGT event D4 proceeds) is consequently lower and, pending the timing of that CGT event A1 (being the sale of the biodiversity credits), could effectively mean that the capital gain is “shifted” from being a discountable CGT event D4 gain that may be eligible for the small business CGT concessions, to being a non-discountable CGT event A1 gain which is ineligible for concessions.

However, it is equally arguable that the movement in the market value of the land is not the only possible approach for determining the opportunity cost. An alternative method for determining opportunity cost could be the value per hectare that has been “given up” as a result of entering the BSA (ie the value per hectare of land that can no longer be used for original purposes). While the cost base for CGT event D4 is prescribed as needing to include the post-covenant market value, if using the costing method for pricing the credits, the opportunity cost that could be included in the credit pricing may instead be worked out on this value per hectare approach. Consequently, an opportunity cost could be recognised in the CGT event D4 proceeds, even in a scenario where the post-covenant land value has increased.

**Change in credit sale contract structure.** Let’s consider a scenario where the CM offer did not seek to lock in 100% of the biodiversity credits upfront due to the mining industry’s volatility and the uncertainty on the project’s progression. As such, CM proposes a first contract executed “now” for the first 14% of credits, and then an option contract is entered into for each of the second and third tranches.

This would mean that the tax liability for the Newmans would align with the sale of biodiversity credits: instead of a single CGT event A1 “today”, there will be several CGT event A1 events across the next two years.<sup>33</sup> This change in approach may also have an impact on the applicability of the 50% general CGT discount if the credits have been owned for more than 12 months by the time an option is exercised.

Of course, there are wider considerations when contemplating multiple contracts. Are they truly separate contracts? How much certainty do each of the parties require – is a put/call option the appropriate approach, or is a call option contract in CM’s favour sufficient for all of the parties? What are the conditions being placed into the agreements – when can one be exercised, and when does each option expire? How do the agreements interact with each other? What happens if the actual quantity of credits needs to be brought forward to be purchased earlier, does the subsequent option allow for that flexibility? Do the agreements allow for variation in purchase price given the markets will undoubtedly move across that time period – or do the parties want to lock in a price now? What happens if the landowner dies before all contracts are exercised and completed?

And of course, as with any contractual arrangement that a tax adviser looks at for a client, we must be asking: is there reasonable basis in the “real world” – commercial, practical – or is someone simply chasing a tax outcome?

## Conclusion

Alternative land use arrangements and agreements can generate significant income for landowners and, as Australian businesses and government bodies have an increasing focus on the environment and how it is distilled into marketable property in all of its forms, we will continue to see landowners seeking to understand the opportunity and costs in these agreements. While the personal reasons for entering into these agreements can significantly vary (eg revenue generation, philanthropic goals), landowners must take care to ensure that they understand the immediate practical and tax implications, as well as the less direct and longer-term consequences, in order to have visibility over the true benefits and cost of entering into one of these arrangements.

**Courtney van Zyl, FTI**  
Associate Partner (Tax Advisory)  
Findex

**David Hall, CTA**  
Partner (Tax Advisory)  
Findex

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- 10 See the note in s 104-47(6).
- 11 S 104-35(3) ITAA97.
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- 14 See the Nature Repair Bill 2023 (Cth) and the Nature Repair (Consequential Amendments) Bill 2023 (Cth).
- 15 Biobanking agreements were established in accordance with the *Threatened Species Conservation Act 1995* (NSW). This was repealed in February 2018 and replaced with the *Biodiversity Conservation Act 2016* (NSW) which governs the current Biodiversity Offsets Scheme. Biobanking agreements that were in place prior to February 2018 are still operational today under grandfathering rules.
- 16 S 6.21(3) of the *Biodiversity Conservation Act 2016*: "If an application for registration of a first transfer is made in respect of a number of biodiversity credits that is less than the number of biodiversity credits created in respect of the biodiversity stewardship site, the amount payable into the Fund [the TFD] before that transfer is registered is (subject to this section) the relevant proportion of the total Fund deposit for the biodiversity stewardship site, or the proceeds of sale of the biodiversity credits, whichever amount is the greater."
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- 33 Noting of course that consideration would be required of CGT events arising as a result of entering into, and the subsequent exercise or lapsing of, an option contract.





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# Superannuation

by Daniel Butler, CTA, DBA Lawyers

## Division 296: revised \$3m+ super tax

This month's article focuses on the revised Div 296 tax that applies to members with greater than \$3 million in superannuation funds from 1 July 2026.

The Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2025 was released on 19 December 2025 for members with superannuation balances over \$3 million. The closing date for feedback on the revised exposure draft legislation was 16 January 2026 and The Tax Institute made a comprehensive submission on the revised provisions.

The revised provisions include substantive changes and policy shifts that requires a careful review to understand how they will apply to superannuation fund members, especially those with self-managed superannuation funds (SMSFs).

The draft provisions provide the legislative framework for raising the new tax and rely heavily on regulations that are yet to issue. The start date is still planned to take effect from 1 July 2026.

### Key (revised) criteria for the new Div 296 tax

Broadly, for SMSFs beyond the first, transitional, year of 2026-27, the revised Div 296 tax is designed with the following features:

- an additional 15% tax will apply reflective of the proportion of the member's total superannuation balance (TSB) that exceeds \$3 million;
- an additional 10% tax will apply reflective of the proportion of the member's total superannuation balance that exceeds \$10 million;
- for members with a TSB of more than \$3 million but less than \$10 million, this can result in a total overall nominal rate of 30% on a member's taxable superannuation earnings (TSE), ie 15% income tax to the fund trustee and 15% Div 296 tax on the proportion of TSE above \$3 million payable by the member;
- for members with a TSB of with more than \$10 million, this can result in a total overall nominal rate of 40% on a member's TSE, ie 15% income tax to the fund trustee, 15% Div 296 tax on the proportion of TSE above

\$3 million payable by the member, and 10% Div 296 tax on the proportion of TSE above \$10 million also payable by the member;

- a member can access money from their superannuation fund to pay the Div 296 tax via a release authority that will be provided by the ATO with each Div 296 assessment. Alternatively, the member can pay the tax from their own resources;
- the \$3 million and \$10 million thresholds will be based on the greater of the member's TSB at the start, or at the end, of the financial year (FY). These thresholds will also be indexed by the consumer price index in increments of \$150,000 for the \$3 million threshold and \$500,000 for the \$10 million threshold;
- the ATO will notify trustees when they have "in-scope" members who are likely to have a Div 296 liability and the fund will report attributable TSE;
- a member's "relevant superannuation earnings" for a "superannuation interest" is the amount attributable to the interest of the "Division 296 fund earnings";
- a member's total superannuation earnings must be added up having regard to the relevant superannuation earnings from each superannuation interest maintained in each superannuation fund, eg an SMSF member may have an interest in a large APRA fund, a retirement savings account and an SMSF, and the attributable earnings for that member from each fund need to be aggregated by the ATO;
- the Div 296 fund earnings under the revised provisions are based on a taxable income methodology for each fund and they are broadly calculated as follows:
  - start with the amount of the fund's relevant taxable income for the FY (or loss);
  - deduct assessable contributions;
  - add back net exempt current pension income (broadly, exempt pension income less deductions under s 8-1 of the *Income Tax Assessment Act 1997* (Cth)); and
  - deduct any non-arm's length income;
- for SMSFs, it is proposed that regulations will issue requiring an actuarial certificate each FY confirming the attributable TSE for each in-scope member based on a proportionate approach, time-weighted where a member is only a member for part of a FY, in a similar manner to how exempt current pension income is currently calculated. As an integrity measure applicable for SMSFs, the regulations will not allow for specific investment portfolios or asset segregation and will reflect a proportionate share. The additional guidance on the proposed regulations for the better targeted superannuation concessions included the following formula:

$$\text{Share of Div 296 fund earnings} = \frac{\text{Average value of the superannuation interest}}{\text{Average value of the total superannuation interests}}$$

- a member's TSE is the amount of their total superannuation earnings multiplied by the relevant proportion that the member's TSB exceeds the \$3 million threshold; and
- for members with more than \$10 million TSB, a similar formula applies in respect of calculating a member's "very large superannuation balance component" based on the member's total superannuation earnings multiplied by the relevant proportion that the member's TSB exceeds the \$10 million threshold.

## Transitional arrangements

There are three key transitional arrangements that apply.

### 2026–27 FY relies on 30 June 2027 TSB

For the 2026–27 FY, the member's TSB is counted at the end of the FY on 30 June 2027. Thus, if a member's TSB exceeds the relevant \$3 million or \$10 million threshold on 30 June 2027 and they have attributable TSE, they will be subject to Div 296 for the 2026–27 FY. As discussed above, after the transitional 2026–27 year, the TSB will be assessed as the greater of the member's TSB at the start, or at the end, of the FY. Thus, members may choose to withdraw money or assets from superannuation prior to 30 June 2027 to seek to fall below the relevant threshold. However, after the transitional year, if the starting balance exceeds the relevant threshold, a subsequent withdrawal may not assist.

### Adjustment of cost base of assets held at 30 June 2026

As the Div 296 tax is to apply from 1 July 2026 and reflects a taxable income methodology where only realised capital gains are taxed, a CGT adjustment is available where a fund can choose to adjust all CGT assets that are held by the fund as at 30 June 2026 to market value to broadly lock out any unrealised gains accrued on those assets prior to 1 July 2026. This adjustment differs from prior CGT resets such as the reset allowed in mid-2017 for transfer balance purposes where an asset-by-asset reset was available. One major issue with the adjustment to all CGT assets being adjusted, rather than an asset-by-asset choice, is that assets with capital losses will be reset with a lower cost base.

### A new death tax?

If an individual dies before the last day of the 2026–27 income year, they are not liable to pay Div 296 tax for that year (see new s 296-1(3) of the *Income Tax (Transitional Provisions) Act 1997* (Cth) (inserted by item 25 of Sch 1 to the proposed Bill)). In contrast, s 296-30 of the prior draft (now defunct) Div 296 legislation stated in s 296-30: "exception – death that you are not liable to pay Div 296 tax for an income year if you die before the last day of the year." Thus, moving forward, the revised Div 296 will be a new form of death tax given that, when a person dies, their legal personal representative (LPR) remains liable for their tax and other liabilities.

This is a big change because, under the prior draft legislation, if you died before any 30 June in the future, you would get out of any future Div 296 tax (but not your other tax liabilities). It was quite straightforward – as long as you died before 30 June. However, under the revised provisions, you will only be released from any future Div 296 tax for the 2026–27 year.

## Other changes impacting a person's death or succession

The revised provisions will also have the effect of accelerating the time that Div 296 tax will be paid by a surviving spouse, given the surviving spouse will be tested based on their higher TSB at the start, or the end, of the FY. However, for the 2026–27 FY, the \$3 million and \$10 million thresholds will be measured at the end of the financial year.

For example, if dad dies on 1 January 2028 with an automatically reversionary pension in favour of mum, and each has \$2 million in superannuation, mum will be assessed to Div 296 tax in respect of the 2027–28 FY as she will have more than \$3 million at the end of that FY, provided she also derives some total superannuation earnings in respect of her interests which includes the reversionary pension transferring to her on dad's death.

Under the prior draft legislation, s 296-55(1)(d) provided:

"(d) subject to subsection (3), the total superannuation balance value, on a day during the year on which you start to be a retirement phase recipient of a superannuation income stream because of the death of another person, of the superannuation interest in a superannuation plan that supports the superannuation income stream;"

Broadly, this resulted in the TSB value of dad's automatically reversionary pension not being counted in mum's adjusted TSB at the end of the year during the FY that dad died. Rather, it was treated as a contribution which was subtracted from the TSB figure when calculating superannuation earnings under the prior draft legislation.

The pension balance from dad's reversionary pension would, however, be counted in mum's TSB in the following FY assuming that no withdrawal was made prior to the start of the next FY under the prior draft legislation. Moreover, s 296-50(1)(b) of the new draft legislation also confirms the fact that a person's total superannuation earnings include earnings in relation to an automatically reversionary pension.

Section 296-50 states:

- "(1) The amount of your *total superannuation earnings* for an income year is the total of your relevant superannuation earnings for the year for:
- each superannuation interest of yours that you have at any time in the year; and
  - each superannuation interest that supports a superannuation income stream of which you are a retirement phase recipient at any time in the year because of the death of another person."

Thus, the calculation of superannuation earnings will become more complicated as there will be a need to calculate the earnings of the two interests and pro-rate those earnings for the time period that the reversionary pension was paid to mum for that FY.

This will give rise to a member considering whether they should change their pension nominations so that they no longer revert to their surviving spouse. Moreover, the revised provisions will also encourage members with legacy pensions to consider whether they can exit such pensions.

The revised provisions can also render a member liable for Div 296 tax for a number of years after they die as the payment of a death benefit may be delayed due to a legal dispute or difficulty in realising assets. In this instance, the deceased's LPR will be liable for the Div 296 without necessarily being able to access any money from the superannuation fund to pay the tax.

This could give rise to considerable hardship where a deceased member's LPR cannot access the superannuation money to pay the Div 296 tax as the superannuation fund trustee is in a dispute with the beneficiaries claiming the death benefit.

## Conclusion

We await the revised draft legislation to issue and the supporting regulations. The government is keen on passing this legislation as soon as possible given the proposed start date for the Div 296 tax was originally 1 July 2025, which, due to the backlash against the prior legislation (especially with taxing unrealised gains and with no indexation of the \$3 million threshold), has been deferred to 1 July 2026.

Until the legislation and regulations are finalised, we need to be careful and issue a disclaimer that the law is yet to be finalised.

**Daniel Butler, CTA**  
Director  
DBA Lawyers

## Events Calendar

## Upcoming months

FEBRUARY

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MARCH

**12–13**

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WA

## WA Tax Forum



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MARCH

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## VIC Tax Forum



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## National Office

CEO: Scott Treatt, CTA

Level 21, 60 Margaret Street

Sydney, NSW 2000

T 1300 829 338

E [tti@taxinstitute.com.au](mailto:tti@taxinstitute.com.au)

## State Offices

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Chair: Alison Stevenson, CTA

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Level 21, 60 Margaret Street

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T 02 8223 0000

E [nsw@taxinstitute.com.au](mailto:nsw@taxinstitute.com.au)

### Victoria

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Level 3, 530 Collins Street

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T 03 9603 2000

E [vic@taxinstitute.com.au](mailto:vic@taxinstitute.com.au)

### Queensland

Chair: Kim Reynolds, CTA

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310 Edward Street

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T 07 3225 5200

E [qld@taxinstitute.com.au](mailto:qld@taxinstitute.com.au)

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152 St Georges Terrace

Perth, WA 6000

T 08 6165 6600

E [wa@taxinstitute.com.au](mailto:wa@taxinstitute.com.au)

### South Australia and Northern Territory

Chair: George Hodson, CTA

75-77 Dale Street

Port Adelaide, SA 5015

T 1300 829 338

E [sa@taxinstitute.com.au](mailto:sa@taxinstitute.com.au)

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E [tas@taxinstitute.com.au](mailto:tas@taxinstitute.com.au)

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