

# Taxation

*in Australia*

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Victor Nguyen*

Surrender of life interest and  
the CGT main residence  
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Imposing administrative  
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## Invitation to write



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

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

## Tax News – at a glance

by TaxCounsel Pty Ltd

# February – what happened in tax?

The following points highlight important federal tax developments that occurred during February 2021. A selection of the developments is considered in more detail in the “Tax News – the details” column on page 394 (at the item number indicated).

### Goods taken from stock: value

The Commissioner has issued a determination that provides an update of amounts that he will accept as estimates of the value of goods taken from trading stock for private use by taxpayers in named industries in the 2020-21 income year (TD 2021/1). **See item 1.**

### Hybrid securities: market value substitution rule

The Commissioner has issued a practical compliance guideline in relation to the application of the market value substitution rules when there is a buy-back or redemption of hybrid securities (PCG 2021/1). **See item 2.**

### Commissioner’s information notice

The Federal Court (Moshinsky J) has dismissed an application for judicial review of a decision of the Commissioner to issue a notice dated 4 March 2020 pursuant to the information-gathering powers conferred on him by the *Taxation Administration Act 1953* (Cth) (and, in particular, by s 353-10 of Sch 1 to that Act), requiring the provision of certain information by the applicant (*CUB Australia Holding Pty Ltd v FCT* [2021] FCA 43). **See item 3.**

### Admission of evidence

The AAT has held that a witness statement of an individual who had died before the hearing of the primary case should, despite the Commissioner’s objections, be admitted into evidence (*Kais and FCT* [2021] AATA 16). **See item 4.**

### Registration cancellation: stay refused

The AAT has refused an application by an individual for a stay of the decision of the Tax Practitioners Board to cancel his registration as a tax agent until his substantive application for the review of the Board’s cancellation decision was determined (*McGuid and Tax Practitioners Board* [2021] AATA 64). **See item 5.**

### Appealing? Keep it simple

In a recent decision in which the Federal Court dismissed an appeal from a decision of the AAT in a case involving issues arising out of the R&D tax incentive scheme, Stewart J noted that the appellant, in its notice of appeal, identified 38 independent errors of law said to have been made by the tribunal in its 69-paragraph decision (*H2O Exchange Pty Ltd v Innovation and Science Australia* [2021] FCA 11). **See item 6.**



## President's Report

by Peter Godber, CTA

# 2021 – a year to be a leader for the tax profession

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### The Institute sets the pace for tax advocacy and education.

In last month's column, I anticipated that this year would be off to a very busy start for The Tax Institute, and that has proven to be the case. As activities build, it is clear that 2021 will be an important year for us across our key business pillars of delivering knowledge and education, promoting policy and advocacy, and offering wider and extensive member support.

The tax profession is being challenged on many fronts. As a body, The Tax Institute is well placed to represent our members' views and to continue to take an active role in our professional future. We need to address evolving issues in tax practice. This includes the emerging intensity around the regulation of tax professionals. It also requires us to break down the uncertainties that we face in Australia's tax law and its administration.

In February, we concluded a number of significant submissions led by our Tax Policy and Advocacy team that relate to matters of technical concern to many members, including a submission to the Board of Taxation on its consultation document for the review of CGT rollover provisions. Our recent submissions have been on important practical topics and were very detailed and well thought through.

Our significant work, *The Case for Change* paper, will soon be finalised. As noted by Giles in this month's CEO's Report, all members will have access to this work and hopefully it will inspire further member thought and discussion.

Successfully completing The Tax Summit: Project Reform was a big achievement for us. The wide, varied and enthusiastic input we received exceeded all of our expectations and forms the basis of *The Case for Change*.

This volume and depth of insight means that documenting our outputs has been extremely energy- and time-consuming. However, we have now produced a document that I think represents a substantive step forward

in Australia's tax reform debate. Well done to everyone who contributed to our final work. We will endeavour to keep the issues it raises on the policy agenda, and we will use our forums and events to keep the issues it addresses front of mind for practitioners, thought leaders and regulators.

Tax reform is crucial to the future of our profession and our economy. The Tax Institute is committed to providing ongoing and much-needed leadership in this space.

### Review of the Tax Practitioners Board: response

We have now had time to better reflect on the report of the review of the Tax Practitioners Board (TPB) and the government's response to it.

Many of the 28 recommendations are generating debate, and that is not surprising given the call that has been made by Treasury for significant further consultation on many aspects. There is a lot of interaction among the recommendations, but it will be important to prioritise them so that action can be taken by Treasury to implement those that are less controversial. Some recommendations (like supporting the independence of the TPB) will be widely supported and should be implemented without fanfare. Others that concern the regulation of tax agents, and their qualification and education requirements, will attract greater debate.

One recommendation that should get high priority is an aspect of recommendation 3.3, which includes the creation of a Tax Practitioner Governance and Standards Forum (TPGSF) and a Charter of Tax Practitioner Governance. The TPGSF will be an important forum for professional associations to provide input on critical professional governance issues and hopefully it will come into existence this year. Professional associations, including ours, are ready to provide input into pressing issues. The Tax Institute will continue to play an important role in advocating for the needs of our members and the profession at large.

Treasury will set out its consultation processes. Our concern is in ensuring that there is sufficient and timely consultation on the issues that affect tax agents, our members, and the conduct of their practices. Matters associated with the TPB review agenda will be given a high priority at The Tax Institute, and we will be appropriately reaching out for member input and collaboration on matters of concern.

I refer back to Giles' CEO's Report for March and the emphasis we have on expanding our reach in advocacy and education. These activities, together with the way we are engaging in some of the critical changes for the tax profession mentioned above, underpin the significant influence I hope we will have in 2021 when representing and supporting the interests of tax professionals in Australia.





## CEO's Report

by Giles Hurst

# Exciting growth in education and advocacy

## The Institute's newest achievements have grown right from its heart.

At The Tax Institute, our roots go deep. We have been growing for over 75 years now, but our foundation remains the same as it has been for decades — a drive to educate, enlighten and develop the tax profession and the system that it upholds.

As the future rushes ever faster towards us, we are growing from those roots, making changes and adapting to a rapidly changing world. But it is very important that, as we move forward, we do so in ways that stay true to the core of who we are and what we do. That may be our new website, which allows us to better reach our members and spread our message, or it may be our professional development events which have taken on a new, hybrid format tailored to a digital world.

Well, I am happy to report to you that, at the moment, we are growing in two new ways that are at the very heart of The Tax Institute's identity: advocacy for tax reform and expanded tax education.

### Advocating for a better future

It is a busy and important time for all of us at The Tax Institute as we prepare to place *The Case for Change* paper — the result of months of hard work, consultation and analysis through The Tax Summit: Project Reform — on the desks of changemakers around the country.

*The Case for Change*, which sets out our priorities and recommendations for meaningful, long-lasting reform of our tax system, is broad in scope and clear in its aim. We are laying the groundwork for a fairer, more efficient, and more equitable tax system, which will enable Australia's economy to grow.

A digital copy of *The Case for Change* will arrive in your inbox soon. I urge you to dive in and explore the ideas and proposals that have been laid out in it — after all, these are the ideas that will shape the tax system that you work with every day. We

will be continuing our advocacy in this area, working with our contacts at the ATO and Treasury to put forward solutions and develop a long-term vision for our profession.

### Educating tomorrow's leaders

As our President, Peter Godber, touched on in his February President's Report, we are also making changes to our education offering in order to allow our organisation to grow and flourish in a changing world. In 2021, the delivery of education at The Tax Institute will operate as a separate but linked entity named HEPCO, trading as The Tax Institute Higher Education.

What does this mean? It means growth. It means new opportunities for our education candidates — both current and future — and for Institute staff who will be working to offer new opportunities to the tax professionals studying with us.

Practically speaking, this will not change the fact that we are one team, here at the Institute. There should be no disruption to our candidates' learning experience, nor to our staff's positions with us. Rather, it poses an opportunity to develop in new and exciting ways.

I would like to take this opportunity to shine the spotlight on Alexandra Wilson, who you may know as our General Manager — Knowledge and Learning. Alexandra will be heading up The Tax Institute Higher Education as its own entity and will be the driving force behind developing a truly world-class tax education experience here at the Institute.

Alexandra brings extensive experience in developing and managing professional development and education programs to our team and has been responsible for bringing you our current renowned structured education program. She has my full confidence and unwavering support in this new endeavour.

As we embark on a new age for education, I'm excited to share a new type of learning that will soon be available at the Institute. During 2020, we learnt that there is no one-size-fits-all when it comes to the way we work and learn professionally. This year, we are applying that lesson to bring you a new way of learning — micro-credentials.

Micro-credentials offer you the chance to study specific elements of the tax world which are relevant to you, your practice and your career goals. That makes it easier to brush up on skills relevant to your practice, branch out and explore new interests, or build your way towards a formal Chartered Tax Adviser qualification.

You can expect the same technical excellence that the Institute has always offered. But now, it is even more tailored, more time efficient, and further in line with what The Tax Institute really is: the home of tax, where you can access what you need, when you need it.

Our new work grows from the heartwood of the Institute, right from its roots. Though we are changing and growing, our core mission is still to do as much good as we possibly can for tax professionals and our tax system. With so many incredible new developments on the horizon for The Tax Institute, it is safe to say that there is no better time to be a part of our organisation. I look forward to another year and then a long future with you all as we grow to new heights together.



## Tax Counsel's Report

by Angie Ananda, CTA

# Will tax reform be delayed again?

**When the federal Budget for 2021-22 is released, it will be interesting to see whether the government takes a brave stance on reforming the Australian tax system.**

### Tax tinkering or tax reform?

Just over a year ago, I wrote about The Tax Institute's federal Budget submission for 2020-21. In that article, I said that to "achieve a structurally sound Australian tax system, one must cast an honest and critical eye over the current system and decide whether all of the features of the current system should remain or should be removed in favour of new or modern features that better support Australia's economic needs". I went on to say that "certain trade-offs will have to be made between current features of the Australian tax system in order to ensure that a structurally sound tax system is set up for the future".

Within a month of that article being published, the COVID-19 pandemic had begun, and the world changed like no one could have predicted. The focus of the government rightly turned to protecting jobs and businesses to keep the Australian economy going. This involved introducing many temporary tax measures and stimulus packages to assist the economy.

Gradually, these measures and stimulus packages will cease (indeed, some already have) but the effects of the COVID-19 pandemic will be felt for generations to come. Nothing can change that. However, we must attempt to mitigate its effects. Large-scale tax reform is what we need to ensure that we have a tax system that can support the recovery of the Australian economy and the Australian people into the future.

To undertake large-scale tax reform following the events of 2020 will take a brave government with foresight. It is unlikely that anyone would be shocked if there is little more than tinkering with the tax system in the upcoming federal Budget. However, that does not mean that it is the right course of action to protect the future of Australia.

Arguably, constant tinkering with the tax system is why there are so many issues with the current tax system. As The Tax

Institute has put forward in its submissions, the "current tax system reflects decades of successive governments adding new provisions and ideas on top of existing provisions without properly considering the interrelationship between different parts of the law and how they impact economic activities and behaviours. One can often see that the original provision has been so layered with changes that the rule's reason for existence has been lost. This only adds to the confusion of our complex and overburdening laws ...".

Is this the time for government to seize the opportunity and embrace the need for tax reform in an effort to assist economic recovery and protect future generations?

### The Tax Institute calls for reform

The Tax Institute would answer the question posed above with a resounding "yes".

In The Tax Institute's federal Budget submission 2021-22, dated 29 January 2021, we outlined the need for holistic reform. We highlighted the unique opportunity that we have in 2021 to build on the learnings from 2020, to reshape and redefine the Australian tax system.

Our position is that this requires a thorough review and reform of the existing Australian tax system. It is only through a whole of system approach to reforms to the tax system that the government will be able to generate sufficient revenue in the long-term to support public expenditure.

The Tax Institute has undertaken a major project to engage with our members and other stakeholders on key issues in the tax system and to identify pathways for reform. *The case for change* discussion paper will soon be presented to the government.

### Seize the opportunity

Many may argue that, in light of 2020, now is not the time for large-scale tax reform. When is the right time? At the end of 2019 (and before), The Tax Institute was calling for much needed tax reform. In 2020, it was not possible. Arguably, now may be the perfect time to reassess our tax system. It is essential that the tax system can support the recovery, and further growth, of Australia's economy. Tax reform will be critical to achieving these objectives.

The events of 2020, and the fear of what the continuing fallout will be, may well lead to a missed opportunity in relation to tax reform.

Comments from the government have already indicated that GST reform is off the cards. Is this a sign that the federal Budget for 2021-22 will not contain any real tax reform and will continue to tinker at the edges of the system?

The Tax Institute is of the view that there has never been a time when reform was more necessary than it is now. We encourage our members, as representatives of the Australian community, to voice their support and urge the government to be brave and start the process.



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William Calokerinos, CTA  
Barrister



## Tax News – the details

by TaxCounsel Pty Ltd

# February – what happened in tax?

The following points highlight important federal tax developments that occurred during February 2021.

### The Commissioner's perspective

#### 1. Goods taken from stock: value

The Commissioner has issued a determination that provides an update of amounts that he will accept as estimates of the value of goods taken from stock for private use by taxpayers in named industries in the 2020-21 income year (TD 2021/1).

The determination explains that, in the context of self-assessment, each taxpayer should be able to demonstrate that the value attributed to goods taken from stock for private use was fair and reasonable. Taxpayers should always have regard to their own circumstances when determining the appropriate value.

The Commissioner has previously issued “goods own use” amounts for a range of industries in recognition of the fact that, in many cases, it is difficult for accurate records to be kept of transactions involving goods taken from stock for private use. These amounts are estimates of the value of goods taken from stock for private use by taxpayers in named industries.

It is also recognised that greater or lesser values may be appropriate in particular cases. Taxpayers may be able to justify a lower value for goods taken from stock than that shown in the determination. In that case, the lower amount should be used. Where the value of goods ex-stock would be significantly greater, the actual amount should be used.

#### 2. Hybrid securities: market value substitution rule

The Commissioner has issued a practical compliance guideline in relation to the application of the market value substitution rules when there is a buy-back or redemption of hybrid securities (PCG 2021/1).

PCG 2021/1 explains that a common form of security in the market is a hybrid security, which is an instrument that exhibits features of both debt and equity. Some of the more common types of hybrid securities are preference shares and capital notes, with these being particularly common in the banking and finance industry. The terms of such hybrid securities will generally permit (but not require) the issuer of the hybrid security to “repay” investors at a particular time in the future where certain conditions are satisfied. Where the

issuer does not elect to repay the investors at that time, the hybrid securities will usually convert into ordinary shares in the issuer at a determined point in time or continue to remain on issue until another relevant date, with the option to repay or convert.

The actual form of repayment will depend on the legal form of the hybrid security. Where the hybrid security is in the form of a preference share (hybrid share), the issuer may, among other mechanisms, repay the investor through an off-market buy-back of the share or, where the hybrid security is in the form of a note (hybrid note), through redemption of the note. Where this happens, certain market value substitution rules (MVSRs) in Australia's income tax law will require the holder of the hybrid security to determine its market value as a part of the process of determining the capital proceeds from the repayment or redemption.

In this type of fact pattern, MVSRs can apply despite the fact that the hybrid securities are widely held and the issuer is acting at arm's length from the holders. This is of relevance because the capital proceeds that are substituted under the MVSRs may not necessarily be equal to the amount actually received.

The ATO recognises the practical problems faced by investors when determining the market value of a hybrid security for the purposes of calculating capital proceeds from a buy-back or redemption. The guideline provides a practical compliance approach for determining the market value of a hybrid security for CGT purposes when it is bought back or redeemed (as relevant) from an investor holding it on capital account.

PCG 2021/1 does not apply to an acquisition, buy-back or redemption of a hybrid security that is subject to the taxation of financial arrangements provisions under Div 230 of the *Income Tax Assessment Act 1997* (Cth).

### Recent case decisions

#### 3. Commissioner's information notice

The Federal Court (Moshinsky J) has dismissed an application for judicial review of a decision of the Commissioner to issue a notice dated 4 March 2020 pursuant to the information-gathering powers conferred on him by the *Taxation Administration Act 1953* (Cth) (and, in particular, by s 353-10 of Sch 1 to that Act), requiring the provision of certain information by the applicant (the March 2020 notice) (*CUB Australia Holding Pty Ltd v FCT*).

On 30 May 2018, in connection with an audit, the Commissioner issued a notice to the applicant pursuant to s 353-10 of Sch 1 to the *Taxation Administration Act 1953* requiring the production of certain documents (the May 2018 notice). The applicant refused to produce some of the documents covered by this notice on the ground of legal professional privilege. It provided some details regarding these documents but did not provide certain additional details requested by the Commissioner to enable him to assess whether the privilege had been properly claimed. In particular, the applicant refused to provide the titles of the documents (or the subject lines for emails), the names of the persons who authored the documents, and the names of the persons who received the documents.



In that context, the Commissioner issued the 4 March 2020 notice, which required the applicant, for every document responsive to the notice issued on 30 May 2018 that was not wholly produced due to claims for legal professional privilege, to provide:

- a. the title of the document. Where the document is an email, the title of the document means the subject line of the email;
- b. the name of the person who authored the document;
- c. the name of each person to whom the document was communicated; and
- d. where the document is an email, for each person who received the email, whether the email was sent directly to the person or copied to the person."

Following a request for reasons pursuant to s 13 of the *Administrative Decisions (Judicial Review) Act 1977* (Cth), on 17 March 2020, the Commissioner provided a statement of reasons for the decision to issue the March 2020 notice.

The applicant, by originating application for judicial review, sought judicial review of the decision of the Commissioner to issue the March 2020 notice. The originating application contained four grounds. The first three grounds challenged the validity of the March 2020 notice. By these grounds, it was contended that: the notice was not authorised by s 353-10 or was otherwise beyond power; alternatively, that the Commissioner's primary or substantial purpose was an improper purpose; alternatively, that the Commissioner took into account an irrelevant consideration. There was substantial overlap between the three grounds. In relation to all three grounds, the applicant contended that, in issuing the notice, the Commissioner's purpose (or substantial purpose) was to determine the validity of the applicant's legal professional privilege claims. The applicant contended that this was not a proper purpose for the exercise of the power conferred by s 353-10 and, accordingly, the notice was invalid.

The fourth ground in the originating application was quite different. By this ground, the applicant contended that the titles of the relevant documents (being the information sought by para a of the Schedule to the March 2020 notice) were themselves privileged. It followed, the applicant contended, that it was not required to produce that information. The applicant sought a declaration to that effect. In contrast with grounds 1 to 3, ground 4 required a determination to be made, on a case-by-case basis, of whether the titles of the relevant documents were covered by legal professional privilege. It appeared from the applicant's outline of submissions that there were 1,421 documents in issue, if emails in an email chain were counted as a single document. If each email in an email chain was counted as a separate document, there were 4,431 documents in issue.

In light of the above, the parties agreed that it was sensible for grounds 1, 2 and 3 to be tried separately and in advance of ground 4. The judgment of Moshinsky J, therefore, dealt only with grounds 1 to 3 of the originating application.

Moshinsky J held that none of grounds 1, 2 and 3 had been made out. In his Honour's view, the applicant's (factual) contention that, in issuing the March 2020 notice, the Commissioner's primary or substantial purpose was to determine the validity of the applicant's legal professional

privilege claims, was not established. His Honour found that the Commissioner's purpose (or substantial purpose) was to obtain information that he considered necessary to determine whether to accept or challenge the applicant's legal professional privilege claims in respect of the relevant documents. Further, his Honour found that the Commissioner considered that the documents, which were responsive to the May 2018 notice, remained relevant to the statutory functions he was still carrying on. In light of these findings, Moshinsky J concluded that the March 2020 notice was issued for the purpose of the administration of a taxation law.

#### 4. Admission of evidence

The AAT has held that a witness statement of an individual who had died before the hearing of the primary case should, despite the Commissioner's objections, be admitted into evidence (*Kais and FCT*<sup>2</sup>).

The AAT accepted that there was obviously potential for unfair prejudice to the Commissioner in admitting the statement into evidence. The actual prejudice would depend on the weight to be attributed to it. However, there may be similar prejudice to the taxpayers if the statement were to be excluded. It was patently of considerable importance to the taxpayers' prospects of discharging their burden of proving that the assessments were excessive.

Given the direct relevance of the statement to the central issue in the case, and that the deceased was the sole director and shareholder of the taxpayer company at the relevant time such that it was not possible to obtain evidence of the matters to which the deceased deposed from other witnesses, the AAT was not persuaded that the potential prejudice identified by the Commissioner outweighed the probative value of the statement. The Commissioner had not pointed to any significant concrete considerations beyond the inability to cross-examine the deceased to support exclusion of the statement.

Accordingly, the AAT considered that the better course was to admit the statement into evidence. The tribunal could determine the weight, if any, to be given to the statement or parts of the statement with the benefit of counsel's foreshadowed submissions. It was to be expected that those submissions would identify any alleged connections or inconsistencies between the statement and other evidence and any alleged internal inconsistencies or any other relevant factors.

#### 5. Registration cancellation: stay refused

The AAT has refused an application by an individual for a stay of the decision of the Tax Practitioners Board to cancel his registration as a tax agent until his substantive application for the review of the Board's cancellation decision was determined (*McGuid and Tax Practitioners Board*<sup>3</sup>).

The tribunal said that, having regard to the nature of the individual's various failures to adhere to appropriate standards of professional and competent conduct, as well as the period of time over which those failures had occurred, the number of taxpayer clients affected and the absence of insight shown by the individual regarding his own unacceptable conduct, the reality was that, even if the tribunal were to accept the substance of his case at the

final hearing (which was that he had not misappropriated moneys or done any wrongdoing throughout his extensive tax practice), the prospect that the tribunal would conclude that he should be immediately returned to the register of tax agents was, at best, remote. This matter weighed strongly in favour of the tribunal refusing the stay.

In relation to the issue of public interest, the tribunal expressed its agreement with the Board's contentions that the individual's repeated failure to uphold the requisite standards of professional and competent practice, his lack of contrition and his failure to appreciate the significance of his acts and omissions demonstrated a real risk of further non-compliance. In this regard, it was especially important that the public "is to be protected [against] the risk to the standing of the profession in the eyes of the public. The effective functioning of the tax agent profession is in the public interest ... [P]reservation of the general community's confidence in tax agents is of fundamental concern" (*Re Evans and Tax Practitioners Board*<sup>4</sup>).

The public interest in maintaining community confidence in registered tax agents, and in preserving the authority of the tribunal, strongly pointed in the present case in favour of the tribunal refusing a stay.

The tribunal also considered several other matters that were relevant to the question of whether a stay order should be made in the circumstances.

### 6. Appealing? Keep it simple

In a recent decision in which the Federal Court dismissed an appeal from a decision of the AAT in a case involving issues arising out of the R&D tax incentive scheme, Stewart J noted that the appellant, in its notice of appeal, identified 38 independent errors of law said to have been made by the tribunal in its 69-paragraph decision (*H2O Exchange Pty Ltd v Innovation and Science Australia*<sup>5</sup>).

Stewart J said that the respondent rightly criticised that approach, drawing attention to the adoption by McHugh J of the words of an American judge that, when he sees "an appellant's brief containing seven to ten points or more, a presumption arises that there is no merit to any of them" (*Tame v New South Wales*<sup>6</sup>).

Stewart J put the point well with the observation:

"Another way of putting the point is that experience shows that the merits of an appeal are generally inversely proportionate to the number of appeal points that are taken."

Stewart J said that, at the hearing of the appeal, counsel for the appellant helpfully, and appropriately, reduced the grounds of appeal down to three.

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#### References

- 1 [2021] FCA 43.
- 2 [2021] AATA 16.
- 3 [2021] AATA 64.
- 4 [2019] AAT 1408.
- 5 [2021] FCA 11.
- 6 [2002] HCA 35 at [70].



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## Tax Tips

by TaxCounsel Pty Ltd

# Options and land: CGT and GST

**Where an option in relation to land is granted, there are significant CGT and GST issues that may need to be taken into account.**

### Background

As with any transaction, where it is proposed that an option in relation to the purchase and sale of land or in relation to the creation of some right in relation to land (for example, the creation of an easement) be granted, it is necessary for the advisers to each of the parties to keep in mind the revenue issues that may be attendant not only on the entry into the option agreement, but also on the issues that may arise if the option is exercised or is not exercised (expires).

This article gives a brief rundown on the way that CGT and GST operate in relation to the grant, exercise or expiry of an option in relation to real estate. There can be other transactions relating to options, for example, the assignment of an option, but these are not considered. Also not considered are possible ordinary income and state and territory revenue issues (principally stamp duty issues).

### Kinds of options

In *FCT v Guy*,<sup>1</sup> Beaumont, Carr and Lindgren JJ in a joint judgment said that the word “option” itself:

“... suggests a right in one party to unilaterally require another party to enter a new set of jural relations or to extend or continue an existing jural relationship. Put and call options, options to purchase and options to renew leases are, perhaps, the most common illustrations.”

As these comments indicate, there are basically two kinds of options that may be granted:

1. a call option which is granted by the owner of an asset (the grantor) and gives the grantee the right (on exercise of the option) to acquire the asset (or some right in respect of the asset) on the terms specified in the option agreement; and
2. a put option which is granted by an entity (the grantor) to the owner of an asset and gives the owner (the grantee) the right (on exercise of the option) to require the grantor to acquire the asset on the terms specified in the option agreement.

In some circumstances, the parties to an agreement may enter into an agreement that grants both a put option and a call option.

The grant of an option may not only be a discrete transaction, but it may also be part of a larger transaction. For example,

a lease of land may itself contain a call option either for the renewal of the lease or for the purchase of the reversionary interest of the lessor.

### Option for creation of asset

An option may be granted not only in relation to the acquisition or disposal of an asset, but also for the creation of an asset or for the creation of some right associated with an asset. For instance, a call option may be granted by a landowner which entitles the grantee (on exercise of the option) to the grant of a lease of the land or to the creation of a right (for example, an easement) over the land.

### Right of pre-emption

An option is to be distinguished from a right of pre-emption (sometimes called a right of first refusal). The valid exercise of an option results in a concluded contract to sell and buy. On the other hand, a right of pre-emption requires two steps before there is a concluded contract to sell and buy. These two steps are: (1) an offer made in accordance with the right; and (2) an acceptance of the offer.

### Grant of option: CGT

#### Option is a CGT asset

An option (whether it is a put option or a call option) is a CGT asset (as defined in s 108-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)). An option is clearly property<sup>2</sup> and, indeed, is included in note 1 to s 108-5 ITAA97 as an example of a CGT asset. There is no definition of the word “option” for CGT purposes and it would, subject to context, take its ordinary legal meaning.

#### CGT event D2 happens for grantor

The grant of an option (whether a put option or a call option) constitutes the happening of CGT event D2 for the grantor at the time when the option is granted (s 104-40(1) and (2) ITAA97).<sup>3</sup>

The fact that a transaction may fall within the terms of not only CGT event D2, but also within the terms of the happening of some other CGT event (for example, CGT event D1 (creating contractual or other rights)), will not be relevant; CGT event D2 will be the relevant CGT event because it is the more specific CGT event in the circumstances (s 102-25 ITAA97).

Whether the grantor of an option (put or call) makes a capital gain or capital loss from the grant of the option is determined by comparing the capital proceeds from the grant of the option with the expenditure that the grantor incurred to grant it (to the extent that the expenditure is not deductible and is not recouped by a non-assessable amount) (s 104-40(3) and (4) ITAA97).

The capital proceeds from the grant of an option are determined in accordance with the usual CGT capital proceeds rules as set out in s 116-20(1) ITAA97, subject to any relevant modifications (including the market value substitution modification, if applicable).

#### Option to acquire and dispose

If an option that is granted requires the grantor to both acquire and create (including grant or issue) or dispose of

a CGT asset, the option is treated as two separate options and 50% of the capital proceeds from the grant is attributed to each option (s 116-70 ITAA97).

**Practice points**

A capital gain or capital loss can arise from the happening of CGT event D2, even where:

- the asset over which the option is granted is a pre-CGT asset; or
- the asset is a post-CGT asset and a capital gain or capital loss from a disposal of the asset would be wholly or partly disregarded (for example, where the asset is a dwelling and the CGT main residence exemption would apply were the dwelling to be disposed of).<sup>4</sup>

Unless the option is for the creation of a CGT asset, the fact that a CGT asset over which an option is granted is a pre-CGT asset or is an exempt CGT asset will, however, become relevant for the purposes of CGT if the option is exercised (see below).

**Example 1**

On 2 February 2021, Hubert grants a call option to James over vacant land, which is a pre-CGT asset. The option consideration is \$15,000 and all of Hubert's costs associated with the grant (which are not deductible) are met by James.

Hubert will make a capital gain of \$15,000 from the happening of CGT event D2, even though, had he disposed of the land, any capital gain or capital loss that would have arisen from the happening of CGT event A1 would have been disregarded.

If James exercises the option, the capital gain made by Hubert from the grant of the option is disregarded and the CGT event A1 capital gain or capital loss will be disregarded because the asset is a pre-CGT asset. See further below.

**Example 2**

On 8 February 2021, Leonie agrees to grant a neighbour (Arthur) a call option for the creation of a drainage easement over the land on which her main residence is situated. Arthur needs this to ensure that he can satisfy potential council requirements that may be imposed on the grant of an application that he has lodged for the development of his land. The consideration for the grant of the option is \$10,000 and, if it is exercised, a further amount of \$25,000 is payable by Arthur.

CGT event D2 will happen for Leonie on the grant of the option and, assuming that Leonie has no cost base amounts, a capital gain of \$10,000 would be made by her. Further, if Arthur exercises the option, the capital gain from the happening of CGT event D2 would be disregarded and a capital gain under CGT event D1 (creating contractual or other rights) would arise. The capital gain that arises from the happening of CGT event D1 would include the option fee as this would be money received by Leonie "in respect of"

**Example 2 (cont)**

CGT event D1 happening. The fact that the land involved is land on which Leonie's main residence is situated is irrelevant when determining whether a capital gain has been made by Leonie. Neither CGT event D1 nor CGT event D2 is a relevant CGT event for the purposes of the CGT main residence exemption.

The potential CGT liabilities should be taken into account by Leonie when negotiating the consideration for the grant of the option and the consideration payable on the exercise of the option.

**Operation of CGT concessions**

The following summarises how the CGT discount capital gain and small business concessions apply to a capital gain from the grant of an option.

**CGT discount capital gain concession**

A capital gain from the happening of CGT event D2 cannot give rise to a discount capital gain, regardless of how long the CGT asset over which the option is granted has been owned (s 115-25(3) ITAA97).

A difficulty arises in relation to the CGT discount capital gain concession where an option is granted within 12 months of the acquisition of the asset.

This difficulty arises out of an anti-avoidance type provision which excludes a capital gain from the CGT discount capital gain concession where the CGT event that triggers the capital gain happens "under an agreement" that was entered into within 12 months of the acquisition of the asset (s 115-40 ITAA97). An option would clearly fall within the concept of an agreement for this purpose. There has been some uncertainty as to whether this provision could apply (and, if so, in what circumstances) where an option that is granted within 12 months of the acquisition of an asset is exercised after the end of that 12-month period.

For example, where a lease of land with, say, a three-year term is granted within 12 months of the lessor's acquisition of the land and the lease contains an option to purchase the lessor's reversionary interest (which is exercisable at any time during the last three months of the term of the lease), and these were the only relevant facts, it is not clear that it would be intended that the anti-avoidance provision should be attracted if the option were to be exercised. One possible argument against the operation of the anti-avoidance provision in such a case is that the option does not stand alone but is part of a wider transaction. The Commissioner's view is not known.

**CGT small business reliefs**

If the land over which a call option is granted meets the active asset test for the purposes of the CGT small business reliefs and all of the other basic conditions for the reliefs to apply are met, a capital gain that results from the happening of CGT event D2 may qualify for CGT small business relief. It needs to be kept in mind, however, that a capital gain made on the grant of an option is disregarded if the option is exercised. This may create some difficulty in cases, for



example, where CGT small business retirement relief has been claimed in relation to the capital gain from the granting of an option which is subsequently exercised.

The basic conditions for the CGT small business reliefs to apply could not be met where the capital gain is made by the grantor from CGT event D2 happening as a result of the grant of a put option over land.

### Grantee's position

Where an option (whether a put option or a call option) is granted, the grantee of an option acquires a CGT asset. The time of acquisition is when the option is granted (s 109-5(2) ITAA97).

The grantee's cost base and reduced cost base of the option would be determined in accordance with the normal rules, subject to any relevant modifications (ss 110-25 and 110-35 ITAA97). An amount that is an allowable deduction would not form part of the cost base (s 110-38 ITAA97).

### Grant of option: GST Supply and acquisition

The grant of an option (whether a put option or a call option) over land would constitute a supply for GST purposes (s 9-10 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99)). Not only would the grant of an option be likely to fall within the description "any form of supply whatsoever", but there are also specific inclusions in the definition of "supply" which would be applicable, in particular, a creation or grant of any right, or in the case of a put option, a grant of real property (as defined). "Real property" is defined for GST purposes to include (inter alia) any interest in, or right over, land or a personal right to call for, or be granted, any interest in or right over land (s 195-1 GSTA99).

Accordingly, if the entity that grants the option (and so makes a supply) is (or is required to be) GST-registered and the supply is otherwise a taxable supply, GST will be payable unless the supply is GST-free or input taxed.

Conversely, the grantee of an option (whether a put option or a call option) would make an acquisition for GST purposes. If the grant was a taxable supply, the grantee is (or is required to be) GST-registered and the acquisition is otherwise a creditable acquisition, the grantee would be entitled to a GST input tax credit.

### Margin scheme not relevant

The fact that the margin scheme is to be applied to the supply of land as a result of the exercise of an option is irrelevant when determining whether the granting of the option is a taxable supply or, if it is, whether the grantee is entitled to an input tax credit.

### Where supply on exercise GST-free or input taxed

The fact that the supply of land that will be made if a call option were to be exercised will be GST-free (for example, as farmland supplied for farming) or input taxed (for example, as non-commercial residential premises that are not new), will have the effect that the grant of the option is also GST-free or input taxed, as the case may be (s 9-30(1)(b) and (2)(b) GSTA99, ID 2005/182, ID 2005/183 and ID 2005/184).

These provisions (that is, s 9-30(1)(b) and (2)(b) GSTA99) apply where there is "a supply of a right to require a supply that would be" GST-free or input taxed (as the case may be). It is clear that those words would cover the grant of a call option and (although not so clear) it is thought that they would also cover the grant of a put option.

In addition, if the supply on the exercise of a call option would be input taxed, the grant of the option would also be input taxed on the basis that it is a financial supply (ID 2005/183). If a supply would otherwise be both GST-free and input taxed, it will (subject to an exception not presently relevant) be GST-free (s 9-30(3) GSTA99).

### Some GST drafting points

A number of GST issues need to be kept in mind when drafting an option in relation to the purchase of land, including:

- it must be determined whether the consideration for the option will be consideration for a taxable supply; if it is, the consideration should be expressed as either a GST-inclusive amount or a GST-exclusive amount, with provision for GST to be added;
- if the supply that will be made on the exercise of an option (a call option at least) will be GST-free or input taxed, relevant provisions which cover this point should be included in the option itself and in the contract that will be entered into if the option is exercised. It is also advisable to provide for GST to be added if there is any likelihood that the supply will not be GST-free or input taxed. This point is of particular importance if the option exercise period is of some length (that is, the status of the supply may change for one reason or another); and
- because a contract will be formed if the option is exercised, care must be taken to ensure that GST is properly taken into account when drafting the terms of that contract.

### Exercise of call option: CGT Grantor's position

Where a call option over a CGT asset or an option to create (including grant or issue) a CGT asset is exercised so that the grantor disposes of (or creates) a CGT asset, the CGT consequences for the grantor are:

- CGT event A1 happens if a CGT asset is disposed of and CGT event D1 happens if a CGT asset is created. The time when whichever of these events happens will be the time when the option agreement was entered into (ss 104-10(3) and 104-35(2) ITAA97);
- any capital gain or capital loss that the grantor made from the grant, renewal or extension of the option is disregarded (s 104-40(5) ITAA97); and
- the capital proceeds from the disposal (or the creation) of the CGT asset include any payment received by the grantor for granting, renewing or extending the option (s 116-65 ITAA97).

An example of an option to create a CGT asset (see the first point above) is an option to grant a lease over land.

### Grantee's position

Where a call option over a CGT asset or an option to create (including grant or issue) a CGT asset is exercised, the CGT consequences to the grantee are:

- the first element of the grantee's cost base and reduced cost base for the CGT asset acquired as a result of the exercise of the option is what the grantee paid for the option (or to renew or extend it), plus any amount that the grantee paid to exercise the option; and
- any capital gain or capital loss that the grantee makes from exercising the option is disregarded (s 134-1(1) and (4) ITAA97).

Where an option over land is granted by will and the exercise price is less than the market value (as was the situation in *AG Healing Co Ltd v Commissioner of Inland Revenue (NZ)*<sup>5</sup>), it would appear that the CGT deceased estate rules in Div 128 ITAA97 would not be relevant. Arguably, the cost base of the land would comprise the amount actually paid on exercise of the option and the value of the option granted (which would broadly be the difference between the value of the land at the date of the testator's death and the amount payable on the exercise of the option).

### Example of CGT consequences of exercise of call option

The following example illustrates the CGT consequences of the exercise of a call option over land.

#### Example

On 8 February 2021, Amateur Pty Ltd grants a call option to Professional Pty Ltd over its business premises. The consideration for the grant of the option is \$80,000, the exercise period is three months, and the exercise price for the option is \$1,400,000 (which includes the consideration for the grant of the option). The premises were acquired by Amateur Pty Ltd in 2011 and have a cost base of \$800,000. Professional Pty Ltd exercises the option on 2 April 2021. Assuming, for the sake of simplicity, that there are no other cost base amounts involved, the CGT position of the parties are as follows.

#### Amateur Pty Ltd

On the grant of the option, CGT event D2 happened and a capital gain of \$80,000 was made by Amateur Pty Ltd. This capital gain would, however, be disregarded on the exercise of the option.

Following the exercise of the option and the completion of the contract, Amateur Pty Ltd would make a capital gain from the happening of CGT event A1, calculated as follows:

Capital proceeds	\$1,400,000
Less: cost base	<u>\$800,000</u>
Capital gain	\$600,000

This capital gain does not qualify for the CGT discount capital gain concession (because the taxpayer is a company). However, the CGT small business reliefs would be available if the basic conditions for the reliefs to apply are met.

#### Example (cont)

#### Professional Pty Ltd

The first element of the cost base and reduced cost base of the premises in Professional Pty Ltd's hands is \$1,400,000.

### Exercise of call option: GST

Where a call option is exercised, this results in a supply being made by the grantor and an acquisition being made by the grantee for GST purposes. Whether this is a taxable supply and, if so, is a creditable acquisition will depend on the operation of the relevant provisions of the GSTA99, including the provisions governing when a supply will be GST-free or input taxed.

For GST purposes, the consideration for the supply on the exercise of a call option is limited to any additional consideration provided, either for the supply or in connection with the exercise of the option; if there is no such additional consideration, then there is no consideration for the supply (s 9-17(1) GSTA99).

#### Example

To take the example above involving Amateur Pty Ltd and Professional Pty Ltd, if the supply of the premises under the contract is a taxable supply, then, unless the margin scheme is applied, the GST payable by Amateur Pty Ltd on the taxable supply will be calculated as  $1/10 \times (\$1,400,000 - \$80,000)$ .

### Exercise of put option: CGT

#### Grantor's position

Where a put option is exercised, the CGT consequences for the grantor are:

- any capital gain or capital loss that the grantor made from the grant, renewal or extension of the option is disregarded (s 104-40(5) ITAA97); and
- the first element of the grantor's cost base and reduced cost base of the CGT asset acquired by the grantor is any amount paid to exercise the option, reduced by any payment received by the grantor for the option (or to renew or extend it) (s 134-1(1) ITAA97).

#### Grantee's position

Where a put option is exercised, the CGT consequences to the grantee are:

- the second element of the grantee's cost base and reduced cost base of the CGT asset acquired by the grantor includes any payment that the grantee made to acquire the option (or to renew or extend it); and
- any capital gain or capital loss that the grantee makes from exercising the option is disregarded (s 134-1(1) and (4) ITAA97).

Even when the parties are not at arm's length, the CGT market value substitution rule does not apply to amounts paid by the grantor on the exercise of a put option where the terms of the exercise are in accordance with the market value

conditions that prevailed at the time when the option was granted (ID 2009/68).

The following example illustrates how the CGT rules operate where a put option is exercised.

### Example

Bluebird Pty Ltd grants Jacob a three-month put option over land that Jacob owns. The option fee paid by Jacob is \$100,000 and the price that Bluebird Pty Ltd will pay if Jacob exercises the option is \$1,500,000. Jacob acquired the land in 1999 with the intention of building factory units to rent out and its cost base before the grant of the option is \$850,000. If Jacob exercises the option and, assuming for the sake of simplicity, there are no other cost base elements for either party, the position would be as follows.

#### Bluebird Pty Ltd

The capital gain of \$100,000 made by Bluebird Pty Ltd on the grant of the option would be disregarded and the first element of the cost base of the land would be:

Exercise price	\$1,500,000
Less: option consideration	<u>\$100,000</u>
First element of cost base	\$1,400,000

#### Jacob

No capital gain or capital loss would be made as a result of the exercise of the option and the capital gain made on the disposal of the land would be calculated as follows:

Capital proceeds		\$1,500,000
Cost base	\$850,000	
Plus	<u>\$100,000</u>	<u>\$950,000</u>
Capital gain		\$550,000

This capital gain potentially qualifies for the CGT discount capital gain concession. The CGT small business reliefs would also be available if the basic conditions for the reliefs to apply are met.

### Exercise of put option: GST

Where a put option is exercised, this results in a supply being made by the grantee and an acquisition being made by the grantor for GST purposes. Whether this is a taxable supply and, if so, is a creditable acquisition will depend on the operation of the relevant provisions of the GSTA99, including the provisions governing when a supply will be GST-free or input taxed. Where there is a taxable supply, the consideration for the supply is limited to any additional consideration provided, either for the supply or in connection with the exercise of the option (s 9-17 GSTA99).

### Expiry or termination of option: CGT

If an option simply expires (that is, the exercise period comes to an end without the option being exercised, renewed or extended) or the option is otherwise terminated (for example, by release or surrender), CGT event C2 would happen (s 104-25 ITAA97). The time when CGT event C2 would happen is when the option expired, it was agreed that the option would terminate or be released, or the

option was in fact terminated. If an option merely expires, the entity owning the option would usually make a capital loss.

When determining the capital proceeds from CGT event C2, the market value substitution rule does not apply where there is no actual consideration for the happening of the event (s 116-30(3) ITAA97). This would usually be the case if an option expires, but if an option is terminated by agreement, there may well be consideration. Market value consideration will be substituted in such a case if the parties were not dealing with each other at arm's length.

### Example 1

(For the sake of simplicity, it is assumed that there are no cost base or reduced cost base elements other than those mentioned.)

On 10 November 2020, Mercury Pty Ltd grants a six-month call option to Thumper Pty Ltd to acquire factory premises owned by Mercury Pty Ltd. The option fee is \$35,000. The premises decline in value over December 2020 and January 2021.

On 20 February 2021, Thumper Pty Ltd (as it is permitted to do under the option agreement) assigns the option to Finetune Pty Ltd for \$20,000. Finetune Pty Ltd does not exercise the option and it expires.

A capital loss of \$15,000 (ie \$35,000 – \$20,000) would be made by Thumper Pty Ltd as a result of the happening of CGT event A1 (the disposal of the option). Finetune Pty Ltd would make a capital loss of \$20,000 on the expiry of the option (CGT event C2).

### Example 2

(For the sake of simplicity, it is assumed that there are no cost base or reduced cost base elements, other than those mentioned.)

On 8 December 2009, Laminate Pty Ltd grants a put option to Henry (who is unrelated to Laminate Pty Ltd) over certain land which is owned by him. The option period is six months, the option fee paid by Henry is \$15,000, and the exercise price is \$1,500,000. Laminate Pty Ltd has a downturn in its business and negotiates with Henry to terminate the option on the payment of \$50,000.

CGT event C2 would happen for Henry and he would make a capital gain of \$35,000 (that is, \$50,000 – \$15,000).

### Expiry of option: GST

Where an option over land simply expires, there should be no GST implications. However, where an option over land is terminated before its expiry, there would be a supply for GST purposes by the grantee of the option (if not under the general concept of supply, then under the specific categories of supply that cover the surrender of real property or the surrender of any right). There would, correspondingly, be an acquisition for the grantor for GST purposes.

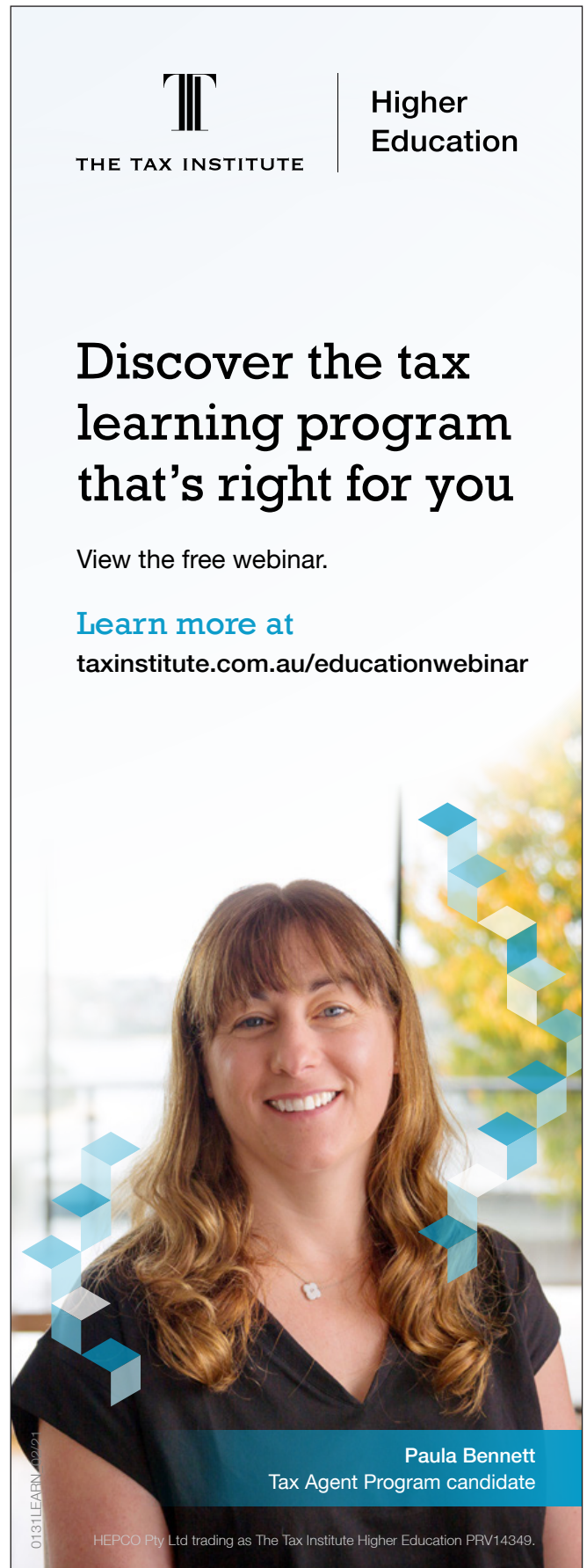
### Conclusion

It will be seen from the above that the CGT and GST implications of the granting or the exercise of an option must be carefully considered in each case. As indicated at the start of this article, there may in some situations be ordinary income tax issues. Also, the possible incidence of stamp duty must not be overlooked.

**TaxCounsel Pty Ltd**

### References

- 1 [1996] FCA 438.
- 2 *George Wimpey & Co Ltd v Inland Revenue Commissioners* [1975] 2 All ER 45; *FCT v Miranda* 76 ATC 4180.
- 3 There are, however, some exceptions to this (which are outside the scope of this article).
- 4 CGT event D2 is not one of the CGT events listed in s 118-110(2) ITAA97 that can activate the CGT main residence exemption (s 118-110(2) ITAA97).
- 5 [1964] NZLR 222.



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## Higher Education

# Breaking down major challenges the key to success

The dux of CTA2B Advanced for 2020 study period 2 shares his tips for managing study and work and his long-term plans.

**Ross Heard, Consultant, Cooper Partners, Western Australia**

**Please provide a brief background of your career in tax**

I began working in tax in January 2017 after undertaking a summer internship at Cooper Partners and I remain with the firm to this day. I work primarily in the firm's tax advisory team, working on a wide range of matters, including employee share schemes, trusts, tax residency and international tax.

**What are your areas of new confidence?**

The CTA2B course has developed my knowledge in a number of areas, including small business CGT concessions, the superannuation guarantee system, and fringe benefits tax. The broad nature of the course has helped to "round out" my tax knowledge, allowing me to provide clients with practical business-ready advice.

**What was the reason for undertaking CTA2B with the Institute?**

One of the great things about CTA2B is that it can be used for credit in both the Chartered Accountants (CA) and Chartered Tax Adviser (CTA) programs. Accordingly, the subject is perfectly adapted to young professionals such as me who are seeking to gain both designations. In addition, I was encouraged by my employer and advised by members of the profession that the subject would be particularly useful for developing my tax advice skills.

**Where to now for you when it comes to continuing tax education?**

One of the many challenges in the field of tax is that the learning never stops. I am currently in the final stages of the CA program and hope to shortly obtain my CA designation. Given the legalistic nature of my work, I have also decided to study law at the University of Western Australia where I am in my second year of the Juris Doctor program. Long term, I intend to combine these legal and accounting

backgrounds and complete the CTA program. Fortunately for me, Cooper Partners' commitment to continuing professional development is extremely strong and the many internal training systems at the firm have me well prepared to tackle these challenges!

**What are the challenges of juggling study and work?**

Juggling study and work can certainly be challenging. For me, the most important thing is to break major challenges into small tasks and to try to maintain a healthy balance between work, study and play. As an avid Fremantle Dockers fan and cricket tragic, this meant setting aside time each week to watch the Dockers lose or play a game of cricket with some mates.

With that in mind, I would advise other students to use "to do" lists wherever possible and reward themselves with the things that they love as each significant item is ticked off.

**What advice do you have for other tax professionals considering the course?**

I would strongly suggest that other tax professionals consider undertaking CTA2B and the broader CTA program. In particular, I would advise accountants who are involved in providing tax advice to consider the course, noting its relevance to developing these skills.





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## Member Profile

This month's column features Nick Wilkins, CTA, from Wilkins Advisory, South Australia.

### Member since

1993

### Area of specialty

My area of specialty is the SME market, with a particular focus on family business and the associated structuring and planning opportunities.

### What made you choose tax as a career and join The Tax Institute?

My career began with a graduate position in a Big 4 accounting firm. It was the luck of the draw as to which division you were assigned to and, in my case, it was business services. While the initial decision may have been out of my control, I quickly realised that tax provided a diverse range of work, much of which is assisting in the future decisions of clients. Joining The Tax Institute was a natural progression due to the excellent training and networking opportunities that membership provides.

### How is your membership beneficial to your practice and clients?

For over 25 years, The Tax Institute has been the first port of call for high-quality tax solutions. Whether it be via the *Tax Knowledge eXchange* database or attendance at training sessions, I know that the information will always be of the highest quality.

Membership of The Tax Institute also excels through the relationships and professional network opportunities with other Institute members in both the legal and accounting professions. It is an immeasurable advantage to have direct access to a range of expert individuals for specific assistance as may be required from time to time.

### What is your most memorable career achievement to date?

In July 2020, I made the decision to establish my own firm, after over 30 years with Big 4/second-tier firms. With the support of my valued clients, I have greatly enjoyed reconnecting with a more comprehensive and direct approach in their operations, especially during these difficult times. While establishing your own firm is never easy, and with the added complication of being mid-pandemic, as many who

have done something similar have advised me: the rewards are great.

### What do you see being the main challenges for tax practitioners this year?

COVID-19 will continue to be the greatest challenge for tax practitioners. The challenges will relate to legislative changes resulting from COVID-19, the economic impact of COVID-19, and the continued impact of working remotely for practitioners and clients. Tax practitioners are well placed to provide quality solutions for their clients to assist them in working through the ongoing COVID-19 pandemic.

### What do you see as the key attributes of an effective leader in the tax profession?

There are many attributes I have admired in the effective leaders I have worked with. The most significant is their ability to listen and their willingness to consult and discuss. The leaders who have inspired me the most always have time to listen to my point of view and then work with me on the merits, and shortcomings, of my position. I am also an advocate for imparting experiential knowledge to others in order to further their professional growth and development within the accounting community.

### Do you have any advice for young professionals just beginning their career in tax?

The best advice I can give to someone entering the profession is that they should ensure that they fully understand the basics, the building blocks, while broadening their professional exposure to a diverse range of clients. Often young professionals prefer working with larger clients but, in my experience, it is generally smaller clients who provide exposure to a broader range of activities and tax issues. This more expansive initial exposure will assist in determining a more specific area of expertise and interest to pursue as a career develops.

### What does work-life balance mean to you and what are your interests outside of work, how do you relax?

The pandemic, and the requirement to work from home for a period, provided a timely opportunity to reflect on my work-life balance and whether I had the mix right. Establishing my own practice mid-2020 and setting it up with the ability to work remotely gave me a much more flexible working environment, with greater control of my work-life balance. I believe that it may be a decision that many other practitioners will consider in the coming years.



# Corporate tax and the erosion of privacy

by Fiona Moore, CTA, Partner – Tax, and Victor Nguyen, Senior Manager – Tax, Ernst & Young

Corporate taxpayer information is increasingly being disclosed to revenue authorities and the general public. The erosion of taxpayer privacy is facilitated by calls for greater transparency (including taxpayer transparency in the context of the ATO's justified trust methodology), as well as legislative and regulatory means. This article considers these matters, as well as how corporate taxpayers may navigate the current tax environment and the importance of maintaining a robust tax corporate governance framework in order to manage tax risks and reputational risk.

## Introduction

The tax affairs of a company have traditionally been a private matter. In the absence of a litigated dispute, tax (in particular, corporate tax) has historically been shielded from public scrutiny. However, it is becoming increasingly evident that the tax affairs of companies are no longer private as governments worldwide drive tax transparency agendas and expand their powers to collect and make public corporate taxpayer information. As a consequence, corporate taxpayers are more cognisant of reputational risk associated with their tax affairs.

With the global rise of tax transparency agendas and proactive engagement being demanded by revenue authorities, companies in Australia are now subject to a myriad of tax disclosure requirements — both to the ATO and more generally. These disclosure requirements provide the ATO with an unprecedented level of information. Additionally, tax transparency initiatives, including the Australian voluntary tax transparency code (TTC), are allowing the general public to gain an insight into the machinations of corporate tax. The once private nature of corporate tax affairs is being eroded. This article will consider how Australia has moved to a more transparent tax environment and some of the legislative and other regulatory means by which this has occurred.

## The private nature of tax affairs: the “secrecy” provisions

Legislation prevents the Commissioner of Taxation from publicly disclosing the tax affairs of a taxpayer. Previously,

the tax secrecy and disclosure provisions were contained in some 20 different pieces of tax legislation,<sup>1</sup> which inevitably made it difficult to consistently apply the provisions. However, the consistent theme of the provisions was the protection of taxpayer privacy. As Lockhart J stated with regard to former s 16 of the *Income Tax Assessment Act 1936* (Cth) (being the “secrecy” provision relevant to income tax information) in *Consolidated Press Holding Ltd*:<sup>2</sup>

“The section reflects the intent of the Parliament to balance two competing areas of public interest: on the one hand the interests of taxpayers in having the privacy of their financial information respected; and on the other hand the facilitation of the administration of governmental business. Taxpayers are responsible for reporting their income and outgoings. It is essential if the confidence of taxpayers is to be maintained that private information concerning their finances and affairs will not be disclosed except in the special circumstances mentioned in the various sub-sections of s. 16. The voluntary disclosure by taxpayers of this confidential information concerning their assessable income and outgoings is vital to the efficient operation of Australia's taxation laws. If taxpayers lack this confidence, reluctance may develop to disclose voluntarily the requisite information.”

In 2006, Treasury undertook a review of the taxation secrecy and disclosure provisions. This led to the standardisation of the tax secrecy provisions in 2010 through the introduction of Div 355 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53). The primary objective of Div 355 was explained as follows:<sup>3</sup>

“The primary objective of the new framework is to protect the confidentiality of taxpayer information. *Compliance with taxation laws could be adversely affected if taxpayers thought that their information could be readily disclosed . . .*

The new framework gives effect to this primary objective by placing a general prohibition on the disclosure of taxpayer information. However, in recognition of the importance that taxpayer information can play in facilitating efficient and effective government administration and law enforcement, disclosures of taxpayer information are permitted in certain specified circumstances. As a guide for future policy consideration, *the disclosure of taxpayer information should be permitted only where the public benefit associated with the disclosure clearly outweighs the need for taxpayer privacy.*” (emphasis added)

Accordingly, at the heart of Div 355 is the protection of taxpayer confidentiality and privacy.

In recent years, however, it has become apparent that the “public benefit” associated with the disclosure of taxpayer information (ie increased tax collections and confirmation that corporate Australia is paying its “fair share” of tax) is beginning to outweigh the need for taxpayer privacy. In short, corporate taxpayers must be seen to be paying their “fair share” of tax or face potential reputational risk. Reputational risk also provides a platform to promote active and willing ATO engagement from companies and other taxpayers in general. While Div 355 has not been substantively amended to facilitate greater disclosure of taxpayer information, increased disclosure is being facilitated by other means.

## Shifting sentiments: demands for a more transparent tax environment

The erosion of taxpayer privacy has been gradual. It is difficult to pinpoint the precise point in time when we began



shifting to a more transparent tax environment. The genesis was perhaps derived from the G20 summit in July 2012 during which world leaders agreed to reform the international tax system. The OECD was tasked with what was the start of the base erosion and profit shifting (BEPS) project — a worldwide project seeking to address “tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity”.<sup>4</sup>

As the BEPS project gained momentum, the debate surrounding whether multinational corporations were paying their “fair share” of tax increased. This ultimately led to the United Kingdom and the United States initiating parliamentary inquiries into multinational corporate tax avoidance in 2012-13. As part of this process, key executives from large multinationals were required to appear in publicly televised hearings and justify (or defend) their company’s tax planning strategies.

In October 2014, Australia joined the parliamentary scrutiny of companies with the launch of the Senate inquiry into tax avoidance and aggressive minimisation by corporations registered in Australia and multinational corporations operating in Australia. The terms of reference of the inquiry included “[a] need for greater transparency to deter tax avoidance and provide assurance that all companies are complying fully with Australia’s tax laws”.<sup>5</sup>

The Senate Committee considered over 100 submissions on the matter and heard from various witnesses at its public hearings, including representatives from the Australian Taxation Office and the Big 4 professional services organisations, as well as executives from various multinationals, many of whom are household names. With respect to the disclosure of taxpayer information, a number of recommendations were made by the Senate Committee, including:<sup>6</sup>

- public reporting by Australian corporations or subsidiaries of multinational corporations with an annual turnover above a specified amount of financial information on revenue, expenses, tax paid and tax benefits/deductions from specific government incentives;
- establishing a public register of tax avoidance settlements reached with the ATO where the value of the settlement exceeds a specified amount;
- publishing excerpts from the country-by-country reports; and
- the tabling in parliament of an annual public report on aggressive tax minimisation and avoidance activities.

The above recommendations heralded the beginning of Australia’s shift away from the traditional perception that corporate tax is a private matter to an open and transparent environment whereby companies’ information is increasingly being disclosed in public forums.

It should also be noted that the term “fair share” in the context of tax has moved beyond a colloquialism and into legislation, with the recent enactment of the *Treasury Laws Amendment (Making Sure Foreign Investors Pay Their Fair Share of Tax in Australia and Other Measures) Act 2019*.

## Public disclosure of tax information: formal requirements

The introduction of ss 3C and 3E TAA53 in 2015 is consistent with the Senate Committee’s recommendations. These provisions require the Commissioner to annually and publicly report the following information for corporate tax entities with a total income of \$100m or more during an income year, and Australian private companies with a total income of \$200m or more during an income year:

- entity name and ABN;
- total income (accounting income);
- taxable income (if any);
- income tax payable (if any); and
- petroleum resource rent tax payable.

The above information is extracted directly from a company’s lodged tax returns and is only updated for amendments to the extent that those amendments (eg amended assessments issued as a result of an audit or a voluntary disclosure) are lodged within a specified period of time (if this window is not met, the amendment will be reflected in the disclosures for the subsequent year).

Without ss 3C and 3E, the Commissioner would ordinarily be precluded from publishing this information by virtue of s 355-30 of Sch 1 TAA53. However, s 355-50 specifically includes, as an exception to the secrecy provisions, disclosures made in performing a taxation officer’s duties, including the duty to make available information under ss 3C and 3E. In this regard, it may be construed that the public benefit associated with this disclosure outweighs the need for taxpayer privacy.

The disclosure of the information required by ss 3C and 3E carries a risk that it may be perceived that the company is not paying an appropriate amount of tax. In this regard, one area of concern from a company’s perspective is that the disclosed information does not paint a complete picture of its tax profile. For example, although a taxpayer may have taxable income for a particular income year, they may nonetheless have no income tax payable due to the application of, for example, franking credits or research and development concessions (both of which are expressly permitted by the legislation).

Another common example where the wrong conclusion may be drawn from disclosures made by the Commissioner under ss 3C and 3E is due to differences between accounting income and taxable income. Often there is no alignment between the two — particularly as accounting income is the gross income calculated in accordance with accounting standards. Accounting income does not take into account expenses. On the other hand, taxable income is calculated in accordance with the tax legislation and takes into account allowable deductions (ie expenses for which a deduction is permitted). Indeed, the Commissioner himself acknowledged the potentially misleading nature of this information during the Senate Committee hearing on 21 April 2016, although he has said that he is merely doing what the law requires:<sup>7</sup>

“It is easy to relate the tax paid to the total income, but total income is a gross figure. The taxable income is net, but they both have income in them. So some people said, ‘Gee, there is a big difference there.’”

That has caused a lot of concern and a lot of issues that are not relevant because they are not the right thing. They are apples and oranges ... So net income and taxable income are two comparators; what is there now is total income. The issues I have had raised with me from this are more to do with: 'Why have you done that? Why have you misled people?' And I have said, 'Well, that is what the legislation says.'

It is therefore imperative that companies manage the inherent reputational risk which manifests through formal disclosures required by law and the general public's interpretation of such information.

### “Leaked” tax information

Notable tax information leaks in recent years, including the Luxembourg Leaks (2014), the Swiss Leaks (2015), the Panama Papers (2015) and the Paradise Papers (2017), present a far greater threat to a company's reputation as these information leaks occur in an unregulated and therefore unpredictable environment. Furthermore, the leaked information may come into the possession of the ATO, which may in turn lead to reviews and audits of entities to which that information relates.

Moreover, the general public has become more engaged and invested in such leaks as a result of the ability to access the information at the touch of a button. The day after the Paradise Papers were released, Google searches for “Paradise Papers” outnumbered searches for “Donald Trump”.<sup>8</sup> In the six weeks after public disclosure of the Paradise Papers, Facebook users had viewed related posts 182 million times.<sup>8</sup> These actions demonstrate the general public's increasing engagement and interest in the once private tax affairs of companies and therefore the inherent reputational risk for companies.

In response to the Panama Papers, the European Union passed the fourth anti-money laundering directive (which came into force on 26 June 2017). The directive requires the disclosure of the true (ie beneficial) owners of EU companies and trusts. The information will be contained on a central, publicly available register which can be accessed by banks, law firms and “any person or organisation that can demonstrate a legitimate interest”.<sup>9</sup> As such, it is evident that the uncontrolled, informal leakage of information has eroded the privacy of taxpayers and can rally governments to formalise disclosures of taxpayer information.

### Voluntary tax transparency code

Although a company is limited in its ability to prevent leaks of taxpayer information, a company can be proactive and transparent regarding its tax affairs by showing that there is indeed “nothing to hide”. The TTC published by the Board of Taxation in 2016 is a set of principles and “minimum standards” for foreign multinationals (with Australian operations) and Australian headquartered businesses to follow in the context of disclosing tax information.

Under the TTC, the Board recommended that “large businesses” (with an annual turnover of \$500m or more) and “medium businesses” (with an annual turnover of at least \$100m but less than \$500m) disclose the minimum standard of information as set out in Table 1.<sup>10</sup>

The TTC provides a platform to allow taxpayers to “explain” and provide additional context to the data disclosed by the

**Table 1. TTC disclosures for large and medium businesses**

TTC disclosure	Who	Minimum standard of information
Part A	“Large” and “medium” businesses	A reconciliation of accounting profit to tax expense and to income tax paid or income tax payable
		Identification of material temporary and non-temporary differences
		Accounting effective company tax rates for Australian and global operations (pursuant to Australian Accounting Standards Board guidance)
Part B	“Large” businesses	Approach to tax strategy and governance
		Tax contribution summary for corporate taxes paid
		Information about international related-party dealings

Commissioner under ss 3C and 3E TAA53 (as discussed above), as well as a response to other media coverage of their tax affairs.

The government subsequently endorsed the TTC in the 2016-17 Budget. As of February 2021, 190 companies have become signatories to the TTC register, together representing more than 60% of the taxable income and tax payable by corporate taxpayers which are subject to the TTC.<sup>11</sup> As signatories, the companies have indicated a commitment to publish the relevant tax information for every income year going forward. Given some of the notable companies that have become signatories, it is now the case that a company may be at risk of reputational damage if it elects not to adopt the TTC. Indeed, companies are gradually becoming attuned to the notion that tax transparency is a minimum expectation in Australia's tax environment and that their tax affairs are no longer private. However, if it is an expectation that a company adopts the TTC, to what extent is it voluntary?

### Information asymmetry between the ATO and taxpayers

Information asymmetry exists where one party (the taxpayer) has more information than the other (the ATO). Taxpayers are rapidly being required to provide additional information to the regulator in the ordinary course of business. A simple example is the company tax return. In 2003, the company tax return form (Form C) was four pages, and the instructions were 99 pages. Fast forward to 2020: the company tax return form (Form C) is now 12 pages, and the instructions are 267 pages. The number of schedules required to be lodged with Form C has also grown, as has the number of pages of disclosures. Put simply, the ATO is demanding an ever-increasing amount of information from taxpayers, in the context of annual reporting requirements and in the course of risk reviews and audits.

Other means by which the ATO is gaining additional information include the following:

- **country-by-country (CbC) reporting:** the OECD BEPS action 13 final report<sup>12</sup> provided revised transfer pricing documentation guidance, including a CbC reporting regime whereby multinationals are to report their international related-party dealings, revenues, profits, and taxes paid by jurisdiction. In an Australian context, Subdiv 815-E of the *Income Tax Assessment Act 1997* (Cth) requires significant global entities to lodge a CbC report, master file and local file. Australia is also a signatory to the *Multilateral competent authority agreement on the exchange of country-by-country reports*, which facilitates the exchange of CbC reports between different revenue authorities. Country-by-country reporting is therefore yet another tool under the active ATO engagement model whereby companies are mandated to disclose their tax information, not only to the ATO, but also to overseas revenue authorities. This is consistent with the pillars of the OECD's BEPS project, one of which is transparency;
- **general purpose financial statements:** s 3CA TAA53 requires significant global entities that are Australian residents, or foreign residents operating through an Australian permanent establishment, to lodge with the ATO a general-purpose financial statement if one is not lodged with the Australian Securities and Investments Commission. The ATO is required to share the general-purpose financial statement with ASIC. The requirement to lodge general-purpose financial statements with the ATO in many regards puts inbound significant global entities on a more equal footing with Australian publicly listed companies in terms of information that is accessible by the ATO; and
- **reportable tax position (RTP) schedule:** in 2011, the ATO introduced the RTP schedule, which required certain companies to disclose their most contestable and material tax positions. Initially limited to those taxpayers deemed to be “higher risk” in an effort to further bridge the gap between tax compliance and tax transparency, the ATO has since expanded the cohort of taxpayers required to lodge the RTP schedule to those companies in “public or international economic groups with a turnover greater than \$250 million”,<sup>13</sup> and has consulted in relation to requiring private groups to lodge the schedule (large private groups will be required to lodge the schedule for income years commencing on or after 1 July 2020). The purpose of the RTP schedule is to provide the ATO with additional taxpayer information at the time income tax returns are lodged to enable the ATO to better understand the tax risks of companies at an earlier stage (as opposed to during a review or an audit). This obligation has significantly increased the amount of information required to be prepared and disclosed by the taxpayer as part of the self-assessment regime.

Much of the information obtained by the ATO through the above reporting obligations would historically have been opaque to the ATO. The current reporting burden placed on companies is indicative of the public and transparent tax environment in which companies must operate within Australia.

## Future disclosures: accounting for uncertain tax positions

Not only are companies required to formally disclose their tax information to the ATO, they are also required to consider their tax affairs in the context of their financial statements in accordance with the AASB's *Uncertainty over income tax treatments* (IFRIC 23), which was approved on 3 August 2017. IFRIC 23 is effective for annual periods beginning on or after 1 January 2019.

IFRIC 23 provides guidance on financial statement disclosures where there is uncertainty about a company's tax treatment of a particular transaction or event. More specifically, companies will be required to disclose amounts in their financial statements to reflect the uncertainty in respect of whether a tax treatment adopted by an entity will be accepted by the taxation authority under tax law. If the company concludes that it is “not probable”<sup>14</sup> that the taxation authority will accept the company's tax treatment, the company must reflect the effect of such uncertainty in its financial statement under either:

- **the most likely amount:** the single most likely amount in a range of possible outcomes. The most likely amount may better predict the resolution of the uncertainty if the possible outcomes are binary or are concentrated on one value; or
- **the expected value:** the sum of the probability-weighted amounts in a range of possible outcomes. The expected value may better predict the resolution of the uncertainty if there is a range of possible outcomes that are neither binary nor concentrated on one value.

Importantly, the assessment under IFRIC 23 must be made on the assumption that the taxation authority has full knowledge of the relevant facts and circumstances (ie assuming 100% detection risk). IFRIC 23 adds to the increasing amount of taxpayer information that is disclosed to the general public, which will inevitably lead to increased public scrutiny of companies with aggressive tax strategies. The IFRIC 23 disclosures may also impact company valuations, credit ratings, funding abilities, and prospective mergers and acquisitions. IFRIC 23 will also encourage company directors to place tax at the forefront of their decision-making process.

## The imperative for greater transparency: “justified trust”

The phrase of “justified trust” is now well-engrained in Australian tax vernacular. The concept originated from the OECD and involves the ATO asking: “If we told the community how we assured the tax paid by a taxpayer, would they be satisfied we did enough?”

In recent years, the ATO's “justified trust” agenda has been executed by way of a program of streamlined assurance reviews of the top 1,000 public companies and multinational organisations, and a program to review the tax performance of the top 500 private groups. These intensive reviews have involved the ATO assessing the entire tax profile of a company and gathering objective evidence that would lead a reasonable person to conclude that the company has paid the right amount of tax and that the ATO is identifying and

addressing tax risks. The areas of focus under the justified trust program include:<sup>15</sup>

- understanding a taxpayer’s tax governance framework;
- identifying tax risks;
- understanding significant and new transactions; and
- understanding why the accounting and tax results vary.

Late last year, the ATO commenced the top 1,000 combined assurance program, which covers both income tax and goods and services tax. This program will replace the streamlined assurance review program for public companies and multinational organisations, which ended in December 2020. The ATO has also commenced the Next 5,000 program which will involve the application of the justified trust methodology in the context of private groups.

Justified trust may be considered an indirect shift away from the current self-assessment tax regime. Although a company will still self-assess when preparing its income tax return, it is also required to assure the ATO that it is paying the right amount of tax through active compliance, engagement and disclosure. Indeed, the ATO has stated that the intended outcome of the justified trust program is to “foster willing participation and engagement across the tax and superannuation system”.<sup>15</sup>

However, in the current transparent environment, the fact that a company pays the right amount of tax (as concluded by a reasonable person) may not align with the general public’s assessment of whether the company is paying its “fair share”. Balancing private company concerns with reputation management is by no means a simple task and additional transparency to the public may be required. Accordingly, it is important for companies to understand the current transparent tax landscape and to manage both the ATO’s expectations and the public’s expectations.

## Managing tax operations in a more transparent environment

In the ever-increasing tax transparent landscape, one best practice to adopt to identify, escalate and mitigate tax risks (and the inherent reputational risk) is a tax corporate governance (TCG) (or tax risk management) framework. In July 2015, the ATO released its *Tax risk management and governance review guide* (the guide) for corporate taxpayers in relation to tax corporate governance. The guide contains what the ATO considers to be “better practices” for large companies in relation to TCG, and it includes:<sup>16</sup>

- **board-level responsibilities:** boards are expected to have a tax strategy, to oversee TCG, and to be able to attest to the operational effectiveness of the organisation’s TCG framework;
- **management-level responsibilities:** management should have the capacity to enforce policies and implement strategies approved by the board;
- **a director’s summary:** outlines the responsibilities of directors and public officers in the context of TCG; and
- **self-assessment procedures:** guidelines for various stakeholders to assist in the testing and assessment of the operational effectiveness of a corporate taxpayer’s TCG framework.

The guide is indicative of the ATO’s increasing focus on TCG, its intention to raise the issue with company boards, and its commitment to reviewing companies’ internal TCG systems. It should be noted that, as part of the ATO’s “justified trust” concept, reviews include as a focal point the organisation’s TCG.

The guide is also reflective of the proactive engagement and assurance expected of companies by the ATO. The ATO not only wants to understand a company’s tax profile, but also its tax strategy, controls and the processes adopted to address tax risks. To this point, the voluntary TTC (see above) recommends that large businesses disclose their approach to tax strategy and governance, including:<sup>17</sup>

- their approach to risk management and governance arrangements;
- their attitude towards tax planning;
- their accepted level of risk in relation to taxation; and
- their approach to engagement with the ATO.

Furthermore, it is important to note that, by implementing a TCG framework, companies may be eligible to access the administrative concession afforded by PS LA 2004/14, which states that the ATO will not ordinarily seek access to advice provided to a corporate board on tax compliance risk.

An operationalised TCG framework is essential in the current Australian tax environment as it will assist in the real-time management of tax risks and reputational risk in the context of the expectations of the ATO and the general public. Without such a framework, it is unclear whether a company can navigate the current transparent tax environment with any peace of mind or certainty.

## Conclusion

The traditional concept of corporate tax affairs being a private matter has gradually eroded over the past few years. In its place is a tax environment with central themes of “public disclosure”, “justified trust” and “transparency”. This has impacted various stakeholders.

For the government, a transparent tax environment aligns with its ongoing agenda of encouraging companies to pay their fair share of tax. This agenda is critical if the government is to similarly enforce tax compliance on small businesses and individual taxpayers — noting that the tax gap from individuals and small businesses is significantly greater than that of large corporates (as well as the amount of tax paid).<sup>18</sup> The increased amount of corporate tax information in the public domain has led to the general public becoming more informed. This awareness may affect individual consumer spending and investment decisions, particularly given the rise of ethical and sustainable investing. However, as noted above, raw tax information may mislead the general public if not properly interpreted and given context.

Ultimately, the costs of a transparent tax environment will be borne by companies, whether it be through increased compliance and reporting costs, exposure to reputational risk, or impacts on financial statements (ie due to increased provisioning in the context of IFRIC 23). Companies need to carefully navigate this new environment and ensure that the tax information being disclosed to the general public and revenue authorities is both accurate and supportable. This is critical in



assuring the ATO that companies are paying the right amount of tax and, more importantly, paying their fair share.

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# Surrender of life interest and the CGT main residence exemption

by Nick Saverimuttu, CTA, Senior Taxation Manager, NSW Trustee and Guardian

TR 2006/14 was released by the ATO on 20 November 2006 and covers a broad range of situations under which life and remainder interests may be created, the various ways in which those interests may be subsequently dealt with, and their respective CGT consequences. This article focuses on the CGT consequences to the trustee if there is a surrender of a testamentary life interest in property. It looks at the various ways in which the property may be dealt with by the trustee after the surrender, the different CGT events each of those ways will give rise to, and the non-availability of the CGT main residence exemption for some of those events. Considering the factors that cause the CGT event to be different and their irrelevance for the main residence exemption, the article questions the policy rationale for allowing the availability of the main residence exemption to be dependent on those factors.

Life interests, as the word implies, are usually meant to continue until the life tenant dies. However, the life tenant may wish to terminate the life interest earlier by surrendering their life interest for no consideration or by disposing of their interest for consideration. If the testamentary life interest is terminated before the death of the life tenant, the property will not be passing under the terms of the will and there can be differing CGT consequences depending on how the property is dealt with after the termination. Key issues include:

- whether the property is sold by the trustee or is transferred in specie to the remainder beneficiaries; and
- whether there are multiple remainder beneficiaries or whether there is a sole remainder beneficiary.

It is useful to note that there are three separate assets for CGT purposes:

1. the life interest owned by the life tenant;
2. the deceased's property that is subject to the life interest and owned by the trustee ("the deceased's property"); and

3. the remainder interest owned by the remainder beneficiaries.

The CGT consequences discussed below relate to the second asset referred to above, namely, the deceased's property. Any capital gain or loss that may arise to the trustee from any of the various CGT events that can potentially occur in relation to the property following the surrender of the life interest will be included when working out the trust's net capital gain or loss and taxed in accordance with Subdiv 115-C of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Broadly, the effect of Subdiv 115-C is to treat any capital gain that is included in the trust's taxable income and assessed to a beneficiary as a capital gain made by the beneficiary.

## The trustee may transfer in specie or sell the property

Following the surrender of the life interest, the trustee may transfer the deceased's property in specie to the remainder beneficiaries or may sell the property on behalf of the remainder beneficiaries. There may be one remainder beneficiary or multiple remainder beneficiaries. The potential CGT events that can arise under these circumstances are CGT events E5, E7 and A1, and these CGT events will have consequences for the trust.

The various ways in which the property may be dealt with following the surrender of the life interest and their CGT consequences to the trust are examined below.

### Situation A: Transfer in specie to remainder beneficiaries – multiple remainder beneficiaries

The CGT events that may be relevant when the property is transferred in specie to multiple remainder beneficiaries are CGT event E5 in s 104-75 ITAA97 at the time of surrender of the life interest, and CGT event E7 in s 104-85 ITAA97 at the time of transfer.

CGT event E5 will occur at the time the life interest is surrendered if the remainder beneficiaries become absolutely entitled to the property at that time. TD 2004/D25 explains that, for assets that are not fungible such as property, absolute entitlement cannot be established if there is more than one beneficiary entitled to it. As there are multiple remainder beneficiaries in this given scenario, absolute entitlement will not be established and CGT event E5 will not occur. There are no CGT consequences to the trustee at the time the life interest is surrendered.

If the property is transferred in specie to the remainder beneficiaries, CGT event E7 in s 104-85 ITAA97 will occur at the time of transfer (transfer of asset to remainder beneficiaries to end capital interest in the trust).

CGT event E7 contains an exception for trusts to which Div 128 ITAA97 applies. If Div 128 applies, CGT event E7 can be ignored.

### Does Div 128 apply under these circumstances?

Section 128-15(3) ITAA97 provides that:

"Any capital gain or capital loss the legal personal representative makes if the asset passes to a beneficiary in your estate is disregarded."

The two conditions that must be met for Div 128 to apply are:

1. the capital gain must be made by the legal personal representative (LPR); and
2. the asset must pass to the beneficiary.

Under these circumstances, the Commissioner is likely to treat the trustee of a testamentary trust the same as an LPR (PS LA 2003/12). However, the Commissioner is unlikely to treat the property as having “passed” to the remainder beneficiaries. Passing in this context would require passing in accordance with the will, ie passing to the remainder beneficiaries after the life tenant dies. Such an approach seems consistent with the examples given in TR 2006/14.

Division 128 will not operate to disregard any capital gain or loss from CGT event E7 because the property is not passing to the remainder beneficiaries after the death of the life tenant in accordance with the terms of the will. CGT event E7 would have been disregarded had the property been transferred to the remainder beneficiaries after the death of the life tenant event.

CGT event E7 will occur when the property is transferred in specie and CGT event E7 will have consequences to the trustee. The following points are relevant when calculating the trust’s capital gain or loss from CGT event E7:

- the market value at the time of transfer is taken as consideration (s 104-85(3) ITAA97);
- the first element of the cost base is determined under s 128-15(4) ITAA97 which provides that a dwelling that was the deceased’s main residence just before they died is acquired for market value at the date of death of the deceased; and
- a partial main residence exemption for the period occupied by the life interest beneficiary is not available (the main residence exemption under Subdiv 118-B ITAA97 is not available for CGT event E7; s 118-110(2) ITAA97 lists the CGT events which are relevant for the purposes of the main residence exemption and CGT event E7 is not included in that list).

#### Example 1. Trustee transfers in specie to multiple remainder beneficiaries

James’s will provided that his main residence be held on trust for his wife for life and for his three daughters in remainder in equal shares.

At the time of James’s death on 14 January 2000, the market value of the residence was \$400,000.

On 14 January 2020, James’s wife surrendered her life interest for no consideration as she was moving into a nursing home and did not need any income from the property. At that time, the market value of the property was \$1,200,000.

On 14 January 2021, the trustee transferred the property to the three daughters as tenants in common. The market value at the time of transfer was \$1,300,000.

#### Outcome

CGT event E7 occurs on 14 January 2021 (the date the property was transferred to the remainder beneficiaries).

#### Example 1 (cont)

The market value on 14 January 2021 is \$1,300,000 (consideration).

The market value on 14 January 2000 is \$400,000 (cost base).

A pro rata main residence exemption for occupation by the life tenant is not available for CGT event E7.

Ignoring other elements of the cost base and the CGT discount, the capital gain that will be included in the trust’s taxable income and assessed in the hands of the beneficiaries is  $1,300,000 - 400,000 = \$900,000$ .

#### Situation B: Sale by trustee – multiple remainder beneficiaries

In situations where there are multiple remainder beneficiaries, the remainder beneficiaries do not become absolutely entitled to the property at the time of surrender. Absolute entitlement to property can only occur if there is a sole beneficiary (TD 2004/D25). This means that CGT event E5 in s 104-75 ITAA97 does not occur at the time of surrender.

CGT event A1 in s 104-10 ITAA97 occurs at the time of sale, and any capital gain or loss will be included when calculating the taxable income of the trust and assessed in accordance with Subdiv 115-C ITAA97.

A partial main residence exemption for the period occupied by the life tenant is available (the main residence exemption is available for CGT event A1), and the capital gain to be included in the trust’s taxable income and assessed in the hands of the beneficiaries is calculated using the formula in s 118-200 ITAA97.

#### Example 2. Sale by trustee, multiple remainder beneficiaries

Assume the same facts as in example 1 except that the trustee sold the property on 14 January 2021 for \$1,300,000.

#### Outcome

CGT event A1 occurs on 14 January 2021.

Consideration for the sale on 14 January 2021 is \$1,300,000.

The capital gain before applying the partial main residence exemption is \$900,000.

The life tenant occupied the property for 20 years out of a total of 21 years.

The capital gain after applying the partial main residence exemption is  $900,000 - 900,000 \times 20/21 = \$42,857$ .

#### Situation C: Transfer in specie to remainder beneficiary – sole remainder beneficiary

The testamentary trust may have only one remainder beneficiary. In such situations, the sole remainder beneficiary will become absolutely entitled to the property at the time of surrender, ie CGT event E5 in s 104-75 ITAA97 occurs in relation to the property at the time of surrender.

Division 128 ITAA97 will not operate to disregard any capital gain or loss from CGT event E5 because the property is not

passing to the remainder beneficiary after the death of the life tenant in accordance the terms of the will.

The following points are relevant when calculating the capital gain or loss from CGT event E5:

- the market value at the time of surrender is taken as the sale proceeds for CGT event E5;
- the cost base is the market value at the date of death of the deceased; and
- a partial main residence exemption, for occupation by the life tenant until the time of surrender, is not available (the main residence exemption under Subdiv 118-B is not available for CGT event E5 (s 118-110(2)(a) ITAA97)).

**Example 3. Trustee transfers in specie to sole remainder beneficiary**

Assume the same facts as in example 1 except that there is a sole remainder beneficiary.

CGT event E5 occurs on 14 January 2020 (the date the life interest was surrendered).

The market value on 14 January 2020 is \$1,200,000 (consideration).

The market value on 14 January 2000 is \$400,000 (cost base).

The capital gain is 1,200,000 – 400,000 = \$800,000.

**Situation D: Sale by trustee – sole remainder beneficiary**

The sole remainder beneficiary becomes absolutely entitled at the time of surrender.

CGT event E5 in s 104-75 ITAA97 occurs on 14 January 2020 (the date the life interest was surrendered).

The outcome is the same as in example 3.

**Summary**

Table 1 summarises the CGT outcomes for the different ways in which the trustee may deal with property after the surrender of the life interest in the property and the factors that cause the outcome to be different.

The main residence exemption for the period the life tenant occupied the property is only available when both of the following conditions are met:

- there are multiple remainder beneficiaries; and
- the trustee sells the property.

As can be seen from examples 1 and 2, in situations where there are multiple remainder beneficiaries, the beneficiaries will be significantly better off having the property sold by the trustee in the estate instead of taking an in specie transfer.

The policy rationale for differentiating on this basis for purposes of granting the main residence exemption in instances when the life tenant surrenders their interest for no consideration is unclear. Remainder beneficiaries should not have to decide whether to sell or take an in specie transfer based on tax. Furthermore, as CGT events E5 and E7 are deemed disposals, the actual sale proceeds will not be available at that time to fund the payment of the CGT.

It may well be that CGT events E5 and E7 can be avoided by a clause in the will that gives the option for the life interest beneficiary to surrender their interest for no consideration as the property would then be passing under the terms of the will and Div 128 ITAA97 can apply to ignore CGT events E5 and E7. This would depend on the Commissioner accepting that a surrender of a life interest pursuant to this clause satisfies the requirement in Div 128 that the property must pass to the remainder beneficiaries in accordance with the terms of the will. Given that TR 2006/14 does not deal with this point, it may be wise to obtain a private ruling from the Commissioner.

**Nick Saverimuttu, CTA**  
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**Table 1. Potential CGT outcomes to the trustee following surrender of life interest**

Situation	Scenario	CGT event	Main residence exemption available?	Capital gain
A	Transfer in specie – multiple remainder beneficiaries	E7	No	\$900,000
B	Sale by trustee – multiple remainder beneficiaries	A1	Yes	\$42,857
C	Transfer in specie – sole remainder beneficiary	E5	No	\$800,000
D	Sale by trustee – sole remainder beneficiary	E5	No	\$800,000





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# Imposing administrative penalties on SMSFs

by Dung Lam, CTA, Special Counsel,  
Coleman Greig Lawyers

The administrative penalties regime was enacted into superannuation law in the 2014 with the aim of providing the ATO with a more flexible tool to enforce compliance with superannuation law. Prior to the enactment of the regime, the ATO's main tool to enforcing compliance was the drastic action of making the errant superannuation fund non-complying. Given the devastating result of making a fund non-complying where half of fund assets would go to paying tax, the ATO was reluctant to impose such a sanction. The administrative penalties regime allows the ATO to impose financial penalties on SMSF trustees in a way which can be calibrated to the degree of culpability. In PS LA 2020/3, the ATO outlines how it will approach the imposition of administrative penalties on SMSFs and its approach to penalty remission.

On 15 October 2020, the ATO issued practice statement PS LA 2020/3 which outlines:

- how the ATO considers the administrative penalties regime applies to superannuation law breaches made by self-managed superannuation funds (SMSFs); and
- what considerations the ATO takes into account when considering remission of such penalties.

This article focuses on salient points raised by the practice statement.

PS LA 2020/3 is a “mixed bag”, with some good aspects and some less kind aspects. On the plus side, the practice statement acknowledges the harshness of the administrative penalty regime where multiple penalties can apply to what practically is one breach and expressly provides for remissions where the result is unintended or unjust. The practice statement's outline of the factors which the ATO sees as relevant for penalty remission is also welcome since the statutory provisions on penalty remission in s 298-20 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA53) are silent on the matter. On the other hand, the issue of PS LA 2020/3 signals an intent by the ATO to take a much firmer stance on penalty remissions than it has in the past where it was felt that too many penalties were being remitted for behaviour which should have been punished.

What PS LA 2020/3 mostly reinforces is the urgent need for SMSF trustees who discover a superannuation breach to seek specialist superannuation advice promptly and, if necessary, to access the ATO's early engagement and voluntary disclosure service as soon as possible. Penalty remission will be a much harder process if the breach is picked up by the ATO.

## How the ATO considers the administrative penalty regime operates

Where SMSF trustees breach superannuation law, the ATO can apply any one or more of the following compliance actions:

1. imposing administrative penalties;<sup>1</sup>
2. issuing education directions;<sup>2</sup>
3. issuing rectification directions;<sup>3</sup>
4. obtaining unenforceable undertakings that certain actions be implemented, including the winding up of the SMSF;<sup>4</sup>
5. disqualifying a person from being an SMSF trustee or a director of an SMSF trustee;<sup>5</sup>
6. seeking court orders to impose civil and criminal penalties;<sup>6</sup>
7. freezing the SMSF's assets;<sup>7</sup> or
8. making the SMSF non-complying which effectively results in the assets and income of the SMSF being taxed at 45% — an extremely adverse result.<sup>8</sup>

The first three compliance actions listed above only apply to superannuation law breaches which occur on or from 1 July 2014. Prior to this time, the ATO found it difficult to properly discipline SMSF trustees on superannuation breaches since the available compliance actions were not easy to take. For instance, the imposition of civil or criminal penalties required court orders and making an SMSF non-complying was such an adverse action that it was rarely pursued. The enactment of the administrative penalties regime, education directions and rectification directions were aimed at providing the ATO with more flexible disciplinary powers.

Under the administrative penalties regime, where an SMSF trustee breaches a superannuation provision listed in s 166 SISA93, s 166 automatically imposes an administrative penalty. Table 1 outlines the administrative penalty provisions listed in s 166 and the amount of such penalty.

A penalty unit is CPI-indexed every three years, and currently is \$222.

Not all breaches of superannuation law are listed in s 166 SISA93. Significantly, fault-based breach provisions which rely on proof of fault based on criminal responsibility principles (such as s 66 SISA93 (the acquisition of an asset from a related party)) are not listed. This is because a breach of such provisions can lead to criminal penalties, including imprisonment.

The fact that s 166 does not list all of the superannuation provisions which a superannuation fund trustee may breach does not mean that the reach of the administrative penalty regime is limited. This is because s 34 SISA93 (breach of a prescribed operating standard) is listed in s 166, and the prescribed operating standards in the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR94) cover most of

**Table 1. Administrative penalties listed in s 166**

SISA93 provision	Description of provision breached	Administrative penalty
S 34(1)	Prescribed operating standards	25 penalty units
S 35B(1)	Accounts and statements	10 penalty units
S 65(1)	Lending to members and relatives	60 penalty units
S 67(1)	Borrowings	60 penalty units
S 84(1)	In-house assets	10 penalty units
S 103(1) and (2)	Duty to keep minutes	10 penalty units
S 103(2A)	Retention of copy of s 71E election	10 penalty units
S 104(1)	Duty to keep records of changes of trustees	10 penalty units
S 104A(2)	Declaration of recognition of obligations and responsibilities	10 penalty units
S 105(1)	Duty to keep and retain member or beneficiary reports	10 penalty units
S 106(1)	Duty to notify of significant adverse events	60 penalty units
S 106A(1)	Duty to notify change in status of entity	20 penalty units
S 124(1)	Written appointment of investment managers	5 penalty units
S 160(4)	Education direction	5 penalty units
S 254(1)	Information to be given to the regulator	5 penalty units
S 347A(5)	Participation in the regulator's statistical program	5 penalty units

the remaining superannuation law breaches that are not listed in s 166. For instance, reg 4.09A SISR94 requires a complying superannuation fund to keep its assets separate, and reg 6.17 SISR94 regulates illegal access to superannuation.<sup>9</sup>

The way that the ATO conceives of a superannuation contravention in PS LA 2020/3 is technical and can lead to multiple breaches (and hence multiple administrative penalties) where practically one might say that only one real breach has occurred. According to the ATO, there is no such thing as a continuing contravention which carries over successive financial years. Rather, a contravention occurs at a particular point in time, and if the breach remains unrectified at the end of the financial year, a second contravention may be triggered.<sup>10</sup>

For example, an SMSF may contravene the rule against lending to members under s 65(1)(a) SISA93 when it makes, say, a \$10,000 loan to a member. If that loan is not repaid by the end of the financial year in line with the loan's repayment schedule, a second contravention occurs since the SMSF's failure to seek repayment of the loan in accordance with the repayment schedule contravenes the rule against providing members with financial assistance in s 65(1)(b). That is, by failing to enforce the loan terms, financial assistance has been provided. More breaches of this financial assistance rule will occur in each subsequent year where the SMSF trustee fails to repay the loan in accordance with its repayment schedule.

This technical approach to a contravention can result in significant administrative penalty amounts being imposed. For instance, if no repayments are made on the \$10,000 loan to the member for three years, this could lead to a prima facie \$53,280 administrative penalty (ie \$222 × 60 penalty units × 4). That is, five times the amount of the \$10,000 loan! The approach taken in PS LA 2020/3 is essentially to start from a high base of multiple penalties, and then focus on penalty remission.

The ATO's stance on contraventions means that loan breaches which have occurred prior to 1 July 2014 may still be dragged into the administrative penalty regime. For example, if an SMSF makes a loan to a member on 1 June 2014, the act of making of the loan is not subject to the administrative penalty regime. However, the SMSF's failure to require repayment of the loan in accordance with the loan repayment schedule at the end of each subsequent financial year would constitute a financial assistance breach on which an administrative penalty can be imposed.

The ATO's position on contraventions reflects the statutory structure of the compliance test for an SMSF in s 42A SISA93. Section 42A generally requires that an SMSF not contravene a regulatory provision on an income year by income year basis in order to continue to be a complying superannuation fund. Where an SMSF breaches a regulatory provision, it only continues to be a complying superannuation fund at the discretion of the ATO.

Administrative penalties can be imposed on an individual SMSF trustee or a corporate SMSF trustee. Where an SMSF has multiple individual trustees, it exposes the SMSF to multiple penalties for the one superannuation law breach. For example, where an SMSF has four individual trustees, a single breach of an administrative penalty may trigger four lots of the administrative penalty — one penalty for each individual trustee. Continuing on with the \$10,000 loan example, the total prima facie administrative penalty amount that can be imposed where the SMSF had four individual trustees is an eye watering \$213,120 (ie 4 × \$53,280).

Only one administrative penalty is imposed on a corporate trustee of an SMSF. However, its directors are jointly and severally liable to pay the penalty.<sup>11</sup> The fact that a corporate trustee is only subject to one administrative penalty for a breach, while multiple penalties can apply where an SMSF has multiple individual trustees, is a significant reason (besides



ease of succession planning) for an SMSF to have a corporate trustee rather than the individual members being trustees.

An administrative penalty can also be imposed on an individual director of a corporate SMSF trustee for a failure to keep minutes,<sup>12</sup> failing to sign a trustee declaration form (declaring their recognition of the duties and obligations of an SMSF trustee) within the required time period,<sup>13</sup> or failing to meet an education direction.<sup>14</sup>

Significantly, a trustee cannot seek reimbursement from the SMSF for payment of an administrative penalty.<sup>15</sup>

### How the ATO approaches penalty remission

The ATO has the power to remit the whole or part of an administrative penalty. A remission decision needs to be made for each trustee on whom the penalty is imposed, taking into account the trustee's particular circumstances.

The fact that a trustee may not have been actively involved in a breach does not automatically lead to penalty remission. Example 9 of PS LA 2020/3 describes an SMSF where the husband is the sole member, but the trustees are the husband and wife. The husband makes all of the decisions for the SMSF and various superannuation law breaches occur. The ATO did not consider that further remission of an administrative penalty was warranted for the wife because "passivity" is not an excuse. That is, trustees are equally responsible to ensure that appropriate controls are in place to prevent contraventions and each trustee needs to ensure that they are fully informed about the actions of the other trustee.

PS LA 2020/3 indicates that the ATO considers the following factors to be relevant when considering penalty remission:

- the objectives of the administrative penalty provision which are to:
  - encourage greater levels of voluntary compliance by ensuring that there are consequences for non-compliance appropriate to the conduct;
  - promote consistent treatment by specifying the penalty amount for each contravention; and
  - shift trustee behaviour so that they do not contravene again;
- trustee behaviour and individual circumstances:
  - whether the trustee has generally tried to act with the care, diligence and skill that an ordinary prudent person would have exercised;
  - what the background, experience and intentions of the trustee are;
  - the compliance history of the trustee;
  - whether rectification has occurred before any ATO contact;
  - whether a voluntary disclosure was made before any ATO contact; and
  - whether there were circumstances outside the trustee's control that caused the contravention, or affected the trustee's ability to comply or rectify;
- the seriousness of the contravention, ie to what extent the SMSF assets are affected and over what time period the contraventions occurred;

- whether the prescribed penalty amount led to an unintended or unjust result (eg whether a cumulative penalty is so large that it is excessive in light of the above factors);
- where multiple administrative penalties apply, whether the cumulative penalty amount is defensible, proper and just in light of the circumstances. For instance, if the multiple penalties arose from a single course of conduct or a particular event, remission may be warranted. In example 10 of PS LA 2020/3, an SMSF lends funds to a member and the member fails to repay the loan in accordance with the loan repayment schedule over a number of years. In such a situation, the ATO imposed one administrative penalty for a breach of s 65(1)(a) (the lending) and one administrative penalty for a breach of s 65(1)(b) (the failure to require repayment). The ATO remitted the administrative penalties imposed in subsequent years for failure to require repayment since they arose out of a single course of conduct in failing to require repayment;
- where multiple superannuation law provisions are breached, the ATO will generally consider what the primary contravention is and remit the administrative penalty arising from the secondary contravention. This is on the basis that the imposition of multiple penalties for one particular event is unjust. The primary contravention is determined based on the behaviour and intention of the trustees. For example, an SMSF loan to a member breaches s 65(1) (the loan rule) and potentially s 84(1) SISA93 (the in-house asset rules). In such a case, the ATO considers the primary contravention to be the breach of the loan rule.

Where a member accesses their superannuation benefits without meeting a condition of release, there is a breach of s 34(1) SISA93 (the operating standards) and s 65(1)(b) SISA93 (the provision of financial assistance). In this situation, the ATO considers the primary contravention to be the breach of the operating standards.

Significantly, PS LA 2020/3 indicates that remission here depends on the circumstances of the case, and that remission should generally not be granted because of multiple penalties arising from one event in cases of fraud, evasion or egregious contraventions.

The penalty remission factors outlined in PS LA 2020/3 are not exhaustive. The ATO describes its discretion to remit a penalty under s 298-20, Sch 1 TAA53 in the practice statement as "unfettered". This means that the ATO may remit the penalty in whole or in part in any manner it wishes. However, this does not mean that the ATO can do anything it wants. Tax case law indicates that the discretion should be exercised in light of the purpose behind the penalty provisions.<sup>16</sup> Additionally, the case law indicates that the relevant question is whether it is appropriate in an individual's circumstances to remit.<sup>17</sup> It is not necessary to show special circumstances for remission, and remission may be appropriate where the outcome would be harsh in an individual's particular circumstances<sup>18</sup> (although it is not necessary to show harshness for remission to occur<sup>19</sup>).

A penalty remission decision must be provided in writing with an explanation. An SMSF trustee who is dissatisfied with a penalty remission decision may object and dispute it under Pt IVC TAA53.<sup>20</sup>



## What should an SMSF trustee do now?

If you are an SMSF trustee or a director of a corporate trustee of a SMSF and are concerned that your SMSF may have breached the superannuation law, you should seek specialist superannuation law advice promptly. Depending on the circumstances, it may be that the specialist advice confirms that there is no breach of the superannuation law at all. If there is a breach, strategies can be considered on how best to minimise the penalties and regularise the situation. Such strategies may include implementing a rectification plan prior to or in conjunction with making a prompt voluntary disclosure to the ATO. Such a voluntary disclosure should comprehensively outline all relevant facts surrounding the breach, including any rectification plan and the grounds for penalty remission. The key is rectifying and disclosing prior to the ATO initiating any compliance action.

The ATO encourages SMSF trustees to engage with it through its early engagement and voluntary disclosure service where breaches have occurred. Affected SMSF trustees should take advantage of this early engagement and voluntary disclosure service since PS LA 2020/3 clearly indicates that penalty remission is a harder prospect in audit. A key requirement of using the ATO's early engagement and voluntary disclosure service is that the SMSF be up to date in the lodgment of its annual returns. Accordingly, voluntary disclosure is usually a coordinated arrangement together with the SMSF's accountant.

Members of an SMSF should also seriously consider whether they should have a corporate trustee for their SMSF in order to minimise the administrative penalties which may be levied where a breach has occurred. While using a company involves annual ASIC fees, such fees can be reduced if the company's sole purpose is to act as an SMSF trustee.

### Dung Lam, CTA

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## A Matter of Trusts

by Edward Hennebry, FTI, Sladen Legal

# Documentary protocols and disclaimers

### A recent Full Federal Court decision reflects the diversity of issues which can arise in the complex world of discretionary trusts.

Recent comments by the Full Federal Court in *Carter v FCT*<sup>1</sup> remind us of the following:

- corporate trustees should ensure that trust resolutions are made in accordance with trust law, the trust deed, the trustee company's constitution, and the *Corporations Act 2001* (Cth);
- default beneficiaries of discretionary trusts seeking to disclaim an entitlement to the income or capital of the trust should be proactive and adopt precise and clear language; and
- the tension between trust law and tax law continues to enliven difficult issues of statutory interpretation and policy.

### The formality issues

Tax advisers may be surprised to see the number of matters that become litigious because rudimentary protocols expressed in an entity's governing documents are not followed.

*Carter* is another example of a case where a taxpayer spent time and incurred expenses contesting Australian Taxation Office scrutiny apparently due to insufficient evidence and a failure to observe documentary formalities.

In *Carter*, the corporate trustee of a family trust failed to adhere to its constitution and the terms of the trust deed when purporting to distribute the discretionary trust's income. This meant that the resolutions of the trustee were ineffective.

From the perspective of the constitution of the corporate trustee:

- the minutes of the annual directors' meeting failed to outline which directors were present, so it was not clear if a quorum was present;
- the minutes were executed by one director as a chairperson, but he did not give evidence as to who attended the meetings;
- one director admitted that she was not aware of the minutes of the meeting or that the company was in fact a trustee of a trust; and

- s 1305(1) of the *Corporations Act 2001* does not operate to make the facts and matters detailed in a company's minutes conclusive evidence of those facts and matters.<sup>2</sup>

From a trust deed compliance perspective:

- distributions of income required the prior written consent of the guardians (in this instance, two people), and there was no evidence that both guardians had consented; and
- the taxpayer's argument that one of the guardians was not aware of its duties and that consent of one guardian was sufficient was rejected based on the clear wording of the trust deed.

Similar adverse outcomes arose to the taxpayer in *Advanced Holdings Pty Ltd as trustee for The Demian Trust v FCT*<sup>3</sup> (on appeal), where, as a result of failing to follow the procedures under a trust deed, the taxpayer was unable to convince the Federal Court that it had been validly appointed as a trustee of a discretionary trust. Consequentially, the trustee was considered to have held units in a unit trust in its personal capacity.

Ultimately, the same adage can be reiterated — read the governing documents of your entity very carefully and document all decisions according to the governing documents. For trusts, the failure to properly document a beneficiary's present entitlement to income can trigger what would be otherwise preventable outcomes (such as trustees being assessed at the highest marginal tax rate).

### The disclaimer issues

In *Carter*, and because of the non-compliance with the trust's constituent documents, the Commissioner issued income tax assessments to the default beneficiaries of the discretionary trust.

The default beneficiaries then prepared a series of disclaimers:

- first, in response to being issued income tax assessments by virtue of the trustee's ineffective distribution; and
- second, in response to the Commissioner's notification of the rejection of their previous disclaimers.

The Commissioner (and the Administrative Appeals Tribunal on review) initially held that these disclaimers were ineffective because the disclaimers either:

- purported to disclaim an annual entitlement to income, but did not purport to disclaim anything more (that is, as default of appointment beneficiaries); or
- were irrelevant because the default beneficiaries had implicitly accepted the present entitlement to the income of the trust by virtue of previously made, but insufficiently worded, disclaimers.

In the end, the Full Federal Court reversed the AAT's decision, deciding that, immediately on gaining full knowledge of the nature of their interests (through the Commissioner's notification of the rejection of their previous disclaimers), the default beneficiaries effectively disclaimed their interests.

This conclusion was not only informed by the timing of when the final disclaimers were made (within eight days of the Commissioner's objection decision), but also due

to the strong and unequivocal language adopted in the disclaimers.

The court noted that, in contrast to the initial disclaimers, the final set of disclaimers expressly disclaimed, in absolute and irrevocable terms, the default beneficiaries' interest and title in the income and capital of the trust on the failure of the trustee to make an effective annual determination.

More significant was the court's pronouncement that an ineffective disclaimer does not constitute implicit acceptance of a gift and prevent subsequent disclaimers from having effect. Rather, all of the facts and circumstances need to be considered.

In this instance, a crucial fact was that the Commissioner had accepted the efficacy of disclaimers made by the beneficiaries in an earlier income year (2011) but rejected identically worded disclaimers for the subsequent income years in dispute. Accordingly, much of the impetus prompting the beneficiaries to draft further disclaimers was as a response to the Commissioner's admission that he was wrong to have accepted that their 2011 disclaimers were effective.

The lessons are therefore:

- beneficiaries who wish to disclaim their entitlement to income under a trust should do so as soon as becoming aware of the entitlement;
- when disclaiming an entitlement, use absolute and unequivocal language. Any qualifications to the entitlement may be insufficient and constitute implicit acceptance;
- default beneficiaries have a higher burden to satisfy when seeking to disclaim their entitlements under a trust. Year-by-year disclaimers will not be effective (*FCT v Ramsden*<sup>4</sup>); and
- even if a revenue authority rejects the efficacy of a disclaimer, it may be still be possible in certain circumstances for a beneficiary to successfully disclaim their trust entitlements.

### Tension between the general law and the tax law

An effective disclaimer of an entitlement defeats the donor's intention to give the relevant property to the donee, with the consequence that the disclaimer operates *retrospectively* as if the entitlement never arose. This is acknowledged in *Ramsden* and ATO ID 2010/85.

However, it remains challenging to reconcile the notion that disclaimers operate retrospectively with the concept that a beneficiary is assessed to tax when they become "presently entitled" (under s 97 of the *Income Tax Assessment Act 1936* (Cth)).

In *Carter*, the Commissioner agitated the above point (albeit unsuccessfully) in arguing that, despite a successful disclaimer, the default beneficiaries were still taxable under s 97. In doing so, he referenced *Harmer v FCT*<sup>5</sup> which confirmed that present entitlement is to be ascertained "as at the time when the interest was derived, that is to say, during the tax years".

In response, the court held that:

- there is nothing in the legislative scheme to indicate that a beneficiary's liability under s 97 is to be determined once and for all by reference to the legal relationships then in existence in the income year in question; and
- a disclaimer does not change the operation of the legislation. Rather, the tax consequences of the disclaimer are determined by the reference to the general law.

The Commissioner had raised similar arguments in *Lewski v FCT*,<sup>6</sup> but the Full Federal Court did not need to consider those arguments because the disclaimers in that case were held to be ineffective.

The Commissioner has sought special leave to the High Court in *Carter*. If special leave is granted, it will be interesting to see if this tension between the general law of disclaimers and retrospectivity, and the legislative mechanism to tax "presently entitled" beneficiaries, is clarified.

This is yet another example of the friction between trust law and tax law. Perhaps it is time to reconsider proposals to modernise the taxation of trusts.

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#### References

- 1 [2020] FCAFC 150.
- 2 Interestingly, the court did not refer to *FCT v Cassaniti* [2018] FCAFC 212 which highlighted the difficulties that the ATO may face when asserting that a taxpayer's statutory burden of proof has not been met in relation to a company's financial books or records as a result of s 1305(1) of the *Corporations Act 2001*.
- 3 [2020] FCA 1479.
- 4 [2005] FCAFC 39.
- 5 [1991] HCA 51.
- 6 [2017] FCAFC 145.





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# Superannuation

by Daniel Butler, CTA, DBA Lawyers

## SMSFs, LRBA's and NALI

**Broadly speaking, LRBA's that are consistent with arm's length terms should not give rise to NALI. On the other hand, LRBA's that are not consistent with arm's length terms may attract NALI.**

### Introduction

When dealing with limited recourse borrowing arrangements (LRBA's), it is important to understand the consequences that may arise where the LRBA is not implemented and maintained on a proper basis. This is especially so in the case of a self-managed superannuation fund (SMSF) undertaking a related party LRBA. The terms and conditions of such an LRBA should either comply with the ATO's safe harbour criteria in PCG 2016/5 or be benchmarked with arm's length evidence.

Having an LRBA that is not properly implemented and maintained can result in non-arm's length income (NALI) and other potential contraventions of the *Superannuation Industry (Supervision) Act 1993* (Cth).

### Relevant legislation

We will first examine the NALI provisions that can apply to a related party LRBA in s 295-550(1) of the *Income Tax Assessment Act 1997* (Cth), which provides:

- “(1) An amount of ordinary income or statutory income is **non-arm's length income** of a complying superannuation entity if, as a result of a scheme the parties to which were not dealing with each other at arm's length in relation to the scheme, one or more of the following applies:
- (a) the amount of the income is more than the amount that the entity might have been expected to derive if those parties had been dealing with each other at arm's length in relation to the scheme;
  - (b) in gaining or producing the income, the entity incurs a loss, outgoing or expenditure of an amount that is less than the amount of a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme;
  - (c) in gaining or producing the income, the entity does not incur a loss, outgoing or expenditure that the entity might have been expected to incur if those parties had been dealing with each other at arm's length in relation to the scheme.”

### Latest ATO draft ruling on NALI

When an SMSF undertakes an LRBA and obtains more income, or where an SMSF trustee incurs a lower than arm's length expense in relation to an arrangement (or does not incur any expense), the ATO would be keen to examine such arrangements to determine if there are any non-arm's length dealings that resulted in increased income or lower expense.

Example 4 from the draft ruling LCR 2019/D3, provides an indication of how the ATO determine whether NALI should be applied to an LRBA.

“Example 4 – purchase financed through a limited recourse borrowing arrangement on non-arm's length terms – NALI

30. During the 2018-19 income year, Kellie as trustee of her SMSF, entered into a non-commercial limited recourse borrowing arrangement (LRBA) with herself in her individual capacity to purchase a commercial property valued at \$2 million. Her SMSF borrowed 100% of the purchase price and the terms of the loan included interest being charged at a rate of 1.5% per annum and repayments only being made on an annual basis over a 25-year period. Kellie's SMSF received a commercial rate of rent from the property of \$12,000 per month.

31. If Kellie's SMSF had entered into an LRBA on arm's length terms, it would be expected that repayments of principal and interest would have occurred on a monthly basis and interest would be charged on the LRBA at a commercial rate. The loan to market value ratio would have also not exceeded commercial levels.

32. For the purposes of subsection 295-550(1), the scheme involves the SMSF entering into the LRBA with Kellie, complying with the terms of the LRBA, purchasing the commercial property, and deriving the rental income. The terms of the LRBA constitute a non-arm's length dealing between the SMSF and Kellie, which resulted in the SMSF incurring expenditure in gaining or producing rental income that was less than would otherwise be expected if those parties were dealing with each other at arm's length in relation to the scheme. The rental income derived from the commercial property is therefore NALI.

33. The non-arm's length expenditure incurred under the LRBA will also result in any capital gain that might arise from a subsequent CGT event happening in relation to the property (such as disposal of the property) being NALI.”

Paragraph 9 of LCR 2019/D3 states:

“An amount of ordinary or statutory income will be NALI of a complying superannuation fund where:

- there is a scheme in which the parties were not dealing with each other at arm's length
- the fund incurs a loss, outgoing or expenditure of an amount in gaining or producing the income, and
- the amount of the loss, outgoing or expenditure is less than the amount that the fund might have been expected to incur had those parties been dealing with each other at arm's length in relation to the scheme.”

Example 4 (quoted above), with a 100% loan to value ratio (LVR), a 25-year loan with annual payments and a 1.5% pa interest rate, appears more favourable to the fund compared to arm's length terms. It would be difficult for Kellie's SMSF to support these terms with arm's length benchmark evidence. Thus, the ATO's view is that NALI would apply to any income from this arrangement (including any capital gain arising on a CGT event in relation to the property).

### Comparing the hypothetical borrowing arrangement to the LRBA “scheme”

When determining whether NALI applies, TD 2016/16 states that an analysis of what the arm’s length borrowing terms would have been is required (“hypothetical borrowing arrangement”). It is then necessary to analyse whether it is reasonable to conclude that the SMSF trustee could have and would have entered into the hypothetical borrowing arrangement. The ATO’s view is that, where it is reasonable to conclude that the SMSF trustee could not or would not have entered into the hypothetical borrowing arrangement, the income from the scheme will be treated as NALI.

The ATO also considers in TD 2016/16 that, where the SMSF trustee could have entered into the arrangement but derives more income compared to an arm’s length hypothetical borrowing arrangement, the income in relation to the scheme will also be taxed as NALI.

Following the introduction of the non-arm’s length expense provisions in s 295-550(1)(b) and (c) (quoted above) from 1 July 2018, the ATO would also seek to apply NALI where the expense in relation to the LRBA was less than (including nil) a hypothetical borrowing arrangement (assuming that the parties were dealing at arm’s length).

For example, in relation to example 4 in LCR 2019/D3, if an arm’s length LRBA was charging 4.5% interest (rather than 1.5%) and was requiring principal and interest repayments on a monthly basis with a 70% LVR, then the ATO would compare the factors set out in Table 1.

As can be seen from Table 1, the hypothetical arm’s length example would, when compared to the terms in example 4, result in a much higher interest expense of \$63,000 pa in year one compared to only \$30,000 of interest under the facts in example 4. Thus, the net rent after interest expense is \$114,000 compared to \$81,000 under the hypothetical arm’s length comparison. This results in an additional \$33,000 of income compared to the hypothetical arm’s length

comparison, thereby giving rise to NALI under s 295-550(1)(b) ITAA97.

The onus is on the SMSF trustee to gather the relevant evidence to support the arm’s length nature of the arrangement.

### ATO safe harbour on LRBAs

The ATO’s “safe harbour” for undertaking an LRBA, namely, PCG 2016/5, has been an excellent ATO initiative, providing great practical guidance. Paragraph 2 of PCG 2016/5 states:

“This Guideline sets out the ‘Safe Harbour’ terms on which SMSF trustees may structure their LRBAs consistent with an arm’s length dealing. That is, for income tax compliance purposes, the Commissioner accepts that an LRBA structured in accordance with this Guideline is consistent with an arm’s length dealing and that the NALI provisions do not apply purely because of the terms of the borrowing arrangement.”

Some of the key criteria that the ATO specifies are to be within the safe harbour include interest rates, LVRs, the maximum loan period, and security. Limited recourse borrowing arrangements that satisfy the ATO safe harbour criteria will be taken to be consistent with an arm’s length dealing.

Broadly speaking, LRBAs that are consistent with arm’s length terms should not give rise to NALI. On the other hand, LRBAs that are not consistent with arm’s length terms may attract NALI.

It is important to note that many refer to non-arm’s length LRBAs as “related party” LRBAs. However, some SMSFs have obtained loans from unrelated parties (such as friends and third parties that are not related parties) that still fall within the ATO’s definition of LRBAs that are not on arm’s length terms. That is, the terms of the arrangement have to be on arm’s length terms, even where the parties are not related.

Funds entering into related party LRBAs should seek to ensure that the terms of the LRBA fall within the safe harbour terms in PCG 2016/5, as this minimises the risk of the ATO asserting that the arrangement might be subject to NALI.

In certain cases, SMSFs may enter into LRBAs that do not comply with PCG 2016/5. This will place the onus on the SMSF trustee to obtain sufficient and appropriate evidence to support the arm’s length nature of the terms of the LRBA. This may be difficult where there is no readily available market information that lenders will provide loans of, say, above an 80% LVR or where an SMSF borrows to invest in a private unit trust. Evidence such as quotes and proposals from third parties, finance brokers and other sources can be obtained to seek to support a fund’s position.

### Tax payable if NALI is invoked

If NALI arises, an SMSF is subject to a 45% tax rate that applies to the non-arm’s length income that is derived from the scheme after deducting any applicable expenses incurred in deriving that income.

Assuming that NALI was applied by the ATO in respect of the fund’s purchase of the property in example 4 above, any net rental income derived from the property would be subject to a 45% tax rate instead of the 15% tax rate that

**Table 1. Comparing a non-arm’s length LRBA with a hypothetical arm’s length arrangement**

Item	Example 4 from LCR 2019/D3	Hypothetical arm’s length
Borrowing	\$2,000,000	\$2,000,000
LVR	100%	70%
Interest rate	1.5% pa	4.5% pa
Repayments	Annual	Monthly
Arm’s length rent	\$144,000 pa	\$144,000 pa
Annual interest *	\$30,000	\$63,000
Net (rent – interest)	\$114,000	\$81,000
Tax rate	45%	15%
Tax payable	\$51,300	\$12,150**
* Interest is based on an annual rate of interest without monthly compounding for simplicity.		
** Tax of \$12,150 is shown for the hypothetical arm’s length example to compare with the NALI example.		

usually applies to complying SMSFs. Table 1 illustrates the tax payable at 45% compared to the usual 15% tax rate. This could be critical if the rental income derived from the property is considerable.

Referring again to example 4 above and to Table 1, the entire \$114,000 is subject to a 45% tax rate, resulting in a tax liability of \$51,300. It is important to note here that NALI can “taint” the entire income from the scheme and not just the additional income derived (ie not just the additional \$33,000 of income compared to the hypothetical arm’s length example above).

For completeness, under NALI, a 45% tax rate still applies to an SMSF deriving NALI even if the fund has one or more members in pension or retirement phase that would otherwise be covered by the pension exemption (eg where the fund was paying a pension when a member retired).

The ATO’s view is that, if NALI applies to the asset, the asset is generally tainted for the rest of its life, and any capital gain on a future disposal (or other CGT event) in respect of that asset is therefore also taxed as NALI. Therefore, in addition to a 45% tax on net rental income from the property, a 45% tax would also apply to any net capital gain in respect of the future sale or disposal of the property (after any applicable CGT discount, an SMSF is entitled to a one-third discount on an asset held for more than 12 months).

Note that NALI is an administrative matter rather than a “penalty” regime. The difficulty with NALI is that, once the arrangement is non-arm’s length, the entire net revenue and assessable capital gain from the asset is generally taxed at 45%. This is why many refer to NALI as “nasty”.

### Likely ATO review

Where an SMSF derives a relatively high income from its assets, it may be a candidate for a NALI review by the ATO. An ATO review can take considerable time and give rise to considerable professional costs due to the various ATO queries.

As noted above, the onus is on the taxpayer (ie the SMSF trustee) to prove that the ATO’s assessment is excessive. The legislation favours the revenue, which places the SMSF trustee (as taxpayer) at a significant disadvantage.

Having an LRBA which is not within the ATO safe harbour criteria or which cannot be backed up with sufficient and appropriate benchmark arm’s length evidence can therefore result in a detailed, time-consuming and costly review. We therefore recommend that expert advice is obtained where any NALI is involved.

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## Alternative Assets Insights

by Nick Houseman, CTA, and  
Sam Lavender, PwC

# Transfer pricing implications of COVID-19

**The OECD has issued guidance to address the transfer pricing challenges faced by taxpayers impacted by the COVID-19 pandemic.**

On 18 December 2020, the Organisation for Economic Co-operation and Development (OECD) issued guidance that provides policy recommendations on the transfer pricing implications of the COVID-19 pandemic (the OECD guidance). The OECD guidance, which represents the consensus view of the 137 members of the inclusive framework on base erosion and profit shifting, is intended to help address the transfer pricing challenges faced by taxpayers in years impacted by the pandemic.

Taxpayers may recall that, in June 2020, the Australia Taxation Office released its own guidance on the transfer pricing implications of the COVID-19 pandemic, as well as a separate notice highlighting the intention to review changes to related-party arrangements that may be deemed to result in certain tax advantages (the ATO guidance). This guidance was supplemented with specific ATO guidance on the interaction between JobKeeper and transfer pricing outcomes.

For taxpayers with international related party dealings and which have been impacted by COVID-19, it will be important to understand the OECD guidance and the ATO guidance when supporting their transfer pricing positions for the COVID-19 impacted income year. It is worth noting that such impact is not limited to the economic and financial effects of COVID-19. It extends, and is not limited, to changes in the Australian entity's functional profile, its bearing and control of risks, and its supply chain, intercompany transactions and business strategies. These changes may mean that historical transfer prices no longer appropriately reflect value creation and/or may mean that existing comparables are no longer comparable.

### Common themes between the OECD guidance and the ATO guidance

In both sets of guidance, there is strong emphasis on the need for taxpayers to appropriately consider the impact of

COVID-19 on their transfer prices, to contemporaneously document their transfer pricing positions, and to substantiate these positions with evidence. The level of transfer pricing analysis to be undertaken will vary on a case-by-case basis but, at a minimum, this should include:

- an accurate delineation of the transaction to identify, with specificity, the economically significant risks borne by each party to the international related party dealing;
- a detailed analysis of the economic impact of COVID-19 risks on the taxpayer, the industry and geographic market in which the taxpayer operates (including the impact of government incentives such as JobKeeper). This should include a similar assessment of the comparables, and
- consideration of the internal and external evidence available to support the conclusions and whether there are any evidentiary gaps that might impact the robustness of the positions taken.

This analysis will allow taxpayers to properly consider key issues, such as whether:

- the comparables remain appropriate or whether a fresh comparables analysis should be undertaken;
- testing should occur for separate periods within the year;
- accurate delineation suggests adjustments to pricing or that independent parties would be expected to renegotiate terms. In either case, whether there is sufficient comparable evidence to support such adjustments;
- secondary transfer pricing methods should be considered to improve transfer pricing documentation;
- certain costs are “exceptional” or “non-recurring” due to COVID-19 or whether these reflect the “new normal”;
- losses are appropriate for Australian distribution entities;
- force majeure clauses might be expected to have been enforced and what is available to support this; and
- JobKeeper and/or other government incentives have been claimed and how these impact the analysis, including the comparables relied on.

Given the complexity of the transfer pricing challenges caused by COVID-19, it is recommended that the transfer pricing documentation process commences earlier than in prior years.

For taxpayers that decide not to undertake this further analysis and seek to roll forward existing transfer pricing documentation (for example, because a view is formed that COVID-19 has not affected their business, industry or comparability analysis), there may be an increased risk that the transfer pricing outcomes on either side of the transaction are not arm's length.

### Differences between the OECD guidance and the ATO guidance: implications for taxpayers

While the two sets of guidance share similarities, there are differences. The OECD has adopted a detailed and principle-based approach which seeks to link with the commentary in the OECD transfer pricing guidelines (an approach that is also conducive to achieving timely consensus). This is important as the 2017 OECD transfer pricing guidelines are prescribed material under the



Australian transfer pricing rules (ie the Australian transfer pricing rules should be read to best achieve consistency with the OECD transfer pricing guidelines).

The ATO guidance outlines the practical approaches that taxpayers may take in supporting their transfer pricing positions. However, the guidance does not focus on the delineation of the transaction and the identification and control of risks (although functions, assets and risks will be taken into consideration by the ATO). Instead, the ATO suggests that taxpayers focus their efforts on the before and after impact of COVID-19, without explaining how the arm's length principle ought to apply when assessing an arm's length outcome. The guidance is intended to be practical rather than technical, and it gives taxpayers clear focus areas on the evidence expected by the ATO and the "standard" of analysis that the ATO expects.

The ATO guidance is also intended to flag the ATO's perceived level of risk of certain facts and circumstances. The key scenarios flagged by the ATO include:

- changes to transfer pricing outcomes that may result in an Australian tax advantage;
- changing intercompany agreements; and
- the treatment of government incentives, with the ATO outlining more prescriptive guidance (particularly relating to JobKeeper, adopting the view that the benefit of government incentives should not move offshore through transfer pricing).

The OECD guidance, on the other hand, encourages an analysis of the facts to determine how government incentives should be treated. Clearly, to the extent that this analysis supports the non-Australian entity sharing in the benefits of government incentive payments, taxpayers should be aware of the strong guidance issued by the ATO which states that:

**"Independent parties acting in a commercially rational manner would not share the benefit of the government assistance."**

Similarly, the ATO has stated that it does not intend to revise the distributor earnings before interest and taxes (EBIT) margin zones in PCG 2019/1, which may mean that a larger number of taxpayers will fall into the "high-risk" zones (these risk ratings will be disclosed to the ATO in the reportable tax position schedule for those taxpayers that are required to submit this schedule with their income tax return). As a result, taxpayers can expect an increased prospect of review and, as seen with other ATO reviews, will be required to explain why EBIT margins fall into high-risk zones.

Taxpayers will need to be aware of these differences in the guidance and their implications, including the ATO's perceived risk profile of certain facts and circumstances. For example, where taxpayers more closely follow the OECD guidance and the resulting transfer pricing outcome falls within one of the ATO's perceived higher-risk scenarios (despite being an arm's length outcome), it is important that contemporaneous documentation and evidence are prepared and obtained.

For taxpayers with international related party dealings that are not impacted by COVID-19, it is expected that there will be a heightened level of review activity by the ATO, particularly during COVID-19 impacted income years.

While these taxpayers may require a lesser degree of work to support their transfer pricing positions, other non-COVID-19 related transfer pricing enquiries may ensue as a result of this heightened activity.

### The takeaway

COVID-19 has caused significant economic and financial disruptions to many businesses which taxpayers will need to account for in their transfer pricing analysis and documentation. This will create challenges for taxpayers. The release of the OECD guidance and the ATO guidance will assist taxpayers in overcoming these challenges and, in the case of the latter, help taxpayers to understand scenarios that the ATO perceives as higher risk.

Crucially, taxpayers will need to start their transfer pricing documentation processes earlier, address the guidance provided, work through the analysis in greater detail than would be the case in a "business as usual" year, and ensure that robust contemporaneous documentation is prepared and substantiated with evidence.

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March 2021

EVENT	DATE	CPD
National/Online		
2021 Superannuation Intensive Series	24–25/3/2021 (online) 31/3/2021 (workshops)	14
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# Giving back to the profession

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

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