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Large business and international: part 1

The Tax Institute

How the current corporate tax system can be changed to get the economy moving

Superannuation: top five litigation risks

Shelley Banton

Tomorrow's tax practice: part 1

Steve Healey, CTA (Life), and Adrian Cartland

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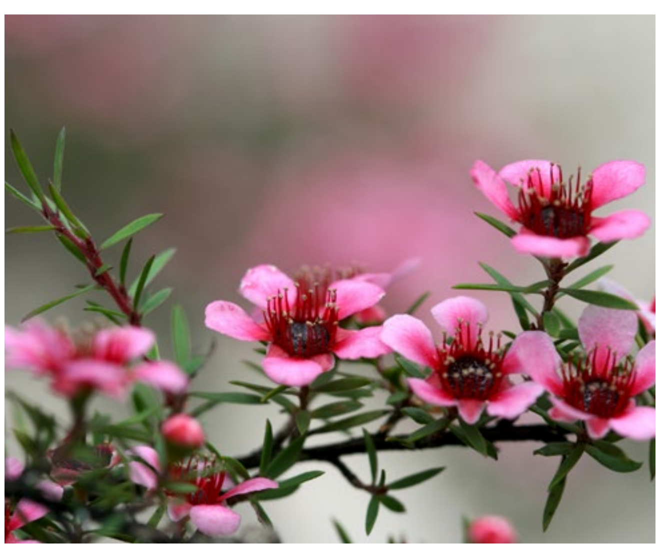

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Invitation to write

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

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

Tax News – at a glance

by TaxCounsel Pty Ltd

August – what happened in tax?

The following points highlight important federal tax developments that occurred during August 2021. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 147 (at the item number indicated).

Employee share scheme reform

On 29 July 2021, the government released draft legislation (and explanatory material) to implement the reforms to the regulatory and tax arrangements for employee share schemes. **See item 1.**

Decision impact statement: Eichmann

The Commissioner has issued a decision impact statement in relation to the decision of the Full Federal Court in *Eichmann v FCT* ([2020] FCAFC 155) which concerned the operation of the definition of active asset that applies for the purposes of the CGT small business concessions (QUD 43 of 2020). **See item 2.**

Vacant land deductions

The Commissioner has released a draft ruling in relation to the statutory restrictions (contained in s 26-102 of the *Income Tax Assessment Act 1997* (ITAA97)) that, from 1 July 2020, limit deductions that would otherwise be available for losses or outgoings that relate to the holding of vacant land (TR 2021/D5). **See item 3.**

Non-arm's length income/expenditure

The Commissioner has released a final law companion ruling to clarify how the amendments to the non-arm's length superannuation provisions of the ITAA97 (and s 295-550 in particular) operate in a scheme where the parties do not deal with each other at arm's length and the trustee of a complying superannuation entity incurs non-arm's length expenditure (or where expenditure is not incurred) in gaining or producing ordinary or statutory income (LCR 2021/2). **See item 4.**

Remission of additional SGC

The Commissioner has released a draft practice statement that sets out what ATO officers need to consider when making a decision on the remission, in whole or part, of the additional superannuation guarantee charge imposed under Pt 7 of the *Superannuation Guarantee (Administration) Act 1992* (Cth) where an employer fails to lodge a superannuation guarantee statement by the lodgment due date (PS LA 2021/D1). **See item 5.**

Was there a change of trustee?

One point of interest in a recent decision of the Full Federal Court (Logan, McKerracher and Perram JJ) which dismissed appeals by the taxpayers from a decision of Davies J, was whether there had been a change of trustee of a discretionary trust called the Demian Trust (*Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT* [2021] FCAFC 135). **See item 6.**

Extension of time to object refused

The AAT has affirmed a decision of the Commissioner to refuse an application by a taxpayer for an extension of time to lodge objections against assessments for a number of income years (*Clark and FCT* [2021] AATA 2446). **See item 7.**

President's Report

by Peter Godber, CTA

Challenges coming our way in different forms

The call for COVID-19 assistance from our states has met with challenges.

We have all seen the pressure that our states have been under in managing the pandemic.

The announcement of financial support for businesses and individuals affected by COVID-19 has been welcomed. However, the rollout of this sort of assistance has not been without its challenges.

One significant problem that many of our members face as intermediaries in the system is having to assist clients who may be eligible for financial support. We all acknowledge that the states have to act quickly in response to health scenarios. However, advisers face a considerable burden when assisting clients who are trying to grapple with uncertain and changing rules that determine if and to what extent a business, or an individual, is eligible for support. Certifying declines in turnover may not always be an easy task.

I sympathise with our members who feel the stress of supporting their clients in many ways during the continuation of the pandemic confusion. In the end, your efforts do make a difference. Please stay connected with the Institute through our *TaxVine* newsletter and other publications where we will be providing information and resources as they are available.

A tax system for our future

There are many facets of the tax system that require review.

The way the states deal with their own debt levels and revenue-raising initiatives is something to watch. We support revenue measures across the states that have consistency and long-term economic benefits. Taxing landowners and land purchasers has, of course, also come forward in recent thinking. Consistency across jurisdictions would be appreciated, not just in existing laws like payroll tax, but in any new COVID-19 support initiatives and in revenue-raising measures that are coming to the fore.

And let's hope that the federal government does not leave what might be considered to be substantive reform to the states. Tax reform is a holistic exercise, and there is a lot to do at a national level. Promotion of that debate and education about the need for holistic reform is highlighted in our Case for Change paper. We stand ready to support further discussion on these issues.

Supporting your professional development

Tax and related measures arising to meet the new world in which we live are challenging for us. However, it continually surprises me how many issues that were relevant decades ago are still current and giving practitioners new headaches. The importance of capital/revenue distinctions will never go away, and problems continue to arise from new or revised interpretations of old tax laws. The taxation of trusts is also a very good example, as we brace and respond to new interpretative guidance on topics in that area.

That is why at The Tax Institute our event programs offer as much for the tax practitioner now as ever before. Deep analysis and thought, matched with good practical guidance and support on dealing with law and administrative change that affects us and our clients, are what you will receive at the many events we are running before the end of 2021.

Many of these events are necessarily going ahead in online formats in order to remain accessible and safe. Our promise is to maintain their technical standard, whether held in-person, online or as a combination. Knowing the long list of high-profile speakers and presenters committed to our various programs, I have no doubt that you will benefit from attending the events we have in store for the remainder of 2021.

In his report this month, Giles has highlighted The Tax Summit 2021, which is a great example of how The Tax Institute can flex with the times and offer so much in a program that is designed to suit members and attendees in a way that accommodates them wherever they are and however busy they might be, all at a very reasonable price. I look forward to reconnecting with you at this long-awaited event and at the many future events coming up in the months ahead.

For those experiencing long periods of lockdown and disruption, we hope that the opportunity to engage with The Tax Institute continues to be something of a positive in your professional lives. I encourage you to get involved and reap the benefit of that connection and community.

CEO's Report

by Giles Hurst

The Tax Summit: challenge accepted

This October, we celebrate the resilience of our profession as we rebuild, reconnect and reunite at The Tax Summit.

I am delighted to be able to invite you all back to The Tax Summit next month, to reunite and reflect on facing and overcoming the challenges of the past 18 months. It's an opportunity to celebrate our leaders, peers and ourselves, for not only persevering through huge difficulties, but coming out stronger, more resourceful and more connected than before.

The recent restrictions and lockdowns around the country have reminded us that COVID-19 still poses significant disruption to our community and how we live our lives. The hurdles we overcame in 2020 are not completely gone, but we now approach them a little wiser than before.

As you work to untangle support measures for your clients once again, there may be a sense of déjà vu — of having fought this fight before. But please remember that we are working with you to tackle this renewed challenge, and our Tax Policy and Advocacy Team are doing all they can to support you. Rest assured you're in safe hands there — it's a team I know I would want in my corner.

While that may be taking much of your time and attention, I urge you not to lose sight of the bigger picture. At The Tax Summit: Challenge Accepted, we turn our attention to the future of our profession, and the tasks of reform, recovery and rebuilding.

The tax profession is uniquely placed to turn these challenging times into opportunity. At The Tax Summit, our best and brightest will be exploring what the future looks like for our economy and our community.

You are likely already aware of our stellar program for the event, which stretches over five days and will be delivered in a unique virtual experience, together with three days of face-to-face sessions in Melbourne.

We have numerous exciting keynote speakers to look forward to, including, but not limited to:

- ATO Commissioner Chris Jordan AO, CTA;
- former Victorian Premier, the Hon. Jeff Kennett AC;
- CEO of the Grattan Institute, Danielle Wood;
- award-winning documentary-maker, Todd Sampson;
- member of the Tax Practitioners Board and the Board of Taxation, Dr Julianne Jaques QC, CTA; and
- human performance researcher, author and educator, Dr Adam Fraser.

The glittering gala dinner to celebrate the Tax Adviser of the Year Awards was a rousing success last year, and for this year's awards, we are looking forward to celebrating our peers who have gone above and beyond during the COVID-19 challenge.

Given the calibre of the speakers, the length of the event and the extensive scope of the technical sessions, you may have noticed that tickets to The Tax Summit are very affordable. This is not a typo on the part of our marketing department, but a very conscious decision that the Institute has made. As we step into a new world of tax, it's important to us that all members step forward with us, so that everyone has the opportunity to stay ahead of the curve. It is our pleasure to deliver The Tax Summit in 2021 as not only one of our biggest events, but also one that is accessible to all members — and one of our best value events as well.

Gathering in Melbourne

Melbourne has been our pick for the host city of The Tax Summit in 2021 ever since we closed the hugely successful inaugural Sydney Tax Summit in 2020. Since then, Victoria has been hit harder by the pandemic than many other states. Melbourne faced a hard road through 2020, spending weeks, and even months, either in lockdown or working under heavy restrictions. As I write this, we are all once again facing disruptions to our lives as the challenges of COVID-19 continue.

This has not turned us away from our choice of host city — on the contrary, we believe it is the perfect place to celebrate triumph over adversity. Having said that, your health and safety remains our top priority. We are closely monitoring the situation in Melbourne and around the country, and will advise you of any updates to plans as soon as possible.

Should you purchase a face-to-face ticket and then for any reason find yourself unable to attend in Melbourne — be that official restrictions or your own personal sense of comfort and safety — you will be able to switch lanes immediately to attend virtually instead and experience the excellent program alongside your peers.

Stay safe and well everyone, and we'll see you — virtually or otherwise — at The Tax Summit!

Tax Counsel's Report

by Julie Abdalla, FTI

Incentivising innovation: a patent box regime

The government's proposed patent box regime is not without complexity but it is a step in the right direction to better incentivise innovation in Australia.

The current settings (and challenges)

Supporting commercialisation has long been a shortcoming of the Australian settings for innovation, including our tax system, with not enough being done to retain Australian-developed intellectual property which has often benefitted from the research and development tax incentive (R&DTI) in Australia.

Australian businesses which innovate encounter a range of challenges throughout the business life cycle. Hurdles include the availability of capital, the size of the Australian market relative to the international settings, and, of course, our tax system. These factors influence decisions by such businesses to relocate offshore, especially during the commercialisation phase of the business life cycle. These settings equally detract from Australia's appeal as a destination for foreign businesses to undertake their innovation activities.

Incentivising innovation

As a step in the right direction, the introduction of a patent box regime was announced in the 2021-22 Federal Budget. The premise of a patent box is concessional tax treatment for income derived from certain kinds of intellectual property (generally, patents). It is designed to encourage that kind of activity to take place and to ensure that local settings are more attractive than taking it offshore. Several OECD countries, like the United Kingdom and the Netherlands, have some form of patent box or preferred income regime for the purpose of incentivising and supporting innovation.

Treasury's consultation and the current proposal

Treasury recently undertook an open consultation in respect of the proposed patent box regime. The policy of the patent box is to encourage businesses in designated sectors to undertake R&D, commercialise their innovations, and retain the ownership of eligible patented innovations in Australia. Putting that policy into practice has some challenges and these are evident in the questions posed by Treasury in its consultation.

The Tax Institute supports the introduction of a patent box regime which is consistent and compliant with the OECD BEPS action 5 minimum standard concerning harmful tax practices and preferential tax regimes. We advocated for this in our pre-2021-22 Federal Budget submission, in the *Case for Change*, and indeed in our submission to Treasury last month in response to its consultation on the proposed patent box.

The patent box is proposed to apply from 1 July 2022 at an effective concessional corporate tax rate of 17%. The rate, while markedly higher than other patent boxes around the globe, is a significant concession to the headline Australian corporate tax rate. The proposed regime is fairly limited in its scope. It is currently proposed to be limited to patents that were not only granted after the Budget announcement, but were also applied for after that date.

The regime is limited to patents in the medical and biotechnology sectors, although the government is considering extending it to the clean energy sector. While this potential extension is welcome, there are many other worthy industries that could be supported by further broadening the scope of the regime. An expansion of industries would conceivably have the added benefit of reducing one element of complexity in the regime, in terms of eligibility.

Learning from experience

The extent to which the patent box is tethered to the framework for the R&DTI will have a significant impact on its success. There are some aspects of the existing framework which make for a good starting point. However, the R&DTI was not established to contemplate a patent box and a nuanced approach is required. The mechanism by which it is delivered is another important consideration. It remains to be seen whether the regime will involve a schedular rate approach or an offset.

The patent box has the potential to encourage Australian businesses to innovate in Australia. It can also play an important role in attracting foreign investment. This can put Australia on the right path to becoming a global innovation hub. Ultimately, businesses, both local and foreign, will need assurance and certainty that the regime is commercially viable and worth the investment. This will be evident in the enabling legislation, supporting guidance, and the approach to its administration.

Where to next?

We understand that Treasury will spend some time carefully considering submissions made by stakeholders, including The Tax Institute. Exposure draft legislation will follow and we expect that this will be accompanied by a further period of open consultation. We also envisage timely consultation and engagement on the administrative aspects of the regime. The Tax Institute will continue to be actively engaged in these consultations and we encourage you to reach out if you have any thoughts on the proposed regime.

Tax News – the details

by TaxCounsel Pty Ltd

August – what happened in tax?

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

Government initiatives

1. Employee share scheme reform

On 29 July 2021, the government released draft legislation (and explanatory material) to implement the reforms to the regulatory and tax arrangements for employee share schemes (ESS).

When releasing the draft legislation, the Assistant Treasurer said that the reforms will make it easier for businesses to offer ESS and will support Australian businesses to attract and retain the talent they need to compete on the global stage.

The tax reforms, announced in the 2021-22 Budget, will remove the cessation of employment as a taxing point for the tax-deferred ESS that are available for all companies. Tax will be deferred until the earliest of the remaining taxing points.

Under the regulatory reforms, employers will not have to consider the *Corporations Act 2001* (Cth) when making ESS offers, provided they do not charge or lend to employees to whom they offer these remuneration packages, and are not otherwise engaged in regulatory avoidance behaviours.

This means that they will not unnecessarily incur regulatory costs associated with considering and complying with disclosure, licensing, anti-hawking, advertising and on-sale obligations.

In addition, the regulatory reforms incorporate feedback previously provided through consultation.

Where employees pay, whether directly, via a contribution plan or through the use of a loan, to participate in an ESS, these reforms:

- increase the value limit of eligible financial products that can be offered by unlisted companies in a 12-month period from $5,000 per employee to $30,000 per employee;
- relax the requirements to lodge disclosure documents; and
- consolidate exemptions and class order relief from disclosure, licensing, anti-hawking, advertising and other obligations under the *Corporations Act 2001*.

By removing these regulatory barriers, it will be easier for businesses to attract employees with ESS offers, in addition to wages.

The Commissioner's perspective

2. Decision impact statement: Eichmann

The Commissioner has issued a decision impact statement in relation to the decision of the Full Federal Court in *Eichmann v FCT*[1] which concerned the operation of the definition of "active asset" that applies for the purposes of the CGT small business concessions (QUD 43 of 2020).

The decision impact statement states that the conclusion of whether an asset is an active asset is intrinsically fact-dependent. As recognised by the Full Federal Court, whether an asset has been used in the course of "carrying on" an identified business, the relevant business demands "inquiries [that] involve issues of fact and degree".

While the Full Federal Court had made it clear that "the legislature has not used language which might confine these inquiries", it remained the case that the asset must be "used at some point in the carrying on of an identified business". The Commissioner will continue to closely examine matters, such as the way in which an asset has been employed in the business and the extent to which the asset has been so employed when considering whether the asset meets the active asset test.

It should be noted that an important aspect of the decision of the Full Federal Court is not referred to in the decision impact statement. This is the emphasis that the Full Federal Court placed on the fact that the small business reliefs were beneficial in nature. In its judgment, the court stated:

> "[40] It follows that because s. 152-40(1)(a) is beneficial in nature, 'its language should be construed so as to give the most complete remedy which is consistent "with the actual language employed" and to which its words "are fairly open"': *Khoury v. Government Insurance Office of New South Wales* [1984] HCA 55 … In that respect, a beneficial construction of legislation may, in our view, legitimately influence constructional choices in a given case which arise from the use of generalised language to describe a necessary connection between two things; here those two things are the use of an asset and the carrying on of a business."

This statement is, it is submitted, an important and timely prompt in relation to the construction of beneficial provisions in taxation legislation and it is not clear why it is not mentioned in the *Eichmann* decision impact statement.

The Commissioner is not seeking leave to appeal to the High Court from the decision of the Full Federal Court.

3. Vacant land deductions

The Commissioner has released a draft ruling in relation to the statutory restrictions (contained in s 26-102 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)) that, from 1 July 2020, limit deductions that would otherwise be available for losses or outgoings that relate to the holding of vacant land (TR 2021/D5).

Leaving aside business or entity exclusions, the following three tests determine whether the section applies to a landholding:

- Is there a substantial and permanent structure on the land?
- If there is a structure, is it in use or available for use?
- If there is a structure available for use, is it independent of and not incidental to the purpose of any other structure or proposed structure on the land?

TR 2021/D5 also considers the following issues:

- residential premises constructed or substantially renovated while the land is held;
- interest incurred after land is sold or business activity has ceased; and
- land in use or available for use in carrying on a business.

Multiple titles of land

In most cases, s 26-102 will apply to land under a single property title. It is not necessary that all of the land under a single title be in use or available for use.

Where land is held under separate multiple titles, the taxpayer needs to determine whether the land under each title is vacant. Section 26-102(1) limits any otherwise deductible holding costs associated with a particular land title if there is no permanent and substantial structure in use or available for use on the land under that title.

Where the land is vacant, the taxpayer needs to determine whether the land is used or available for use in carrying on a business. This will be a question of fact and it is possible that the land under some titles will be used in carrying on a business while others are not.

TR 2021/D5 contains an appendix which sets out a proposed practical administration approach to assist taxpayers in complying with the vacant land deduction prohibition provision.

The ATO recognises that there will naturally be short periods of time when residential premises are unavailable for lease, hire or licence for reasons other than an exceptional circumstance or natural disaster. For example, it would be expected that, between tenancies, there will be a brief period when the premises cannot practically be made available for lease because it is necessary for the owner to undertake minor maintenance and repairs.

The ATO also accepts that, when leasing vacant land to another entity, it will not always be obvious whether the lessee is carrying on a business. The holder of the land may not have sufficient information to ascertain whether the usual indicia of a business are present in the activity conducted by the lessee.

When leasing vacant land to another entity, the taxpayer should make a reasonable assessment of the other entity's use of the land.

4. Non-arm's length income/expenditure

The Commissioner has released a final law companion ruling to clarify how the amendments to the non-arm's length superannuation provisions of the ITAA97 (and s 295-550 in particular) operate in a scheme where the parties do not deal with each other at arm's length and the trustee of a complying superannuation entity incurs non-arm's length expenditure (or where expenditure is not incurred) in gaining or producing ordinary or statutory income (LCR 2021/2).

The amendments were made by the *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019* and apply in relation to income derived in the 2018-19 and later income years, regardless of whether the scheme was entered into before 1 July 2018.

The amendments were intended to clarify the application of the nom-arm's length provisions where a complying superannuation fund incurs a loss, outgoing or expenditure (or does not incur a loss, outgoing or expenditure) in certain circumstances, and to ensure that income is also non-arm's length income if the fund does not incur a loss, outgoing or expenditure that the fund might have been expected to incur if the parties had been dealing with each other at arm's length in relation to a scheme.

LCR 2021/2 considers (with supporting examples) the following:

- the application of the non-arm's length expenditure provisions;
- the purchase of an asset under a non-arm's length arrangement;
- in the case of self-managed superannuation funds, the capacity in which activities are performed; and
- the application of the market value substitution rules.

Compliance approach

LCR 2021/2 also sets out a practical administration approach where non-arm's length expenditure will have a sufficient nexus to all of the ordinary and/or statutory income derived by the complying superannuation fund. Where the fund incurs non-arm's length expenditure of this nature, the nexus between the expenditure and all of the income derived by the fund is sufficient for all of the income to be non-arm's length income.

It is the Commissioner's view that, to avoid the application of the non-arm's length income provisions, parties to these arrangements must deal at arm's length and that arm's length expenditure amounts must be incurred by the complying superannuation fund.

Nevertheless, the Commissioner is alive to concerns that a finding that general fund expenses are non-arm's length is likely to have a very significant tax impact on the complying superannuation fund, even where the relevant expenses are immaterial.

For this reason, from 1 July 2022, where the ATO applies any compliance resources for such general fund expenses, they will only be directed:

- for an SMSF: toward ascertaining whether the parties have made a reasonable attempt to determine an arm's length expenditure amount for services provided to the fund, other than services provided by an individual either acting in the capacity as trustee of the SMSF or as a director of a body corporate that is a trustee of the fund; and
- for a large APRA-regulated superannuation fund: toward reviewing supporting documentation that evidences that appropriate internal controls and processes are in place

and that reasonable steps were taken to determine an arm's length expenditure amount.

Provided this is the case, the ATO will not allocate compliance resources to determine whether those expenses are in fact arm's length expenses.

This compliance approach does not impact the compliance approach set out in PCG 2020/5. That guideline sets out a compliance approach with respect to non-arm's length expenditure of a general nature that has a sufficient nexus to all ordinary and/or statutory income derived by the complying superannuation fund that is incurred on or before 30 June 2022.

5. Remission of additional SGC

The Commissioner has released a draft practice statement that sets out what ATO officers need to consider when making a decision on the remission, in whole or part, of the additional superannuation guarantee charge (SGC) imposed under Pt 7 of the *Superannuation Guarantee (Administration) Act 1992* (Cth) where an employer fails to lodge a superannuation guarantee (SG) statement by the lodgment due date (PS LA 2021/D1).

This additional SGC (referred to as the "Part 7 penalty") arises in two situations:

- where an employer lodges an SG statement for a quarter after the due date; or
- where the ATO makes a default assessment of the employer's liability for the SGC because an employer has not lodged an SG statement for a quarter and the ATO is of the opinion that the employer is liable to pay the SGC for the quarter.

The Part 7 penalty is automatically imposed on an employer by law and is equal to double the SGC payable by the employer for the quarter.

If an employer claims a late payment offset (LPO) to reduce their SGC payable, this reduction is disregarded for the purposes of calculating the amount of the Part 7 penalty imposed. In other words, the Part 7 penalty imposed is equal to double the total SGC for the quarter if no LPOs were claimed.

If an employer's SGC assessment for a quarter is amended and a Part 7 penalty was imposed on the original SGC assessment, the Part 7 penalty assessment for the quarter must also be amended.

On the other hand, if a Part 7 penalty was not imposed on the original SGC assessment for a quarter because the SG statement was lodged before the legislated due date, the Part 7 penalty is not imposed for any subsequent amendments.

However, in either of these circumstances, an administrative penalty for making a false or misleading statement may be imposed.

Points made in PS LA 2021/D1 that may be noted are:

- the discretion to remit the Part 7 penalty, in full or in part, can be done as part of the assessment of the penalty or after the penalty is assessed (through an objection decision);
- the ability to remit a Part 7 penalty imposed for a historical quarter may be restricted to a final penalty of at least 100% of the SGC;
- employers have the right to object to an assessment of a Part 7 penalty. While there is no separate right to object to the remission decision itself, an objection to the assessment encompasses the decision to remit;
- the Part 7 penalty is automatically imposed at a rate of 200% and whether the penalty should be remitted should be considered in all cases. Except in rare cases where an employer is engaging in egregious tax avoidance behaviour, the Part 7 penalty should be remitted either in part or in full; and
- the remission decision should take into account all of the relevant facts and indicia and the four-step penalty remission process outlined in PS LA 2021/D1 must be followed.

In some limited cases, it may be appropriate to provide additional remission to an employer in conjunction with a direction for education — this is known as a "penalty relief" arrangement.

PS LA 2021/D1 also considers how the Part 7 penalty interacts with other administrative penalties.

Recent case decisions

6. Was there a change of trustee?

One point of interest in a recent decision of the Full Federal Court (Logan, McKerracher and Perram JJ) which dismissed appeals by the taxpayers from a decision of Davies J, was whether there had been a change of trustee of a discretionary trust called the Demian Trust (*Advanced Holdings Pty Ltd as Trustee for The Demian Trust v FCT*[2]).

The Lewisham Estates Trust (LET) was a unit trust that was established by deed dated 1 May 2003. Advanced Holdings Pty Ltd (controlled by a Mr Demian) was the sole unitholder of the LET since its creation. Advanced Holdings Pty Ltd therefore received distributions from the activities of the LET which included the proceeds from the development of certain properties referred to as the Lewisham Properties. There was a significant question as to the capacity in which Advanced Holdings Pty Ltd held the LET units.

The taxpayers contended that, just under a month before the creation of the LET, Advanced Holdings Pty Ltd became the trustee of the Demian Trust (in the place of Demian Holdings Pty Ltd) by a "Deed of Appointment of Trustee" dated 2 April 2003 and executed by Mr Demian as principal of the Demian Trust. The taxpayers contended that Advanced Holdings Pty Ltd held the LET units in its capacity as trustee of the Demian Trust. At first instance, Davies J disagreed, finding that Advanced Holdings Pty Ltd was not validly appointed as trustee of the Demian Trust by the April 2003 instrument. The Full Court affirmed her Honour's finding.

Clause 22 of the Demian Trust Deed (titled "Power of Appointment of New Trustee") provided, relevantly:

> "The Principal [Mr Demian] may at any time by notice in writing to the Trustee remove from office any or all of the Trustees or Trustee for the time being of this Deed and may by Deed appoint a new Trustee in its or their place to be the Trustee hereof …"

The 2 April 2003 "Deed of Appointment of a Trustee" was addressed to "the Trustee and Beneficiaries" of the Demian Trust and stated:

> "Pursuant to clause 22 of the trust deed dated 20th March 1998 governing the said Trust, I appoint Advanced Holdings Pty Limited as trustee of the Demian Trust."

The taxpayers contended that the 2 April 2003 instrument should be construed to be effective by impliedly removing Demian Holdings Pty Ltd as the trustee and effecting the appointment of Advanced Holdings Pty Ltd. The taxpayers contended that the court should give effect to the objective intention sought to be achieved where the words of an instrument allow that intention to be given effect.

In a joint judgment, the Full Court said that the relevant intention was that manifested by the April 2003 instrument read in its surrounding circumstances. The text of the instrument provided no support for the submissions advanced by the taxpayers because it did not in any way refer to the removal of the existing trustee. It spoke only of appointing Advanced Holdings Pty Ltd "as trustee", not as the "new" trustee for the Demian Trust. The absence of words such as "new" or "replacement" created a significant difficulty for the taxpayers. To achieve the outcome advanced by the taxpayers, they would cross the line from construction into rectification.

The Full Court, agreeing with Davies J, also rejected arguments for the taxpayers that there had been a change of trustee of the Demian Trust from Demian Holdings Pty Ltd to Advanced Holdings Pty Ltd by a series of documents dated 13 November 2006. There were several issues raised, but one that may be noted arose out of the fact that cl 5(a) of the Demian Trust Deed required the trustee of that trust to give two months' notice of its resignation and there was no evidence of the provision of that notice.

A number of other issues arose for decision but the above is referred to as emphasising the need to comply with the terms of a trust deed to ensure that what may be intended to happen does in fact happen.

7. Extension of time to object refused

The AAT has affirmed a decision of the Commissioner to refuse an application by a taxpayer for an extension of time to lodge objections against assessments for a number of income years (*Clark and FCT*[3]).

On 22 October 2020, objections against income tax assessments were lodged on behalf of the taxpayer, accompanied by a request to extend the time for objection. The objections, which related to the income years 2007-08 to 2017-18 inclusive, sought to have included, in the calculation of the assessments of taxable income for these income years, travel allowances and corresponding travel allowance expense deductions calculated on the basis of the Commissioner's published "reasonable amounts".

The reason for the delay in objecting was that the taxpayer, who had previously prepared his own tax returns, was not aware that he could disclose the allowances and claim deductions. It was only when the taxpayer engaged a tax agent to prepare his return that he became aware of this.

The AAT, in rejecting the extension of time applications, said that the long delay in lodging the objections, especially in respect of the earlier years, weighed against granting the extensions. This was not a case where the taxpayer missed a deadline by a short period. The objections were sought to be treated as lodged within time — in some cases, some years after the statutory time limits had expired. While that did not automatically disqualify an applicant from obtaining an extension of time, the longer the delay, the more (depending on the circumstances) this would weigh against granting an extension.

The AAT also said that it may be that the greater the potential benefit, the greater the potential for prejudice to an applicant. The additional amounts sought to be claimed in this case were not insignificant in the context of the taxpayer's income. While ordinarily this factor would be given some weight in favour of granting an extension where the potential benefit is, in relative terms, not insignificant, in this case, because the taxpayer would have little prospect of succeeding with the objections if the extensions were allowed, it was not clear that there was in fact potential for any actual benefit to the taxpayer if the extensions were granted.

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References

1 [2020] FCAFC 155.
2 [2021] FCAFC 135.
3 [2021] AATA 2446.

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Tax Tips

by TaxCounsel Pty Ltd

GST contractual issues

A recent decision of the Victorian Supreme Court considered several issues that arose out of the GST provisions of a contract for the sale and purchase of land.

Background

The contractual contexts in which GST issues may arise are many and varied. There will, of course, be cases where the GST position is clear. For instance, the sale by an individual of their main residence would not of itself trigger any GST issues. At the other extreme, the disposal by a developer of newly constructed units would be a GST supply that would be subject to GST.[1] In other situations, the GST position may not be clear. This may, for example, be the case where there is a question of whether the disposal is in the course of the carrying on by the vendor of an enterprise in the GST sense.

Further, in those cases where there is a potential GST liability or it is not clear whether there is such a liability, there may be relevant GST concessions that will require suitable provision being made in the contract. Examples of such concessions are the margin scheme, the going concern concession, and the input-taxed supply of residential premises that are not new or commercial residential premises.

For example, where there is a disposal of land and there is the possibility of a GST liability, the vendor may include in the contract a contingent agreement to the effect that, if it turns out that the sale is a taxable supply, the parties agree that the margin scheme is to apply in the event that there is a liability to GST.[2]

Standard form contracts (such as are used in relation to the sale and purchase of land) now usually contain GST provisions, but even here, it must not be assumed that the standard GST provisions are appropriate in a particular situation.

Contractual provisions which were comprised in the general conditions and the special conditions of a contract, and related to the operation of the GST-free going concern concession, were considered in the recent decision of Forbes J in *K7 Developments Pty Ltd v Abbotsford Estates Pty Ltd*.[3]

GST-free going concern concession

The GST-free going concern concession is provided for in s 38-325 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99) which reads as follows:

"**38–325 Supply of a going concern**

(1) The supply of a going concern is ***GST-free*** if:

(a) the supply is for consideration; and

(b) the recipient is registered or required to be registered; and

(c) the supplier and the recipient have agreed in writing that the supply is of a going concern.

(2) A ***supply of a going concern*** is a supply under an arrangement under which:

(a) the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise; and

(b) the supplier carries on, or will carry on, the enterprise until the day of the supply (whether or not as a part of a larger enterprise carried on by the supplier)."

At a general level, this concession provides benefits to the recipient of the supply (principally, a lower overall purchase price and lower stamp duty) but potentially can result in an adverse outcome for the vendor (an increased GST liability if the Commissioner assesses GST on the basis that the terms of s 38-325 have not been met). And even if, in such a case, the vendor has included provisions in the contract that entitle the vendor to recover the GST from the purchaser, the vendor has the task of enforcing those provisions.

The facts of K7 Developments

On 15 June 2017, the plaintiff entered into a contract (the contract) with the defendant to purchase a property at 288 to 298 Johnston Street, Abbotsford (the property) from the defendant. The settlement date for the contract was to be 15 March 2018.

The property was commercially leased at the time and the contract specified that the sale was of land on which a "going concern" was being carried on. The contract specified that the purchase price was plus GST, but that GST was only payable if special condition (SC) 31 applied.

The plaintiff requested an extension of the settlement date, anticipating that there might be a delay in the arrival of funds from overseas. On 15 January 2018, the parties agreed on the terms for an extension of settlement until 15 May 2018 (the extension agreement).

For a variety of reasons, settlement did not occur on 15 March 2018, nor during the period of the extension agreement. Consequently, on 12 June 2018, the defendant vendor issued the plaintiff purchaser with a notice of default (the default notice) pursuant to general condition 27 of the contract.

The plaintiff disputed being in default and disputed the validity of the default notice but, nevertheless, made an offer to settle the property on 19 June 2018 which was not accepted by the defendant. The defendant advised that it intended to act on the default notice, to consider the contract terminated or rescinded, and to place the property back on the market. In response, on 24 August 2018, the plaintiff issued the proceedings that were before the court and which, inter alia, sought specific performance of the contract by the defendant and other relief.

In September 2018, the defendant took steps to put the property back on the market. However, negotiations between

the parties continued and, although reaching an "in principle" agreement in October 2018, terms could not be agreed. The defendant again considered the plaintiff to have repudiated the contract and an agreement to settle in October 2018, and so signed a contract with a third party for the sale of the property.

On 17 December 2018, the defendant filed its defence to the proceedings brought by the plaintiff and made a counterclaim seeking to recover its loss and damage arising from the delayed settlement and steps to resell the property. It disputed that the plaintiff was entitled to specific performance of the contract.

Ultimately, the transfer of title from defendant to plaintiff was settled on 6 May 2019.

At the time of the entry into the contract, the property was subject to four tenancy agreements. Pursuant to the contract, the property was to be supplied to the plaintiff at settlement as a "going concern" within the meaning of s 38-325 GSTA99 (set out above). The going concern was the commercial leasing arrangement being carried on that attracted the sale of the land as one capable of being a "going concern". One condition for the going concern concession to apply was that the enterprise was one which the supplier (vendor) carries on, or will carry on, until the day of supply.

On 19 March 2018, notification that two of the tenants had vacated the premises was communicated to the plaintiff. On that date, it was informed that one tenant, Tippling House Pty Ltd (Tippling House), had vacated in September 2017 and the other on 28 February 2018. No information was provided as to any steps taken by the vendor since September 2017 to re-let the premises so as to maintain the property as a going concern. Rather, the vendor simply noted that part of the supply was now subject to GST for which the purchaser was liable.

The defendant suggested entering into a related party lease for the vacant portion. The defendant was not open to a 12-month tenancy, instead proposing a month-to-month tenancy. On 28 March 2018, the plaintiff indicated that it had received advice from its accountant that the proposed related party lease would not comply with s 38-325 GSTA99. The plaintiff did not want to enter into the proposed related party lease, at its cost, and still bear the consequences if the property was subsequently treated as a taxable supply in part.

This highlighted a disagreement between the parties as to who carried the GST obligation if it arose by reason of the sale being, in part, no longer of a going concern. The plaintiff asserted that, pursuant to general condition (GC) 13.5(c) of the contract, the vendor warranted that it would carry on the going concern to the date of supply and that the defendant was in breach of that provision. As a consequence, the plaintiff argued that it was not liable for GST. The defendant asserted that this general condition was inconsistent with SC 31(g)(ii), which stated that the vendor provided no warranty that the supply made would constitute the supply of a going concern. Where there was inconsistency, the contract provided that the special condition prevailed and, so, the defendant argued that any GST liability rested with the purchaser.

The GST provisions of the contract

GC 13 relevantly provided:

> "**GST**
>
> 13.1 The purchaser does not have to pay the vendor any GST payable by the vendor in respect of a taxable supply made under this contract in addition to the price unless the particulars of sale specify that the price is 'plus GST'. However the purchaser must pay to the vendor any GST payable by the vendor:
>
> ...
>
> (c) if the particulars of sale specify that the supply made under this contract is of a going concern and the supply (or part of it) does not satisfy the requirements of section 38-325 of the *GST Act*.
>
> 13.2 The purchaser must pay to the vendor any GST payable by the vendor in respect of a taxable supply made under this contract in addition to the price if the particulars of sale specify that the price is 'plus GST'.
>
> 13.3 If the purchaser is liable to pay GST, the purchaser is not required to make payment until provided with a tax invoice, unless the margin scheme applies.
>
> ...
>
> 13.5 If the particulars of sale specify that the supply made under this contract is a 'going concern':
>
> (a) the parties agree that this contract is for the supply of a going concern; and
>
> (b) the purchaser warrants that the purchaser is, or prior to settlement will be, registered for GST; and
>
> (c) the vendor warrants that the vendor will carry on the going concern until the date of supply."

The contract did specify "plus GST" and identified the supply of a "going concern". Under the general condition, GST was payable by the purchaser if, in accordance with GC 13.1(c), the supply made under the contract did not satisfy the requirements of the GSTA99. Otherwise, the contract provided that GST was only payable if SC 31 applied.

SC 31 relevantly provided:

> "**GST**
>
> **(a) GST definitions**
>
> ...
>
> **(d) Time for Payment**
>
> The recipient must pay the amount referred to in Special Condition 31(c)[4] in addition to and at the same time as payment for the Taxable Supply is required to be made under this Contract of Sale.
>
> **(e) Tax Invoice**
>
> If a Taxable Supply is made or varied under this Contract in respect to which GST is payable, the supplier must provide the recipient of the supply a valid Tax Invoice as the case may be at or before the time of payment or variation.
>
> ...
>
> **(g) Going Concern**
>
> If the Particulars of Sale specify that the supply made under this contract is Supply of a Going Concern then the following shall apply:
>
> i. The Purchaser has concluded that the supply made under this Contract is a Supply of a Going Concern.

ii. The Vendor provides no warranty that the supply made under this Contract will constitute the Supply of a Going Concern.

iii. The Purchaser warrants that it is, and will be at Settlement, registered for GST within the meaning of the GST Act.

iv. If after the date of this Contract the Vendor, acting reasonably, determines for any reason that only part of the supply constitutes a Supply of a Going Concern and that GST is payable in respect of a Taxable Supply under this Contract, then this Special Condition of this Contract shall apply and the Purchaser must pay to the Vendor an amount equal to the GST and any interest and/or penalties that the Vendor is required to pay to the Australian Taxation Office in respect of the Taxable Supply. In such a case the Vendor must notify the Purchaser in writing that the Vendor is required to pay the Australian Taxation Office specifying the GST and any interest and/or penalties payable in respect of the Taxable Supply and the Purchaser must forthwith pay to the Vendor the amount of any GST and any interest and/or penalties as notified to it within 14 days after receipt of the Vendor's notice. This Special Condition does not merge on completion of this Contract nor registration of the transfer of land."

The special conditions also provided that, where there was any inconsistency between general conditions and special conditions, then the special conditions prevailed and had priority to the extent of any inconsistency. GC 13 was not amended or deleted by the special conditions.

Issues in dispute

There were a number of issues raised in the proceedings before the court, but the issue of present interest was the correct construction of what may be referred to as the GST provisions of the contract. These provisions, which are set out above, were the obligations imposed by the warranty of the vendor in GC 13 and the provision of no warranty of the vendor in SC 31 in relation to carrying on a going concern on the property.

Vendor's contention

The defendant vendor submitted that the warranty provided by the vendor in GC 13.5(c), that it would carry on the going concern until the date of supply, was inconsistent with SC 31(g)(ii), which gave no warranty that the supply would constitute a going concern. Therefore, so it was argued, SC 31(g)(ii) in clear and unambiguous words negated the warranty contained in GC 13.5(c). The defendant submitted that it acted in accordance with SC 31(g)(iv) as it acted reasonably to determine that only part of the supply was of a going concern. It advanced the straightforward proposition that the effect of SC 31 was that, if the vendor determined that GST was payable, the purchaser had to pay it, subject only to the qualification that the vendor must act reasonably in the determination that GST is payable.

Purchaser's contention

The plaintiff purchaser submitted that there was no inconsistency and that the defendant, by not taking steps to maintain the whole of the property as a going concern, was in breach of the contractual warranty to do so.

Construction of GC 13.5 and SC 31

Forbes J said[5] that the general condition recorded the agreement of the parties at the time of entering into the contract that it was one for the supply of a going concern. The vendor's warranty in GC 13.5 then reflected the requirement imposed on a supplier by s 38-325(2)(b) GSTA99 if the supplier is to be exempt from its liability for payment of GST. The purchaser's contractual warranty that they were registered for GST also reflected the requirements on a recipient in s 38-325(1) GSTA99.

After saying that SC 31 had application where the particulars of sale specified the supply of a going concern (as was the case here) and where, by operation of GC 13.5(a), the parties have agreed that it was the supply of a going concern, her Honour said that SC 31 should be interpreted in light of the agreement expressed in GC 13 in a harmonious way if that were possible. Her Honour said that if the intent and purpose was to negate GC 13 entirely, it would surely have resulted in the deletion of the vendor's warranty from the general conditions.

Forbes J went on to make these points:[6]

- by SC 31(g)(i), the purchaser was to reach its own conclusion as to whether the enterprise to be supplied was in fact that of a going concern. The purchaser could only do so at the time of signing the contract. It did not have prospective application. While, at the signing of the contract, the vendor agreed that the enterprise being supplied was a going concern, the vendor, by SC 31(g)(ii), gave no warranty that the supply would constitute (in the sense that it would in fact meet the definition of) a supply of a going concern for tax exemption purposes at the time the supply was made on settlement;
- the defendant's submission (which really contended for an interpretation of SC 31 that the vendor did not warrant to continue to operate the enterprise so that it is a going concern) was inconsistent with the plain words which were directed at the constitution or description of the supply. That construction would be inconsistent not only with the warranty given in GC 13.5, but also with the obligation on the supplier under s 38-325(2)(b) GSTA99. At the time of signing the contract as a going concern, the vendor (supplier) agreed that the enterprise would be carried on until the date of supply. The warranty to continue the enterprise was a different thing to the description of the enterprise and whether the description met the definition. The vendor gave no warranty as to whether the nature of the enterprise that it carried on, and would continue to carry on, met the definition and description. The two warranties were different and not inconsistent with each other; and
- SC 31(g)(iv) related to events after the date of the contract. It was directed at a vendor who determined, after entering the contract, that the part of the supply that was being provided no longer met the definition of a going concern. The reason for the changed nature of the supply was not limited other than by the supplier being required to act reasonably in determining the changed nature of the supply. The requirement to act reasonably had some purpose and should be read in light of the supplier's warranty and intent to continue the enterprise until supply

at settlement. The qualification of acting reasonably must be directed not only at the notification of the change in the nature of the arrangement, but also at the actions of the vendor in attempting to maintain the enterprise.

Forbes J then went on to say:[7]

"I have therefore concluded that SC31 is directed at maintaining the nature or description of the enterprise as it is undertaken between the contract and settlement. It is not directed at circumstances where a decision taken by the vendor to cease or suspend the enterprise. It is not inconsistent with the defendant's warranty to carry on the enterprise until settlement.

The vendor led no evidence of any steps to carry on the going concern following vacation by tenants up until 15 March 2018, or indeed at any time thereafter. The submission put was that it had no obligation to do so.

This construction means that there is no inconsistency between the General Condition and the Special Condition. The position of both parties to the contract is protected by the warranties exchanged. On this interpretation, SC 31(g)(iv) has real work to do to protect a vendor. It protects a vendor, acting reasonably to meet its warranty to carry on the enterprise until the date of supply, who nevertheless determines that part of the enterprise to be supplied can no longer be described as that of a going concern and therefore the exemption from GST is no longer applicable. In such circumstances, the vendor's liability for GST must be paid by the purchaser to the vendor. The clause should not be read so widely as permitting a vendor to unilaterally decide to cease its operation of the enterprise it has warranted to continue, and then, having so decided, notifying the purchaser of that decision. The requirement to act reasonably incorporates the action of undertaking the enterprise, not solely in notifying the purchaser."

Later, her Honour said:[8]

"I find no evidence that after the Contract was signed the vendor took any steps to comply with the warranty that it would carry on the going concern until the date of supply. As a result of my conclusion that SC 31 does not conflict with the vendor's warranty to do so, I conclude that the vendor was in breach of the Contract."

Observations

The decision in this case highlights the need to draft GST provisions in a contract so that they clearly enunciate what is intended. This will particularly be so where there are provisions that must be read together. Also, where it is possible that the contract may not be completed for some time, extra precautions will be needed.

TaxCounsel Pty Ltd

References

1 In this kind of case, there may be GST remittance obligations imposed on the purchaser under Subdiv 14-E of Sch 1 to the *Taxation Administration Act 1953* (Cth), and provisions may be needed in the contract on this issue.

2 The Commissioner accepts the efficacy of such contingent agreements. See GSTR 2006/7.

3 [2021] VSC 422.

4 The text of this paragraph is not included in the judgment.

5 [2021] VSC 422 at [102].

6 [2021] VSC 422 at [104]-[106].

7 [2021] VSC 422 at [107]-[109].

8 [2021] VSC 422 at [117].

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Mid Market Focus

by Guy Brandon, CTA, HLB Mann Judd

Restructuring: racing to IPO with blinkers on

A review of a couple of key areas when restructuring for IPO, if incorrectly judged, may cause an unexpected tax liability.

Introduction

It is clear that the initial public offering (IPO) space has heated up over the past 12 months. What may not be so clear is the manner by which a company (in the example in this article, ListCo) has achieved the structure by which it will list. That is, whether the precursor to its current structure was:

- listing the current operating vehicle "as is";
- ListCo, or a newly incorporated subsidiary(s), making asset acquisitions;
- ListCo, or a newly incorporated subsidiary(s), acquiring company(s); or
- variations on the theme.

Road to restructure

It is also important to ascertain how any acquisitions were made (eg consideration) and from whom the acquisitions were made.

Forms of consideration for these acquisitions may include cash, scrip, other forms of shares (eg convertible redeemable preference shares), options, and other rights.

The acquisition(s) may be from a third party or a related party, and may or may not be at arm's length.

There appears to be more listings now that are not just the current company listing "as is". Therefore, the manner by which ListCo's overall package (including structure and assets) is brought to market may result in unexpected federal and/or state taxation liabilities[1] to the shareholders of ListCo before, at or after IPO.

Some of the most problematic restructuring comes from "rolling in" companies to ListCo. For example, ListCo via a share sale and purchase agreement (SSPA) will purchase 100% of the shares in, say, SubCo for some, or all, of the following consideration:

- cash;
- scrip in ListCo; and/or
- "shares in ListCo, subject to certain conditions" (conditional shares).

During the planning period for the restructure, the manner by which the consideration for the "rolling in" of SubCo may change as part of the drafting process prior to settling on the final SSPA.

Some of the reasons for the change may stem from:

- the value of the company(s) being rolled in may not be settled at the outset and may be reviewed as part of the process;
- the balancing of the cash required by the initial shareholder(s) compared to the cash being taken out of the deal (eg not available for working capital or for capital expenditure);
- the level of ownership/control post-IPO by the former owners; and
- notwithstanding the likely escrow period for the current owners, the ability to reduce the level of ownership/control until certain conditions are met. Those vesting conditions could be a market condition (eg ListCo reaching a 20-day volume-weighted average price of $0.50) or a non-market condition (eg ListCo reaching a consolidated annual turnover of $25m for the first time in an income year).

While discussions about other forms of consideration continue, eg special class shares or partly paid shares, there is every possibility that this form of consideration will not be available for ListCo or that it will not look good to the prospective investor(s) as they are more in the realm of closely-held companies. For example (using different levels for different types of consideration):

- $2m cash (level 1);
- 30 million scrip in ListCo (level 2);[2]
- 20 million share rights in ListCo (level 3) — 10 million with a non-market vesting condition (N-MVC) of ListCo reaching a consolidated annual turnover of $25m for the first time in an income year and an additional 10 million with a N-MVC of ListCo reaching a consolidated annual turnover of $50m for the first time in an income year. Note that subsequent satisfaction of the N-MVC may cause either (depending on the drafting of the agreement):
  - the automatic issuing of shares in ListCo (automatic share rights (ASRs)); or
  - the opportunity to subsequently exercise the right to be issued shares in ListCo (exercisable share rights (ESRs)).

Consideration received by the current shareholder in SubCo includes:

- $2m cash (level 1);
- $6m: the market value of the 30 million scrip in ListCo (level 2); and
- $TBD: the market value of 20 million share rights in ListCo (level 3).

For the purposes of this example, the cost base of the current shareholder's shares in SubCo is $200k.

The tax implications for the current shareholder in SubCo are:

- cash: level 1;
- scrip: level 2;
- share rights: level 3.

The tax implications for the current shareholder may also be influenced by the following:

- how they hold their current shareholdings (eg individually, via a discretionary trust, or beneficially held by a company);
- the level of capital losses;
- the ability to utilise the small business CGT relief concessions;
- the ability to self-fund their current tax liability (eg not having to realise assets to fund the tax liability); and
- the necessity to defer tax (on non-cash consideration) until such time as their interests are disposed of for cash (which is the most likely of scenarios in the author's experience).

For the purposes of this example:

- ListCo and the current shareholder of SubCo are related parties (and not acting at arm's length);[3]
- there is no consideration that the scrip or share rights are provided by ListCo to the current shareholder in SubCo as a result of an employee share scheme (ie it is not a scheme under which scrip or share rights are provided by ListCo to employees, or associates of employees (including past or prospective employees) of ListCo (or any of its subsidiaries) in relation to any employee's employment);[4]
- to the extent that the shareholder in SubCo is a company, the 50% discount capital gain is not relevant (although a current capital loss or carried forward net capital loss may be used as a partial offset, if available);[5]
- scrip-for-scrip roll-over concessional treatment in Subdiv 124-M ITAA97 is not applicable to level 3 as the consideration provided does not satisfy all of the conditions in that Subdivision;[6] and
- the "look-through earnout rights" concessional treatment is not applicable to level 3 as the consideration provided does not satisfy all of the conditions in Subdiv 118-I ITAA97.[7]

While cash (level 1) is assessable immediately, let us now look into the future at the scrip (level 2) and the share rights (level 3).

Scrip: level 2

Broadly speaking, subject to Subdiv 124-M ITAA97, scrip-for-scrip roll-over will effectively defer the taxation.

Share rights: level 3

To the extent that the N-MVC of ListCo reaching a consolidated annual turnover of $25m is met:

- with regard to the ASRs:
  - CGT event C2[8] happens (the ASRs end on the issue of the shares);
  - the capital gain (or capital loss) will depend on the market value of the shares on the issue of the shares less the cost base of the ASRs;
  - the possible exceptions include (but, on review, are unlikely to apply):
    - s 130-40 ITAA97 (it is unlikely that Subdiv 130-B ITAA97 is applicable as it is arguable that at least one of the criteria is failed (ie the current shareholder in SubCo paid for the rights by way of the transfer of the shares); and
    - s 134-1 ITAA97 (Div 134 ITAA97) is not relevant as options have not been exercised in these circumstances; and
- with regard to the ESRs:
  - these are more correctly known as (and in the agreement are drafted as) zero-priced options (ZEPOs);
  - achieving the hurdle (eg N-MVC) does not cause the issuing of the shares in ListCo. It provides the holder with the ability to exercise the ZEPOs prior to their maturity. The vesting itself does not cause a taxing point (ie it does not cause CGT event C2 to happen);
  - CGT event C2 does not happen on the ZEPOs being "exercised" (see s 134-1(4) ITAA97). It does alter the cost base of the ultimate shares in ListCo; and
  - the taxing point will be when the shares are subsequently sold.

Critically, the current SubCo shareholder will have to get the ZEPOs independently valued for tax purposes, as that value will be assessable on receipt of the ZEPOs. Also, the ZEPOs may need to be valued as part of the notice of meeting in respect of the IPO, and it would be suggested to the shareholder that they speak to the accountants/auditors/lawyers preparing the notice of meeting together as, depending on the nature of the acquisition, it may cause the valuation of the ZEPOs to be valued under different AASB standards. The valuation date may also be critical.

The following tables set out some scenarios of tax outcomes.

Assumptions for all scenarios

Cash received	$2,000,000
Value of 20 million ZEPOs now	As per each scenario
List price at IPO	$0.20
Value of 30 million shares	$6,000,000
Current shareholder's (CurrSH) cost base	$200,000
Tax rate for CurrSH (company)	30%
Value per share of ListCo +1 year	$0.50

Scenario 1. Value of ZEPOs now = $0.01

Now

	Consideration deferred	Consideration now	Cost base deferred	Cost base now	Assessable	Tax
Cash		$1,400,000		$48,780	$1,351,220	
ZEPOs		$140,000		$4,878	$135,122	
Scrip	$4,200,000		$146,341			
					$1,486,342	**$445,903**

Plus 1 year (ZEPOs vest and exercised and, with other scrip, are sold)

	Consideration	Cost base	Assessable	Tax
Cash	–	–	–	
ZEPOs	$7,000,000	$140,000	$6,860,000	
Scrip	$10,500,000	$146,341	$10,353,659	
			$17,213,659	**$5,164,098**

Scenario 2. Value of ZEPOs now = $0.05

Now

	Consideration deferred	Consideration now	Cost base deferred	Cost base now	Assessable	Tax
Cash		$1,400,000		$44,444	$1,355,556	
ZEPOs		$700,000		$22,222	$677,778	
Scrip	$4,200,000		$133,333			
					$2,033,334	**$610,000**

Plus 1 year (ZEPOs vest and exercised and, with other scrip, are sold)

	Consideration	Cost base	Assessable	Tax
Cash	–	–	–	
ZEPOs	$7,000,000	$700,000	$6,300,000	
Scrip	$10,500,000	$133,333	$10,366,667	
			$16,666,667	**$5,000,000**

Scenario 3. Value of ZEPOs now = $0.10

Now

	Consideration deferred	Consideration now	Cost base deferred	Cost base now	Assessable	Tax
Cash		$1,400,000		$40,000	$1,360,000	
ZEPOs		$1,400,000		$40,000	$1,360,000	
Scrip	$4,200,000		$120,000			
					$2,720,000	**$816,000**

Plus 1 year (ZEPOs vest and exercised and, with other scrip, are sold)

	Consideration	Cost base	Assessable	Tax
Cash	–	–	–	
ZEPOs	$7,000,000	$1,400,000	$5,600,000	
Scrip	$10,500,000	$120,000	$10,380,000	
			$15,980,000	**$4,794,000**

Scenario 4. Value of ZEPOs now = $0.20

Now

	Consideration deferred	Consideration now	Cost base deferred	Cost base now	Assessable	Tax
Cash		$1,400,000		$33,333	$1,366,667	
ZEPOs		$2,800,000		$66,667	$2,733,333	
Scrip	$4,200,000		$100,000			
					$4,100,000	**$1,230,000**

Plus 1 year (ZEPOs vest and exercised and, with other scrip, are sold)

	Consideration	Cost base	Assessable	Tax
Cash	–	–	–	
ZEPOs	$7,000,000	$2,800,000	$4,200,000	
Scrip	$10,500,000	$100,000	$10,400,000	
			$14,600,000	**$4,380,000**

Summary

Restructuring as part of a future IPO (or any exit strategy monetisation) for the original shareholders can result in an unexpected, unfunded tax liability. It is critical to review all parts of the process to determine the timing and likely tax so that it can be managed, as the ability to sell down may not be practical or possible (eg due to trading blackouts for directors).

Guy Brandon, CTA
Tax Consulting Partner
HLB Mann Judd WA

References

1 As part of the restructuring, where applicable (eg in Western Australia), "relevant reconstruction transaction" or "relevant consolidation transaction" relief may have been previously used as part of the restructure process. There is a possibility that this relief may be clawed back (possibly with penalties) as part of the subsequent IPO.

2 The list price is expected to be $0.20 and this is determined to be the market value of ListCo's shares at that time (30,000,000 × $0.20 = $6,000,000).

3 To the extent that the parties were acting at arm's length, s 124-780(4) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) is not satisfied and s 124-780(5) ITAA97 is not applicable. Therefore, the shares do not need to have the same kind of rights and obligations as those attached to the original share (eg a convertible redeemable preference share) may be provided in exchange of SubCo's ordinary share.

4 There may be consideration as to whether the scrip or rights/options are for the rolling in of the subsidiary or subsequently in respect of the shareholder(s) subsequent employment (eg as a (non-) executive director). This area can be problematical.

If the scrip or rights/options are included in the SSPA as part of the consideration and there is no comment in relation to the shareholder's employment/director role, it is more likely that the scrip or rights/options will be consideration for the sale of shares in SubCo.

If the SSPA is silent and the scrip or rights/options are granted under a (future) employment agreement, they will be assessed under Div 83A ITAA97.

This maybe problematical when the shareholder believes that the roll-over (for scrip) is, say, under Subdiv 124-M ITAA97 and they own more than 10% of the shares in ListCo. The reason is that the failure of the 10% test will not allow a deferral of the taxing point for the shares (all other provisions being satisfied).

Conversely, where the rights/options are acquired as part of the acquisition and the shareholder(s) incorrectly believe that they are in respect of employment (although the SSPA clearly states that they are part consideration for the sale of SubCo), they will not be able to defer the initial taxing point (even if all of the provisions in Div 83A ITAA97 are satisfied).

5 When a company is held by another company, it generally gives pause due to the inability of a company to access the 50% CGT discount (Subdiv 115-A ITAA97). However, there may be a number of reasons why the company is the beneficial shareholder (eg not wanting to deal with an issue under Div 7A of the *Income Tax Assessment Act 1936* (Cth) by loaning funds to a discretionary trust — sometimes context is lost with the passing of time). Or it could just be that the ASIC form was incorrectly completed and the company did not beneficially hold the shares (and has the deed of trust to prove it).

6 The current shareholders in SubCo will fail s 124-780(1)(a)(i) ITAA97 as a share in ListCo is not provided in exchange for the share in SubCo.

7 The current shareholders in SubCo will fail s 118-565(1)(h) ITAA97 as the parties to the arrangement were not dealing with each other at arm's length. To the extent that the parties were acting at arm's length, there are still a number of requirements in s 118-565 ITAA97 that need to be satisfied for the level 3 consideration to be treated as a look-through earnout (ie Subdiv 118-I ITAA97 would be failed if the level 3 consideration was to have a maturity ending more than five years after the end of the income year in which the CGT event happened).

8 S 104-25 ITAA97.

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Becoming clear on future dreams

The dux of CommLaw3 Property Law in Study Period 1, 2021 explains why the right time to study tax is now.

Xin Sun, Quality Consultant, Superconcepts Pty Ltd, New South Wales

Please provide a brief background of your career in tax

I started as a fund accountant for SMSF funds and, in February 2019, after two years, became a quality consultant. I have a master's degree in professional accounting from the University of Sydney and became a chartered accountant in February 2021. I have worked in the SMSF industry for four years now and take care of the lodgments and compliance issues for a range of customers.

What was the reason for undertaking CommLaw3 Property Law?

My primary reason for undertaking CommLaw3 Property Law was to qualify as a tax agent. At work, we are encouraged to become tax agents. I only needed one commercial law subject to be eligible as a tax agent because of my prior learning.

I have never had anything to do with property law — it was an unknown area. While I have some general knowledge about the other subjects offered by The Tax Institute, studying property law was more interesting for me as I had no prior experience with this topic.

What skill or knowledge areas have you gained by undertaking this subject?

CommLaw3 Property Law is a broad subject that provides an overview of property law. By completing it, I understand the difference between the concepts of real and personal property.

Have you applied this new knowledge in your role?

I haven't applied this new knowledge in my role because SMSF funds usually do not invest in property. However, if I were to embark on a new career journey, property law would be interesting.

How did you juggle study, work and other commitments?

At Superconcepts, we have been working remotely for more than a year. Working from home helped me to balance study and work, and the time saved in travelling to work went towards studying.

In addition, I have found that managing extra-curriculum activities like study has become easier because there is more flexibility around working hours. My best advice for managing the workload is to make a plan and stick to it.

Thankfully, my family helped me around the house so I could focus on work and study.

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

I plan to become a Chartered Tax Adviser. With my prior learning, I only need to complete CTA3 Advisory to achieve the designation. But for now, I'm taking a holiday!

What advice do you have for other tax professionals considering structured learning?

Education is essential to enriching your tax knowledge and offers a good chance for you to think about your career path. In addition, working remotely has given many people more time to undertake further education, especially while in a lockdown. This will help you to prepare for new opportunities once markets reopen and to get clarity on what you are interested in and what you want to do in the future.

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Large business and international: part 1

by The Tax Institute

This article represents the first instalment of the *Case for Change* chapter on large business and international taxation. It exposes the unnecessary complexities in our corporate tax rules that have built up over the years, often on the basis of addressing some perceived integrity issue. In the process, innovation has been stifled and both domestic and foreign investment have been deterred. While the mix of taxes should rely less on an inefficient tax like corporate tax, this article illustrates that more is needed; that the fundamental rules themselves need significant reform. This first instalment looks at some of the fundamental building blocks of the corporate tax base, analyses the issues and suggests options for creating a more competitive system. The second instalment, to be published in the next issue of *Taxation in Australia*, will cover certain special corporate tax regimes and international issues.

Overview

When reviewing the state of the Australian economy and the ability of the tax system to support it in present circumstances and into the future, an initial consideration is complexity. While some argue that a complex economy requires a complex system, there is no evidence to support this claim. In fact, other countries with equally complex economies have much simpler systems. Accordingly, it is difficult to say that Australia has achieved the right balance or is even headed in the right direction with a tax system able to support its economy in the future. As John Kenneth Galbraith said, “Do not be alarmed by simplification, complexity is often a device for claiming sophistication, or for evading simple truths”. It appears the great economist had a prescient view of the Australian tax laws and those relating to corporate and international taxation in particular. The laws have become so ridiculously complex that they threaten to choke the very life out of the thing that is sought to be taxed. When that occurs, there will be nothing left to tax.

In the context of the current economic climate, taking into account factors such as the challenges of a global economy, increased digitalisation, declining growth and productivity, and the impact of the COVID-19 pandemic, corporate tax as a major source of revenue is unsustainable.

The current economy, often dubbed the ‘fourth industrial revolution’, and the fate of the future economy need to be considered alongside the issues associated with this, including inefficiency in the tax system, the rise of artificial intelligence, climate change, Australia’s ageing demographic and intergenerational concerns.

As highlighted throughout the *Case for Change* paper, around 90% of Australian tax revenue is raised through only 10 out of some 125 different taxes that are currently levied on businesses and individuals.[1] As also discussed throughout the *Case for Change* paper, the tax mix must be reviewed and reset, with a shift away from an over-reliance on income and corporate taxes towards greater balance across key revenue heads, including consumption taxes.

It would be invaluable to launch an educational program for taxpayers to better understand the scope and purpose of consumption tax. This would assist taxpayers to understand the rationale and merits of such a shift, the true impact on their day-to-day activities, and would ultimately support voluntary compliance.

In the corporate sector, significant compliance costs consume a disproportionate amount of tax function time and resources despite ATO data indicating a high level of voluntary tax compliance by large corporates.[2] This is exacerbated by unilateral departures from international practices and OECD/G20 guidelines. Examples in recent history have included the approach to the diverted profits tax (DPT)[3] and the hybrid mismatch integrity rule.

In relation to the DPT, not only did Australia progress with its implementation ahead of the agreed OECD timetable, the end result was also a significant departure from what was envisaged as part of the OECD’s base erosion and profit shifting project.[4] The draconian operation of the DPT, its interaction with the existing general anti-avoidance regime contained in Pt IVA, and its exclusion from the scope of our tax treaty network have been the subject of criticism, domestically and internationally.

Likewise, the hybrid mismatch rules did not entirely follow the OECD recommendations, with one of the most notable departures being the introduction of a targeted integrity rule. At a very high level, the rule is designed to prevent multinational groups from establishing structures to circumvent the hybrid mismatch rules and effectively requires lending into Australia to be taxed at a rate in excess of 10% in a foreign jurisdiction. It is a departure from the general deduction/non-inclusion rule, which does not require foreign tax to be payable in a particular jurisdiction.

The Tax Institute supports the significant progress achieved to address base erosion and profit shifting at the international level collectively by the OECD/G20, and the implementation of domestic measures that complement this work. It is noted that the OECD has on more than one occasion cautioned against unilateral moves by individual countries.[5] These departures undermine Australia’s commitment to the OECD and multilaterally coordinated responses to international issues. Not only do such actions put Australia at risk of adverse responses from other jurisdictions, they also give

rise to additional costs for multinational corporations in complying with different rules in the various jurisdictions in which they operate.

There are significant discrepancies in the proportion of tax collected compared to the number of different taxes. This is exacerbated by the disproportionate collection of tax in terms of the taxpayers affected. The Australian economy is dominated by the mining, retail and financial services sectors. Large corporates operating in Australia are responsible for approximately 62% of all corporate tax paid and collecting 65% of net GST. This gives rise to a degree of reliance on the same taxpayers in these industries and an overall concentration risk.

Over several decades, there has been strong international competition for inward investment and this has had a significant role in influencing other countries' decisions to lower their corporate tax rates.[6] It is also important to recognise that a headline corporate tax rate is not the starting and finishing point of a sophisticated corporate tax regime. Other factors which go to the tax base, such as incentives, allowances, concessions and, of course, integrity measures, are critical factors which affect a country's attractiveness for corporate investment and activity. Those factors impact the effective tax rate, the importance of which should not be ignored in assessing Australia's overall competitiveness. It is also important to keep in mind that a corporate tax does not simply fall to companies. Like other taxes, corporate tax is ultimately borne by individuals, directly, in terms of shareholders, but also indirectly, in terms of workers, consumers and others.[7] This is an important consideration in assessing how progressive or regressive corporate tax may in fact be and may provide some support for a shift towards source-based taxing of economic activity (considered below in the international context).

Research undertaken by Treasury has demonstrated that an improvement in Australia's living standards must be driven by a higher level of labour productivity and that this can be achieved through a reduction in the company tax rate, among other things. The reduced capital investment in the last twenty years in Australia has been a significant cause of lower levels of productivity. The Productivity Commission noted that weakness in labour productivity "can be partly attributed to a marked slowdown in investment in capital — so much so that the ratio of capital to labour has fallen — 'capital shallowing'".[8] Ironically, this has occurred at a time when, due to global monetary loosening, there is an increasing pool of investment capital available to be deployed.

Addressing the corporate tax rate to reduce the drag on the economy of an inefficient tax should thereby encourage investment. This is the case even after allowing for a shift in the tax mix to greater reliance on other taxes, or a reduction in government spending to recover lost revenue, because it lowers the before-tax cost of capital. The result is that investment is encouraged which increases capital stock and labour productivity.[9] Ultimately, increased productivity results in increases in living standards.

The government and the Australian people need to consider what Australia's future looks like, and whether the path we are headed down aligns with what we want it to look like. For example, will our economy be a net capital importer or net capital exporter in future? While the argument is not beyond controversy, government policy on matters such as the corporate tax rate and foreign investment rules, among other things, has a significant impact on foreign investment. The tax system as a whole is in dire need of a comprehensive review followed by genuine reform.

> *"Addressing the inefficient corporate tax to reduce the drag on the economy should encourage investment."*

Tax policy and system maintenance

The structures of the Australian economy, the tax system and our political model are impediments to broad tax reform. There are missed opportunities for the government due to delays in producing policy. However, the commercial world does not stop spinning and businesses and investors move on without waiting for government policy to do what is prudent, commercial, and appropriate from a risk management perspective. Where such business decisions lead to investment in jurisdictions other than Australia, including by Australian investors, it can be significantly detrimental to Australia's economy and future.

Although Australia is reliant on foreign capital, there are few incentives for foreign investors to enter the Australian market. On the other hand, there is little broad appreciation that the taxation of foreign equity and debt is deliberately differentiated. Debt taxation is substantially driven by international norms and negotiated outcomes, recognising that the cost of tax on debt is often borne by the Australian borrower. Similarly, together with the thin capitalisation rules, the Australian settings mean the effective overall rate of tax for foreign corporate investors can be lower than the headline rate of corporate tax. This is a deliberate policy setting to encourage foreign investment.

Likewise, although encouraging Australian business growth and expansion appears to be a priority, there is a lack of genuine support for the overseas expansion of Australian businesses. Innovation is perceived as a cost rather than as an investment.[10] This is compounded by significant concerns from foreign investors and multinational enterprises about the Australian tax policy settings and the impact of the political environment, particularly during continued periods of political volatility and instability. The Australian political landscape has become accustomed to a level of political discourse which is short-sighted and antagonistic, at times, even within the same political party. A tendency to espouse what sounds immediately attractive on the surface, and what is therefore expected to win votes, rather than having the courage to lead the debate on what is actually needed, particularly where the two do not align, has had a damaging effect on Australia's ability to develop sound tax policy and

law. This detracts from sensible discussion of holistic tax reform and is ultimately to the detriment of the Australian people.

The tax policy framework must therefore be reset. Tax reform must be driven by a forward-looking focus and must keep in mind how foreign capital can be attracted and can create a stronger economy through new industries and jobs. Tax reform and incentives underpinned by sound tax policy will encourage business investment and job creation in Australia. Options for better tax policy formulation are contained in chapter 13 of the *Case for Change*.[11]

Fundamentals of the Australian corporate tax system

Corporate residency and liability to tax

Companies that are resident in Australia for income tax purposes (see below) are broadly subject to Australian corporate tax on worldwide taxable profits, including capital gains. Non-resident companies are subject to Australian corporate tax on their Australian-sourced profits only. Where a company is resident in a country with which Australia has concluded a tax treaty, Australia's right to tax business profits is generally limited to profits attributable to a permanent establishment in Australia, as defined in each particular tax treaty and subject to any modification by the operation of the *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*.

A company is a resident of Australia for income tax purposes if it is incorporated in Australia or, if not incorporated in Australia, it carries on business in Australia and either: (i) its central management and control are in Australia; or (ii) its voting power is controlled by shareholders who are residents of Australia.

Current guidance from the ATO has indicated that, if a foreign incorporated company carries on a business and has its central management and control in Australia, it will carry on business in Australia within the meaning of the 'central management and control' test of residency, even though no part of the actual trading or investment operations of the business take place in Australia.[12] However, in the 2020–21 Federal Budget, the federal government announced proposed amendments to the existing legislation to clarify the position.[13] The proposed amendments are intended to ensure that a foreign incorporated company will only be treated as an Australian tax resident if it has a 'significant economic connection to Australia'. This test will be satisfied where both the company's core commercial activities are undertaken in Australia and its central management and control is in Australia.

The announced measure is consistent with the recommendation made by the Board of Taxation in its 2020 report titled *Review of corporate tax residency*[14] and is designed to reflect the position prior to the decision in *Bywater Investments Ltd v FCT*[15] (*Bywater*). This was a welcome announcement which substantially reinstates the position in the withdrawn TR 2004/15.[16] Enactment of the amendments will provide long-awaited certainty for corporate taxpayers. This is a positive step in the right direction to encourage greater foreign investment in Australia. However, this must be coupled with further action, including, first and foremost, a reduction in the corporate tax rate (see below).

The corporate tax rate(s)

There are two fundamental issues with the Australian corporate tax rate(s). The first is that the system is complicated by dual rates, and the second is that the headline rate is too high.

Dual rate system

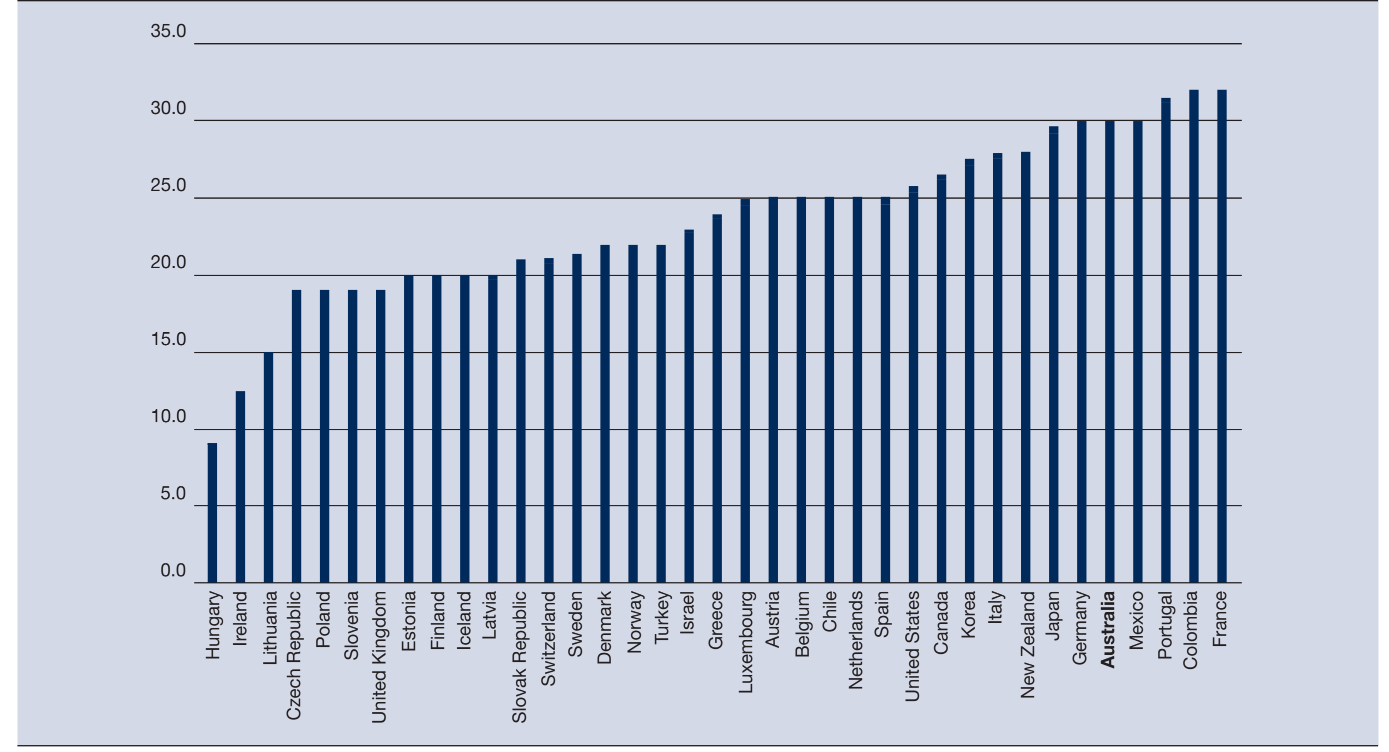
Currently, Australia operates a dual corporate tax rate system. A headline rate of 30% applies to most companies. However, from the 2017–18 income year, a lower rate applies to 'base rate entities' with a lower aggregated turnover and income that is not predominantly passive. From the 2017–18 to 2019–20 income years, companies that are base rate entities were taxed at a lower company tax rate of 27.5%. That rate reduced to 26% for the 2020–21 income year and to 25% in the 2021–22 income year. A base rate entity is a company that has an aggregated turnover less than the aggregated turnover threshold of $50m from the 2018–19 income year (formerly $25m). In addition, 80% or less of its assessable income may be base rate entity passive income. This is in place of the requirement to be carrying on a business.

The Tax Institute is of the view that a single corporate tax rate across all companies should apply in Australia. The dual system has added a range of complexities to an already complex system. It produces anomalous outcomes, particularly because a company can oscillate between the two rates from one year to the next. A significant area in which this issue manifests is in determining a company's franking rate. The imputation rules can cause a company's tax rate to differ from its franking rate, and the franking rate can also change from one year to the next. The current system of companies franking dividends at different tax rates depending on their turnover and income year is complicated. It can encourage or discourage the payment of dividends based on the tax outcome of the dividend rather than underlying economic or commercial reasons. The identification of different franking rates also leads to a greater risk of errors in the preparation of tax returns and year-end affairs, thereby increasing the compliance burden and potential for disputes. Anomalous outcomes also arise in relation to the operation of the rules as they apply to non-portfolio dividends and shares held by trusts interposed between trading companies and corporate beneficiaries. Some of these outcomes are considered in further detail in chapter 3 of the *Case for Change*.[17]

The headline corporate tax rate

Australia's headline corporate tax rate is one of the highest in the OECD (see Figure 1).[18] The corporate tax rate in any jurisdiction is an important consideration for potential investors. Australia's current rate is uncompetitive when benchmarked against other OECD countries, and indeed when compared to other countries in the Asia-Pacific region and its major trading partners.

Figure 1. Corporate tax rates across OECD countries



This is a disincentive to foreign investment, on which Australia is heavily reliant. Further, in combination with factors such as the current lack of legislated incentives to innovate and develop intellectual property onshore, and Australia's CFC rules, it unfairly disadvantages Australian businesses and hinders their ability to expand both nationally and across borders.

The Tax Institute has persistently advocated that a single, lower rate, no higher than 25%, should apply to all companies, irrespective of their aggregated turnover or proportion of passive income. Even with a flat corporate tax rate of 25%, Australia would remain in the top one-third of OECD countries' highest corporate income tax rates, acknowledging the recent 2021 Budget announcement by the UK Chancellor of an increase to the UK corporate tax rate from 19% to 25%,[19] and the expected increase by the Biden Administration of the US corporate tax rate from 21% to 28%.[20] While acknowledging that reductions in corporate tax rates are difficult politically, having regard to the foregoing, the known economic cost of corporate taxes[21] and the unwieldy dual rates should, at a minimum, suggest the rates be aligned at the lower 25% rate.

In the Asia-Pacific region, a rate of 25% would remain substantially higher than the headline corporate tax rate of neighbouring countries. While this would still leave Australia in a relatively uncompetitive position in the Asia-Pacific region, given the contentious debate surrounding the reduction of the rate, it is viewed as a step in the right direction. Looking ahead, we also recommend a reassessment of the impact of the rate and consideration of a further slight reduction in the future. We acknowledge that the G7 have recently agreed to a proposal by the US in connection with the work of the OECD that a minimum corporate tax rate of 15% be adopted.

We acknowledge that an alternative source of revenue to compensate for the perceived loss of revenue that may result from a rate cut may be required. In this regard, a shift in the tax mix away from relying on corporate tax towards relying on more broad-based consumption taxes should assist to compensate for the reduction in corporate tax revenue collections if the corporate tax rate were to be reduced. Appropriate modifications to the dividend imputation system could provide another way to fund the reduction in the corporate tax rate. Some such modifications are considered below.

Entity taxation and imputation

Income tax was introduced in Australia in 1915. Under that system, companies were taxed only on their retained profits via a deduction for dividends paid. Shareholders were taxed on the dividends received. In 1922, the system was reformed to treat all company profits as taxable. The non-refundable rebate continued with the effect that those individual shareholders on higher marginal rates received a full rebate for corporate tax paid, whereas individuals on lower marginal rates did not. In 1940, the rebate for dividends was removed due to an increased need for revenue to fund Australia's Second World War efforts. While it had been intended only as a temporary measure, the absence of the rebate lasted well beyond the end of the war.[22]

In a classical company taxation system, a company is taxed on its income as an entity distinct from its shareholders, each of whom are taxed individually on their dividend income at their personal marginal tax rates. Without modification, this system gives rise to double taxation, whereby tax is payable on the same income by two different entities (being, first by the company, and second by the shareholder on receipt of a dividend in that shareholder's proportionate holding). This was the case in Australia between 1940 and 1986.[23]

Such double taxation is remedied in different ways around the world. In some cases, the company is treated as a 'look-through' (similar to our trust taxation system), while in other countries, Australia included, a credit is effectively allowed to the shareholder for some or all of the tax already paid by the company. That is, the tax paid by the company is *imputed* to the shareholder.

The imputation system was introduced in Australia in 1987 and is now over 30 years old. It is a full imputation system whereby a company which pays corporate tax on its income may attach a franking (imputation) credit to distributions made to its shareholders up to an amount equal to the tax paid by the company (that is, a franked divided). The franking credit may then be used by the shareholder to offset their personal tax liability.

As noted in the *Financial system inquiry final report* in November 2014:[24]

> "The implications of dividend imputation are less clear. The introduction of imputation reduced firms' cost of equity; however, the effectiveness of imputation in lowering the cost of capital arguably has declined as the economy has become more open. The tax benefits of imputation may encourage domestic investors to invest in domestic firms with domestically-focused investments, which would limit opportunities and increase risk from less diversified portfolios.
>
> To the extent that imputation distorts the allocation of funding, a lower company tax rate would be likely to reduce those distortions. A lower company tax rate would also enhance Australia's attractiveness as a place to invest, which would increase Australia's productivity and living standards."

Refund of franking credits

The Australian system goes a step further than standard full imputation and allows for a refund of franking credits where the tax rate payable by the shareholder is lower than the company tax rate. This aspect of the imputation system was introduced in 2000 by the Howard Government to provide relief to low-income shareholders. This change also benefited superannuation funds. The combination of this refund system coupled with a low rate of tax (or nil in the case of income from assets set aside to pay superannuation income streams) has made investment in Australian shares very attractive to Australian superannuation funds.

Interaction with tax concessions and other forms of income

Full imputation can undo some of the work done by concessions that operate to effectively reduce the corporate tax payable, such as the R&D tax incentive and, more recently, the tax-free cashflow boost stimulus measure in response to the COVID-19 pandemic. Such concessions are intended to be tax-free for the recipient company; however, once that income is distributed in the form of a divided to shareholders, tax is effectively required to be paid on the distribution at the tax rate of the shareholders without a tax offset, thus undoing the tax-free concession granted to the company. Anomalies also arise where resident companies expand offshore and repatriate profits as non-assessable non-exempt income under Subdiv 768-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Investors seeking franking credits are less likely to invest in such companies and the current system does not lend itself to a simple solution in such cases.

Franking credits are valued by Australian resident shareholders as a tax offset, though offer little value to non-resident shareholders, other than eliminating the need for dividend withholding tax to the extent that the dividend is franked. This potentially influences (and distorts) corporate behaviour and incentives in respect of the location of investment, financing and distribution policies.

Integrity measures

Over the years, a number of integrity measures have been introduced to target the manipulation of the imputation system. Among others, these measures include:

- anti-streaming rules: to ensure that franking benefits are not streamed mainly to members that would receive a greater benefit;
- anti-avoidance rules: to address franking credit schemes;
- holding period and related payment rules: to prevent trading schemes where a taxpayer might, for example, acquire shares cum dividend, receive the dividend and franking credits, and dispose at a loss;
- rules to counteract dividend streaming, stripping and washing;
- share capital tainting rules: to prevent companies disguising a dividend as a tax-preferred capital distribution from the share capital account; and
- debt/equity rules to prevent payments in the nature of interest being treated as dividends and vice versa.

Such measures have been enacted at various stages to target particular instances of contrivance relevant to financial markets at the time. While for the most part they have been effective, in certain cases, they have become outdated, and many have actually been repealed but are retained by reference or inference. Unsurprisingly, the variety of different measures introduces an additional layer of complexity and brings with it an additional administrative burden.

Options for reform

There are three primary options to address issues in the imputation system: full imputation, partial imputation and no imputation. Full imputation could be retained, largely without modification but critically with the removal of the two-tiered system. Alternatively, Australia could move to a partial imputation system. This would involve a degree of imputation that balances the impact on superannuation funds and individual investors with the removal of some of the biases that currently exist. Such a partial imputation system could

be achieved in numerous ways. For example, imputation could be permitted up to a dollar limit or a percentage, with the excess either exempt or taxed at a flat rate, potentially lower than the corporate tax rate. Rather than a global change, partial imputation could apply to particular classes of shareholders or to certain types of companies, though it is acknowledged that this would introduce a greater degree of complexity into the system.

Alternatively, imputation could be replaced with a lower corporate tax rate combined with certain exemptions and allowances. A number of jurisdictions fully exempt company-to-company dividends. For example, in the UK, provided that certain broad conditions are met, foreign and UK dividends received by UK companies are exempt. Individuals in the UK do not pay tax on dividend income that falls within their personal allowance (being akin to the tax-free threshold) or the amount which comprises their dividend allowance (GBP2,000 of an individual's dividend income for the 2020–21 year). To the extent that dividend income exceeds those allowances (noting that dividends are taxed at the individual's highest marginal tax rate), the rate of tax paid on such income depends on the individual's income tax band. Importantly, the dividend allowance operates as a 0% tax rate. It does not reduce total income for UK tax purposes with the effect that dividend income that is untaxed as a result of the allowance is still included in an individual's basic rate and higher rate limits.[25] Adopting this approach *without* reducing corporate tax rates at the same time would represent an effective increase in taxation of company profits which is not advocated given the inefficiency of corporate taxes as referred to above.

Another option is to introduce a withholding tax system, much like current arrangements in respect of cross-border distributions. A further alternative may be a return to a full classical system (no imputation), with a suitably reduced company tax rate. Such a proposal would recognise the advantages of investment through a company vehicle, and otherwise leave shareholders in positions which differ according to their individual circumstances. It is acknowledged that this option would be out of step internationally and highly unpalatable politically.

A further approach might be to consider a dividend deduction regime. This would result in no taxation on distributed profits at the company level but taxation at the shareholder level. Whether concessional rates of tax should apply to shareholders, as in the UK, would need to be considered. Retained profits would be subject to corporate tax. The outcome would be very close to the current imputation regime, although the mechanism would differ.

There are features of an allowance for corporate equity (ACE) in a deduction system, albeit such regimes generally involve high taxes on the remaining profits, often described as economic rents. Under an ACE, the overall corporate tax is reduced but with a narrow base and higher headline rate. Concessional taxation at the shareholder level may also apply (or there could be retention of imputation but with an expected lower rate of imputation/franking being passed to shareholders by virtue of less tax being paid by the company). Thus, an ACE represents a viable alternative and is often cited as such.[26]

The European Commission has recently suggested that, to address the debt-equity bias in corporate taxation, an allowance for corporate taxation should be created.[27] This would be a form of ACE. It is considered in the Commission's paper that such an allowance would result in higher levels of equity financing, thereby making companies less vulnerable to economic shocks.

Utilisation of tax losses

Provided that certain tests are satisfied, company tax losses may be carried forward indefinitely and applied against taxable income in later years. Losses were briefly permitted to be carried back in the 2012–13 income year to the 2011–12 income year, though this reform was short-lived and subsequently repealed. As part of the 2020–21 Federal Budget, the government announced a temporary loss carry-back measure, permitting eligible corporate entities with less than $5b turnover in a relevant loss year to carry back certain tax losses. Originally expiring in the 2021–22 year, it was extended in the 2021–22 Federal Budget to apply to losses up to the 2022–23 income year. In such cases, companies can claim a refundable tax offset up to the amount of their previous income tax liabilities and their franking account balance at the end of the year in which the tax return in which the tax offset is claimed is filed.

It would be an understatement to say that the company loss rules are complex. We highlight below certain significant challenges:

- challenges in applying the same business test, including practical and administrative difficulties of tracing through entities;
- uncertain application of the same business test and similar business test, heavily left to the discretion of the Commissioner; and
- ambiguity in the interpretation and application of the loss integrity provisions, such as in relation to the unrealised net loss provisions contained in Subdiv 165-CC ITAA97 and the inter-entity loss duplication rules contained in Subdiv 165-CD ITAA97.

The interaction between the loss rules and particular regimes within the tax system, such as the tax consolidation rules,[28] gives rise to additional layers of complexity. We also note that there are the different regimes for company losses and trust losses, and of course the separate but related issue of the different treatment of revenue and capital losses and specifically the artificial quarantining of capital losses. Quarantining of capital losses is a completely artificial concept. To quarantine all losses and require them to be carried forward is problematic in itself, and largely without justification other than the protection of the revenue base. However, the quarantining of capital losses as a further subset gives rise to another layer of complexity including timing issues, among other things. While this has the potential to affect a broad range of taxpayers, it can often be problematic for large businesses, and unnecessarily so, given that there is no differential in the tax rate.

This complexity stifles genuine business restructuring and has the potential to discourage innovation and risk-taking.

The Tax Institute considers that it is time to reassess why losses are treated so differently to other tax assets.

Trading in loss-making companies has gained a negative connotation, though this was not always the case. In fact, until the beginning of the 1960s, it was not considered problematic.[29] The underlying premise as to why tax losses are treated differently to other assets with certain tax attributes is essentially to protect the revenue base, given that part of the underlying principle is to slow the rate at which losses are utilised. However, this is mostly a timing issue and only occasionally a permanent (and unjustified) gain to the revenue. In a 'pure' system, the artificiality of the 'income year' for an ongoing business would be recognised and a tax refund given for losses recorded in a given tax period, in the same way tax is collected when a profit arises in a tax period.

When parties trade in assets carrying particular tax attributes, the threshold issue is largely around market value pricing. Otherwise, it can be noted that in particular regimes, such as in the context of building allowances, deductions transfer from one party to another based on the expenditure by the original owner of the relevant asset.[30] There is no reason in principle why a similar approach could not be applied to tax losses, other than the protection of the revenue. It should not matter that a third party is willing to pay for a bundle of losses upfront, rather than the original owner waiting to generate enough future income to have the funds returned by the government by virtue of the offset.

If some form of limitation on the utilisation is required due to concerns on the impact on the revenue, an alternative option would be to allow simplified access to losses, potentially on a straight-line basis for a finite period, for example, 10% each year for 10 years. If such a model were given effect, it would do away with the need for most of the loss rules, including the continuity of ownership test and same business test, and the various associated administrative and compliance costs.

Further, noting the artificial construct of a 'tax year', given that businesses generally operate both before and after a tax year, there should be no reason why losses may not be carried back, subject of course to reasonable integrity measures.

There is no denying that integrity measures must underpin the tax system to ensure that contrivance is deterred and counteracted. In the case of dealings in losses, this may be to prevent duplication or artificial manufacture of losses. However, such measures must be balanced to ensure that the tax system not only permits, but also supports legitimate business restructures and transactions.

Capital gains tax

CGT events underpin the CGT system, but this was not always the case and was not originally intended. When CGT was introduced in 1985, it was a simpler system, essentially based around assets which were disposed of, having been previously acquired. Today, we have more than 50 different CGT events and, suffice to say, the system has got out of hand. It is important to stop and reassess how and why we arrived at this position and, more importantly, to course correct.

Around a decade before the CGT was introduced, the Asprey report recommended the introduction of a tax on realised capital gains.[31] Although it did not prescribe all aspects of the calculation of the capital gain, the Asprey report recommended:

> "23.39. It is recommended that to determine the amount of the gain there should be deducted from the proceeds of *sale of the asset*:
>
> (a) The cost of the asset, including all costs directly incurred in the purchase such as stamp duty, legal costs and agent's commission. This will apply in the case of assets purchased after the date of introduction of the tax, while to those already owned by the taxpayer at that date the provisions outlined in paragraphs 23.31–23.34 will apply.
>
> (b) Expenditure incurred in enhancing the value of the asset or preserving the taxpayer's title to it. This would usually include the cost of improvements and additions but not expenditure that has been previously allowed as a deduction for income tax purposes. In particular, expenditure related to the use or enjoyment of the asset would not form part of the cost base nor would outgoings such as repairs or interest which have been allowed as a deduction for income tax purposes.
>
> (c) Costs directly incurred in the sale of the asset, such as stamp duty, legal costs and agent's commission." (emphasis added)

The Asprey report's recommendations did not go so far as to presuppose the means of realisation of a capital gain, nor to prescribe the calculation of costs to be taken into account.

About a decade later, the 1985 draft white paper *Reform of the Australian tax system* (colloquially known as the RATS paper) considered certain issues associated with the taxation of gains on capital.[32] It addressed some of the different models and experience of other jurisdictions including, but not limited to, the issues of 'lock-in', 'bunching' and timing. The RATS paper contemplated the principle of symmetrical treatment between capital gains and losses, the effect of which would treat losses as deductible on realisation in the same way that gains would be assessable on realisation. Similar to the Asprey report, it did not prescribe the manner in which gains or losses should be determined. Rather, it provided something closer to a broad overarching policy statement of CGT.[33]

Despite the broad principles contemplated ahead of its enactment, the CGT rules took a somewhat different path. While the detail of the government announcement introducing the new rules was largely consistent with the RATS paper, the first notable difference related to timing — the rules only applied to assets acquired after 19 September 1985.[34] It would be an understatement to describe the legislation that followed as overly prescriptive, though as we can see from the current rules, that was just the beginning. Concepts like 'asset', 'disposal' and 'acquisition' were thought necessary to be defined.[35] New principles, such as in relation to timing, which did not always follow ordinary concepts, were also introduced, as well as prescriptive rules for the calculation of a capital gain or loss, the determination of parts of consideration and cost base.[36] The overly prescriptive approach taken in the *Income Tax Assessment Act 1936*

(Cth) (ITAA36) necessitated adjustments for exceptions and modifications.[37]

Suffice to say, the 1997 rewrite introducing the concept of CGT events was no improvement in terms of the sheer volume of the legislation, nor the gaps that nevertheless arose.[38] In many aspects of the Australian tax system, we have gone so far down the path of equity that we have lost all sight of simplicity, and sometimes even equity itself. The CGT provisions are no exception. A law that at its core is simple to express and can, in fact, be done in a few paragraphs need not be over-engineered into volumes of legislation, the only solution to which is even more legislation. This is a fundamental design flaw and must be corrected before it is worsened.

Section 104-5 ITAA97 contains a summary of the current CGT events, extracted at a high level in Table 1.

Table 1. Summary of CGT events

A1 – disposal of a CGT asset.	H2 – receipt for event relating to a CGT asset.
B1 – use and enjoyment before title passes.	I1 – individual or company stops being an Australian resident.
C1 – loss or destruction of a CGT asset.	I2 – trust stops being a resident trust.
C2 – cancellation, surrender and similar endings.	J1 – company stops being a member of wholly-owned group after roll-over.
C3 – end of option to acquire shares, etc.	J2 – change in relation to replacement asset or improved asset after a roll-over under Subdivision 152-E.
D1 – creating contractual or other rights.	J4 – trust fails to cease to exist after a roll-over under Subdivision 124-N.
D2 – granting an option.	J5 – failure to acquire replacement asset and to incur fourth element expenditure after a roll-over under Subdivision 152-E.
D3 – granting a right to income from mining.	J6 – cost of acquisition of replacement asset or amount of fourth element expenditure, or both, not sufficient to cover disregarded capital gain.
D4 – entering into a conservation covenant.	K1 – as the result of an incoming international transfer of a Kyoto unit or an Australian carbon credit unit from your foreign account or your nominee's foreign account, you start to hold the unit as a registered emissions unit.
E1 – creating a trust over a CGT asset.	K2 – bankrupt pays amount in relation to debt.
E2 – transferring a CGT asset to a trust.	K3 – asset passing to tax-advantaged entity.
E3 – converting a trust to a unit trust.	K4 – CGT asset starts being trading stock.
E4 – capital payment for trust interest.	K5 – special capital loss from collectable that has fallen in market value.
E5 – beneficiary becoming entitled to a trust asset.	K6 – pre-CGT shares or trust interest.
E6 – disposal to beneficiary to end income right.	K7 – balancing adjustment occurs for a depreciating asset that you used for purposes other than taxable purposes.
E7 – disposal to beneficiary to end capital interest.	K8 – direct value shifts affecting your equity or loan interests in a company or trust.
E8 – disposal by beneficiary of capital interest.	K9 – entitlement to receive payment of a carried interest.
E9 – creating a trust over future property.	K10 – you make a forex realisation gain covered by item 1 of the table in subsection 775-70(1).
E10 – annual cost base reduction exceeds cost base of interest in AMIT.	K11 – you make a forex realisation loss covered by item1 of the table in subsection 775-75(1).
F1 – granting a lease.	K12 – foreign hybrid loss exposure adjustment.
F2 – granting a long term lease.	L1 – reduction under section 705-57 in tax cost setting amount of assets of entity becoming subsidiary member of consolidated group or MEC group.
F3 – lessor pays lessee to get lease changed.	L2 – amount remaining after step 3A etc. of joining allocable cost amount is negative.
F4 – lessee receives payment for changing lease.	L3 – tax cost setting amounts for retained cost base assets exceed joining allocable cost amount.
F5 – lessor receives payment for changing lease.	L4 – no reset cost base assets against which to apply excess of net allocable cost amount on joining.
G1 – capital payment for shares.	L5 – amount remaining after step 4 of leaving allocable cost amount is negative.
G3 – liquidator or administrator declares shares or financial instruments worthless.	L6 – error in calculation of tax cost setting amount for joining entity's assets: CGT event L6.
H1 – forfeiture of a deposit.	L8 – reduction in tax cost setting amount for reset cost base assets on joining cannot be allocated.

While the current rules could be described as comprehensive, at least in the sense that they attempt to cover all bases, they are still deficient and there remains numerous gaps in the system. Notable inadequacies relate to the treatment of earnouts, liabilities, foreign exchange gains and losses on liabilities originally addressed by Div 3B ITAA36 and the subsequent band-aid solution of Div 775 ITAA97, the commercial debt forgiveness rules, defeasance gains, the limited recourse debt rules, gains on financial arrangement liabilities and, of course, in relation to aspects of consolidation.[39] Some of these regimes are considered further in part 2 of this chapter of the *Case for Change* paper (to be published in the October issue of this journal).

It is possible to do away with the 54 CGT events and introduce a simplified, principled provision using ss 6-5 and 8-1 ITAA97 as a model. Such a provision would broadly require the inclusion in assessable income of any net capital gain made, being capital gains less capital losses.[40] Following this path, at most, we may simply retain a slightly modified version of s 100-45 ITAA97, which sets out how to calculate the capital gain or loss for most CGT events.[41] The effect still would be to include net capital gains in taxable income. Ultimately, the same outcome, but without the unnecessary complexity of determining the relevant CGT event and navigating its nuances. Such a simpler rule would also be broader in its scope — it could cover gains and losses on liabilities, for example. That would obviate the need for the many special rules that presently exist to overcome the currently narrow base of the CGT regime.

Not only would this save significant administrative and compliance costs, it would also increase flexibility and ensure that our CGT rules are future-proofed without the need for ad hoc solutions in response to changes in our economic landscape and emerging practices. Together, these factors would, of course, positively impact productivity.

CGT roll-overs

The broader CGT regime encompasses various forms of concessions, exemptions and other reliefs, ranging from discounted rates for certain taxpayers, to roll-overs which allow certain capital gains to be deferred or, in some cases, disregarded. Existing roll-overs (and any proposed reforms) must be considered in the context of the existing CGT regime, centred around CGT events (and any broader reforms that are required). There are a number of different CGT roll-overs which may be broadly categorised into groups. These include same asset or replacement asset roll-overs, scrip-for-scrip roll-over, demergers, small business restructures, and those related to relationship breakdowns.

The Board of Taxation is currently in the process of a review of CGT roll-over relief which was announced in December 2019.[42] As part of this process, the Board has identified elements of the policy underpinning the availability of CGT roll-overs.[43] Roll-overs are essentially intended to overcome distortions in investment decisions arising from the particular expression in our laws of a realisation method of CGT. Among other things, one of the fundamental principles underpinning roll-over relief is that there should not be a taxing event where there is continuity in the economic ownership of a CGT asset. This, and the broader policy of roll-over reliefs, should underpin any proposed reforms in this area.

Moreover, roll-overs are fundamentally not anti-avoidance provisions. Of course, integrity measures are required to ensure that roll-overs are not manipulated. However, such measures are inherent in some of the conditions for existing roll-overs, and are, of course, found in the general anti-avoidance regime contained in Pt IVA ITAA36. However, to ensure a balanced outcome, and particularly since the problems identified in relation to the existing roll-overs generally do not relate to integrity concerns, the starting point should not be to approach a change from an anti-avoidance perspective.

The Tax Institute has made submissions to the Board of Taxation in respect of the ongoing review.[44] We are of the view that, in the existing system, the preferred option is to resolve particular issues arising in the context of certain roll-overs. This is not to say that broader reforms are not possible, or indeed desirable. However, such reforms must be part of a more expansive, holistic package which takes into account the CGT provisions dictating the triggering of a liability (to which roll-over relief may apply). The proposed general business restructure roll-over, particularly in the form contained in the Board's second consultation paper, is not the solution. The proposal, while intending to introduce simplicity into a complex system, instead introduces ambiguity which has the potential to increase administrative and compliance costs and exacerbate the challenges it seeks to resolve.

While a general roll-over is unlikely to be workable in the current CGT landscape, it may be more feasible if the CGT regime is simplified as suggested above. Importantly, given that CGT can be triggered in a private or domestic context, and the policy underlying the availability of roll-over relief is not limited to business restructures, a general roll-over would need to be broad enough to cover such circumstances. It would be inconsistent with the policy of CGT roll-overs to introduce a general roll-over which is designed to replace some existing roll-overs but simply eliminates certain others in the process.

Conclusion

This article represents the first instalment of the *Case for Change* chapter on large business and international taxation and has attempted to identify some of the obstacles and opportunities to encourage both an outward-looking Australian corporate sector and an attractive environment for foreign capital. In response to those limitations, this article and the *Case for Change* has considered how current fundamental corporate tax settings could be recalibrated to be consistent with leading international trends for corporate taxation and moving beyond the traditional parameters of corporate taxation.

The second instalment, to be published in the next issue of *Taxation in Australia*, will cover certain special corporate tax regimes and international issues.

The Tax Institute

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Superannuation: top five litigation risks

by Shelley Banton, Head of Education, ASF Audits

While it is not compulsory to have a self-managed superannuation fund, SMSF trustees must have a proper understanding of their role and responsibilities under the superannuation legislation. The penalties for not complying can be harsh, with the fund facing potential tax consequences and trustee disqualification. With the road to SMSF compliance fraught with disaster, recurring themes continue to provide the biggest challenge. The impact of COVID-19 has tested SMSFs in many ways, but we continue to see the same mistakes occur in the areas of: the market valuation of assets; the tax residency of an SMSF; non-arm's length income and expenses; in-house assets; and the liability for accountants and auditors. The purpose of this article is to explore these SMSF compliance issues and focus on the practical implications for SMSF trustees and accountants alike.

Introduction

While it is not compulsory to have a self-managed superannuation fund, SMSF trustees must have a proper understanding of their role and responsibilities under the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA93) and the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR94).

Section 31 SISA93 sets out the prescribed operating standards applicable to the operation of SMSFs and under which trustees must comply. It contains standards that include, but are not limited to, trustee behaviour, contributions, retirement income streams, the investment and management of assets, and the winding-up of an SMSF.

SMSF trustees who do not manage their funds within the law can face severe penalties, and the fund can potentially suffer tax consequences. As all penalties are payable by the SMSF trustee personally and not from the SMSF's bank account, the financial impact of not complying can be harsh.

While there are multiple ways in which SMSF trustees (and accountants) can fall foul of the superannuation law, the top five mistakes continue to be in the following areas:

1. the market valuation of assets;
2. the tax residency of an SMSF;
3. non-arm's length income and expenses;
4. in-house assets; and
5. the liability for accountants and auditors.

Over the last 12 months, the impact of COVID-19 has also presented additional challenges to the SMSF industry in these key areas. The government responded by implementing a series of measures designed to protect and support SMSF trustees during this trying time.

Not only have some of the government stimulus measures been unprecedented, such as the early release of superannuation, but also there have been generous compliance concessions provided to SMSF trustees by the Australian Taxation Office in recognition of the difficulties as a result of the pandemic.

Ensuring that SMSF trustees continue to comply with all of their obligations and responsibilities beyond the ATO's tailored support during COVID-19 is critical. However, given the amount of legislation and documentation required to meet regulatory compliance, it is not always easy to stay on top of the superannuation laws.

We have also seen SMSF auditors coming into the firing line due to SMSF trustees looking for a scapegoat to recoup losses incurred by poor investment decisions. There are many factors that SMSF auditors and accountants must consider in this new paradigm of litigation.

In general, SMSF auditors and accountants can mitigate the risk of litigation by acting competently and professionally. The secret is in taking reasonable and appropriate steps to work with care, skill and diligence in line with professional obligations.

Market valuation of assets

Regulation 8.02B SISR94

Regulation 8.02B SISR94 stipulates the requirement to value fund assets at market value in each financial year. It became a non-reportable contravention in 2013 as a result of SMSF trustees:

- not revaluing assets at the commencement of a pension (essentially to manipulate the minimum payment); and
- leaving some assets at cost (to avoid exceeding the 5% in-house asset limit).

In 2014, the ATO made it a reportable contravention, with some SMSF trustees facing compliance breaches for the first time due to not updating asset values to their market value.

Documentation issues

The current market valuation of all SMSF assets significantly impacts a member's $1.6m transfer balance cap, $1.6m total superannuation balance, and their ability to commence a pension. As a result, market valuations have come under intense ATO scrutiny to ensure that SMSF trustees are not deliberately undervaluing assets.

The challenge facing accountants is obtaining sufficient and appropriate evidence that proves the market value of the assets to SMSF auditors.

It should be noted that it is not the SMSF auditor's job to undertake the valuation itself. The auditor must review the evidence provided and look for sources of data used, assumptions and methods used, and their appropriateness and consistency with the prior period. To this end, the SMSF auditor must rely on their professional judgment to ascertain whether the evidence provided supports a current market valuation and to determine that the valuation is not unreasonable.

Accountants may experience problems obtaining up-to-date valuations when the fund has more complex assets, such as investments in unlisted entities or property. One common problem is that unlisted entities do not have the same disclosure requirements as public companies. Typically, the unaudited financial statements have the assets valued at cost, which is generally insufficient audit evidence and does not satisfy reg 8.02B SISR94.

Below are some examples of documentation that an auditor may request for unlisted assets:

- signed financial statements by the directors or trustees;
- a property valuation (where the property is the entity's only asset);
- proof of the recent sale of units or shares to a third party in the past 12 months; and
- written verification from a director of the entity (this must be from an unrelated party).

While this list is not exhaustive, it is clear that difficulties arise where there is no option but to rely on third parties for information, resulting in lengthy delays to the audit.

SMSF trustees

Trustees and directors of a corporate trustee who fail to value an SMSF asset as required are potentially liable to an administrative penalty of 10 penalty units, an equivalent of $2,220 in the 2021 financial year.

An SMSF trustee receives the penalty personally, which means that a fund with four individual trustees could face total penalties of $8,880 which must be paid personally and not from the fund. On the other hand, a corporate trustee will be fined $2,220 because it has one trustee regardless of the number of directors.

SMSF trustees should be aware that a change in accounting or valuation methodologies from the prior year (without sufficient justification) may raise additional scrutiny from the auditor. Also, failing to keep accounting records (which includes records about market value) as required under s 103 SISA93 is an offence of strict liability, with a penalty of 50 penalty units, or $10,500 per trustee.

SMSF accountants

With the high risk of an ATO audit, SMSF accountants may be risking their professional reputation by aligning themselves with SMSF auditors who shortcut their audit obligations.

Suppose the ATO selected a fund for review that resulted in an adverse outcome. In that case, the accountant might be at risk of a potential professional indemnity claim from the SMSF trustee. Essentially, the trustee would have recourse to the accountant as they relied on the accountant's advice to engage the SMSF auditor in the first place.

SMSF auditors

SMSF auditors need to be especially vigilant when reviewing valuations because they will be held accountable for reviewing documented evidence demonstrating that a fund's assets are valued according to the requirements of reg 8.02B SISR94.

One of the reasons is the 2018 auditor litigation cases, *Cam & Bear Pty Ltd v McGoldrick*[1] (*McGoldrick*) and *Ryan Wealth Holdings Pty Ltd v Baumgartner*[2] (*Baumgartner*). In both cases, the auditors were held liable for the losses in those funds due to insufficient audit evidence on file to confirm the existence, nature, ownership and market value of fund assets.

Where an SMSF auditor also lacks evidence for a number of funds, which coincides with a heavy reliance on fees generated for those funds through a single referral source, the ATO may consider auditor independence an issue and refer the auditor to the Australian Securities and Investments Commission (ASIC) for further investigation. Lack of audit evidence concerning market valuations is the main reason why the ATO refers SMSF auditors to ASIC.

SMSF auditors are required to qualify Part A of the financial report where insufficient audit evidence does not support the value of a material asset, such as property.

Where the asset's value is material, Part B of the audit report will be also qualified. The SMSF auditor is required to lodge an auditor contravention report (ACR) with the ATO where the fund has failed the trustee behaviour test or the financial threshold test.

ATO audit evidence

The ATO has designed a valuation guide[3] which provides SMSF trustees with the assurance that the ATO will accept the valuation supplied by SMSF trustees if they follow the guide (see Appendices 1 and 2).

The guide provides a list of valuation requirements for various events, such as preparing the fund's financial statements and related party transactions.

The ATO recommends using a qualified independent valuer where the asset's value represents a significant proportion of the fund's value or when the nature of the asset indicates that the valuation is likely to be complex or challenging.

Property valuations

A property valuation by a qualified valuer will be acceptable for all property types, as will a market valuation or appraisal by a real estate agent.

When valuing real property, relevant factors and considerations may include:

- the value of similar properties and recent comparable sales results;
- the amount that was paid for the property in an arm's length market (if the purchase was recent and no events have materially affected its value since the purchase);
- independent appraisals from a real estate agent (kerbside);
- whether the property has undergone improvements since it was last valued;
- the rates notice (if it is consistent with other valuation evidence); and

– for commercial properties, net income yields (not sufficient evidence on their own and only appropriate where tenants are unrelated).

Generally, it is not sufficient for valuations to be based on only one item of evidence in the above list. When valuing real property assets, the valuation may be undertaken by anyone as long as it is based on objective and supportable data.

A valuation undertaken by a property valuation service provider, including online services or real estate agents, would be acceptable. However, the valuation must stipulate the supportable data. For example, if a real estate agent appraisal or an online report is provided, the valuation should list the comparable sales data used in the report.

Also, it should be noted that council rate values are unacceptable for rural and commercial properties. They can be relied on for residential properties, but further evidence will be required to support the valuation method used.

The ATO has warned SMSF trustees that valuations providing a range of values based on property sale averages may not be accurate in a property.

The ATO has also stated that it is not acceptable to use the lower end of a valuation range for one purpose (such as for transfer balance cap purposes) and the higher end of the range for another purpose (such as transitional CGT relief purposes).

Market valuation of rent

Properties leased to related parties must be undertaken on commercial terms and the rent paid at market value to ensure compliance with reg 8.02B SISR94.

It is best practice to have an independent rental assessment undertaken when the property is valued to enable the SMSF auditor to confirm that rent is paid at market rates.

Any identified shortfall in rent may be a breach of s 109 SISA93 and reportable to the ATO. The timing of rent payments and all lease-related payments, such as expenses, are also relevant and will be checked to ensure that they are paid under the terms of the lease and on an arms-length basis.

Unlisted entities

Generally, the types of audit evidence that would be acceptable for an unlisted entity includes, but is not limited to, the following:

– the share/unit price of equity/new units raised/issued in the past 12 months;

– the share/unit price of shares/units sold in the past 12 months;

– a separate valuation of the company/unit trust assets (including intangible assets) and liabilities, with evidence and calculations provided;

– the net tangible asset of a company/unit trust (only reliable when the assets are valued in the financial statements at market/fair value (refer to the valuation policy in the notes to the financial statements)); and

– the cost price of shares/units (only reliable in the first year the fund acquired the shares/units).

SMSF auditors cannot accept the cost price of the asset in the statement of financial position and net tangible asset to satisfy reg 8.02B SISR94. The reason is that a private company/unit trust prepares special purpose financial statements, and the investments are typically valued at cost or written down value. Additionally, a signed copy of the unlisted entity's financial statements is required as evidence to confirm that the company is a going concern.

COVID-19 impact

SMSF trustees may find it difficult to obtain market valuations for illiquid assets where traditional businesses and economies have been affected.

Remember, it is not the SMSF auditor's job to value an asset. They will be looking for documentation and evidence provided by the SMSF trustee to ensure that the methodology behind the valuation is understood and the asset is fairly valued.

An external valuation may become materially inaccurate or the property's value could materially change since it was last valued because of a change in market conditions or events, such as a natural disaster or a global pandemic. In these circumstances, trustees should no longer rely on it and should obtain a new valuation or other sources of evidence to support the valuation. The simplest way, but not necessarily the most cost-effective, is to obtain a valuation through an independent professional valuer.

While SMSF trustees may face difficulties providing evidence for the market value of fund assets due to COVID-19, SMSF auditors are still required to lodge an ACR where the contravention meets the reporting criteria.

The ACR must include the reasons as to why the trustee was unable to obtain the appropriate evidence. If the ATO is satisfied that this was due to the impacts of COVID-19, the contravention will not result in any penalties. Instead, the trustee will receive a letter from the ATO advising them to ensure that they comply with the ATO's valuation guidelines and have supporting valuation evidence by the time of their next audit, if possible, as repeated contraventions can lead to penalties.

Related party lease agreements

SMSF auditors will be on full alert where property held in the fund or a related entity is rented to a related party. The auditor must ask questions such as whether the rent is being paid at market value and whether the lease terms are conducted on an arm's length basis.

With flexible working arrangements becoming commonplace, the ability to command pre-COVID-19 rents has been significantly affected. Many landlords are currently offering lease agreements with several incentives to lure tenants back into the market.

Obtaining an independent rental assessment confirming that rent is at market rates where negotiated incentives are in place could be problematic.

The issue for related-party tenants is that the specific incentive terms are not always publicly available as negotiations occur behind closed doors.

While there may be anecdotal evidence to support the rapidly changing nature of commercial lease agreements, SMSF auditors may not consider this to be sufficient evidence at audit.

While the valuation will state the rent's market value, it generally will not refer to specific lease incentives provided under the agreement, allowing the auditor to confirm that they are on commercial terms. An independent valuer or agent should verify any incentives provided to a related party tenant to ensure that they are on commercial terms and are similar to what is offered in the marketplace.

The ATO has also said that the net income yield of commercial properties is not sufficient evidence on its own and is only appropriate where the tenants are unrelated.

Tax residency of an SMSF

An SMSF can continue to be a complying superannuation fund and receive tax concessions as long as it meets the residency rules throughout the year. Where the fund cannot meet the residency rules, it may become non-complying and the income of the fund will be taxed at the highest marginal tax rate.

Residency rules

There are three residency rules that SMSFs must meet to be an Australian superannuation fund:

1. the fund was established in Australia, or at least one of its assets is located in Australia. The fund was "established in Australia" if the initial contribution to establish the fund was paid and accepted in Australia;
2. the central management and control of the fund is ordinarily in Australia. This means that the SMSF's strategic decisions are regularly made, and high-level duties and activities are performed, in Australia, including:
    a. formulating the investment strategy of the fund;
    b. reviewing the performance of the fund's investments;
    c. formulating a strategy for the prudential management of any reserves; and
    d. determining how assets are to be used for member benefits.

    In general, an SMSF will still meet this requirement even if its central management and control is temporarily outside Australia for up to two years. If central management and control of the fund is permanently outside Australia for any period, it will not meet this requirement; and
3. the fund either has no active members, or it has active members who are Australian residents and who hold at least 50% of either:
    a. the total market value of the fund's assets attributable to superannuation interests; or
    b. the sum of the amounts that would be payable to active members if they decided to leave the fund.

    A member is considered an "active member" if they contribute to the fund or contributions to the fund have been made on their behalf.

Members going overseas

When a member plans to go overseas for an indeterminable period, the ATO recommends seeking professional advice to ensure that their SMSF continues to comply with the residency rules.

If a member becomes a non-resident but still wishes to make or receive contributions, this can be done through an Australian Prudential Regulation Authority (APRA) regulated fund.

When they return as an Australian resident, the member can roll over all contributions made during this period to their SMSF.

If an SMSF fails the residency test, all member accounts should be rolled over to an APRA fund, and the fund wound up to avoid being made non-complying.

COVID-19

COVID-19 has resulted in many countries imposing travel bans and restrictions on international travel. There is a high degree of uncertainty around the thousands of Australians still stranded overseas due to COVID-19.

The ATO has stated that, if individual trustees or directors of an SMSF's corporate trustee remain overseas due to COVID-19, they will not apply compliance resources to determine whether the SMSF meets the relevant residence conditions.

The other requirement that an SMSF must meet to remain complying in the face of not meeting the central management and control rule is that there cannot be any other changes in the SMSF or the trustees' circumstances affecting the other conditions.

Residency status of an SMSF

A recent private binding ruling from the ATO[4] found that an SMSF can continue to pass all conditions of the residency test if a member were overseas for more than two years.

When the fund's trustees are absent from Australia for a period of greater than two years, the fund will only satisfy the test in s 295-95(2) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) if the trustees can establish that their absence was temporary.

The ATO has also released TR 2008/9. Paragraph 33 states:

> "The CM&C [central management and control] of a fund will be 'temporarily' outside Australia if the person or persons who exercise the CM&C of the fund are outside Australia for a relatively short period of time and during that time they exercise the CM&C of the fund overseas. The duration of the absence must either be defined in advance or related (both in intention and fact) to the fulfilment of a specific, passing purpose. Whether an absence is considered to be temporary will involve consideration of questions of degree which must be decided by reference to the circumstances of each particular case."

The situation in the private binding ruling is that the member was going to be overseas for the period of absence defined in advance as longer than two years, accepting an employment position as a foreign diplomat, specified as a three-year appointment. Accordingly, the entire period of absence was related to the fulfilment of a specific purpose.

The provided evidence and statements supported the fact that the member would not abandon their intention to return to Australia at the expiration of the appointment. The member would continue to maintain their home, other assets and health insurances in Australia, indicating a durability of association with Australia.

Due to the above reasons, while the CM&C of the fund may be outside of Australia for a period greater than two years, the period of absence of the CM&C was temporary and remained ordinarily in Australia. Accordingly, the fund satisfied the CM&C test under s 295-95(2)(b) ITAA97.

2021 Budget

The government announced in its 2021 Budget that it will extend the central management and control test from two years to five years and will scrap the active member test for SMSFs.

The measure will have effect from the start of the first financial year after royal assent of the enabling legislation, which the government expects to have occurred before 1 July 2022. It will allow SMSF members to continue contributing to their superannuation fund while temporarily overseas, ensuring parity with members of large APRA-regulated funds.

Non-arm's length income and expenses

The non-arm's length income (NALI) and expenses provisions under s 295-550 ITAA97 remove the tax concessions where an SMSF and other parties are not dealing at arm's length with regard to a scheme. Under these circumstances, the SMSF's ordinary or statutory income is more than if it were dealing at arm's length.

Where the SMSF inappropriately benefits, the NALI provisions seek to tax the fund at the highest marginal tax rate, which will apply to:

- ordinary or statutory income derived from schemes;
- dividends or amounts attributable to dividends; and
- entitlements to trust income (both fixed and non-fixed entitlements).

The other consideration is that, from the 2018-19 income year, NALI also includes the income derived from a scheme where a loss, an outgoing or expenditure is less than the amount (including a nil amount) that the entity might have expected to incur in gaining or producing income.

The government has recently passed legislation to reduce the ambiguity surrounding the effect of non-arm's length expenditure (NALE) on SMSFs. Where a fund incurs less (or nil) expenditure by participating in a scheme where the parties do not deal with each other at arm's-length, it will result in:

- the income being taxed at the top marginal rate; and
- any eventual capital gain on disposal of the asset being treated as NALI.

Remember, too, that NALI and NALE will apply regardless of whether the asset is acquired in line with s 66 SISA93 (the acquisition of assets from a related party).

Market value substitution rules

When the scheme involves acquiring an asset at less than market value, the asset's cost base will be modified by the market value substitution rule in s 112-20 ITAA97. As a result, the amount of any capital gain will be affected as the cost base must be treated by the SMSF as having acquired the asset at market value. It is irrelevant whether the asset was purchased directly or is accounted for through an in specie contribution.

NALI rules

The NALI rules that apply to SMSFs are that all fund activities must be undertaken on commercial terms and all assets purchased at market value. Additionally, each situation is assessed on its merit as to whether NALI applies to the income of a particular asset or all of the fund's income.

The SIS rules state that, where parties are not dealing at arm's length and the terms are more favourable to the SMSF, there will be no breach of s 109 SISA93. However, the NALI provisions then apply, which remove the fund's tax concessions where the SMSF and other parties are not dealing at arm's length in relation to a scheme.

Where income is deemed to be NALI, all of the income generated from that asset will be taxed at the top marginal tax rate of 47%, even if the member is in pension phase.

Generally, where no link can be found between the activity undertaken and a particular asset, NALI will apply to all income of the fund in that financial year.

The ATO has published PCG 2020/5, which sets out the ATO's compliance approach for SMSFs concerning NALE of a general nature. PCG 2020/5 should be read in conjunction with LCR 2019/D3, which provides examples of how the new legislation applies with the following situations giving rise to NALI:

Asset purchased less than market value

A property is purchased for $200,000 while the market value is $800,000. This situation provides sufficient connection between the NALE incurred in acquiring the property. All rental income is NALI, and any capital gain from the disposal of the property is also NALI.

Trustee uses their professional services firm (non-asset-related)

The partner of an accounting firm is the trustee of their SMSF and uses the firm to provide accounting services to the fund, but there is no fee charged. In this case, the trustee is not acting as a trustee but has provided services that a third party undertakes.

The SMSF has acquired the services under a non-arm's length agreement, providing a connection between the NALE and the fund income that classifies all of the SMSF's income for the financial year as NALI.

Trustee uses their professional services firm (asset-related)

The trustee of a fund is a licensed real estate agent and provides property management services to the SMSF as a licenced real estate agent. The fund is invoiced 50% of the fee that would otherwise be charged to a non-related party.

There is sufficient nexus between the NALE and the rental income derived from the residential property such that all rental income will be NALI as long as the non-arm's length deal remains in place.

Related party LRBA financed on non-arm's length terms

A related party limited recourse borrowing arrangement (LRBA) involved a 25-year term and a 1.5% interest rate. The terms of the LRBA constitute a non-arm's length dealing between the fund and the lender. All rental income derived from the property is NALI, and any capital gain that might arise from a subsequent CGT event happening is also NALI.

Acquisition of fixed entitlement in unit trust

The trustee of a fund entered into a non-commercial related party LRBA to acquire units in a listed unit trust. There was no interest charged on the loan, and repayments were not required until the end of the 25-year term. The units provide the fund with a fixed entitlement to the income of the unit trust.

The terms of the LRBA constitute a non-arm's length dealing between the trustee as the lender and the fund, which results in the fund incurring NALE that would otherwise be expected if they were dealing on commercial terms. All distributions from the units in the unit trust and any future distributions will be NALI.

What is an arm's length dealing?

It can be challenging to determine the exact price of an arm's length dealing, as this could fall within a range of commercial prices. One typical example is that a fund may accept a market interest rate within a band of rates available to it on an arm's length basis.

Most importantly, parties may enter into arrangements that result in discounted prices or favourable terms. The justification could be that a party operates on a simple cost-recovery basis for particular services on commercial terms because of the economies of scale that it achieves within its business by providing other services.

Audit implications

From an audit perspective, NALI is not a compliance breach but a tax issue. In most cases, it will result in a management letter comment notifying trustees that the tax calculation has been misstated. However, where it is materially misstated, SMSF auditors will be required to qualify Part A of their audit report.

As previously mentioned, there is a new addition to the NALI rules that considers fund expenditure. Where the fund incurs a loss, an outgoing or expenditure that 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, the NALI provisions will apply.

ATO transitional approach

The ATO has delayed the commencement of LCR 2019/D3 for the 2018-19, 2019-20, 2020-21 and 2021-22 financial years. It has stated that SMSFs will not be investigated for NALI where the fund incurred NALE of a general nature, such as NALE on accounting services.

The terms of LCR 2019/D3 mean that, if an SMSF's affairs are not structured correctly, even for a minor expenditure, all of the superannuation fund's income (revenue and statutory income) could face income tax at the highest marginal tax rate.

SMSF auditors are not required to apply this transitional compliance approach where the fund incurred NALE directly relating to the fund deriving particular ordinary or statutory income during the financial years 2018 to 2022 as previously mentioned.

> *"Avoid in-house asset issues by asking if the transaction could be entered into with a stranger."*

In-house assets

An in-house asset is defined under s 71 SISA93 and is, subject to specific exceptions: a loan to or an investment in a related party of the SMSF; an investment in a related trust; or an asset that is subject to a lease or lease arrangement with a related party of the fund. A related party is any member of the fund, a standard employer-sponsor, or a Part 8 associate of either of these.

In broad terms, an asset of an SMSF used and enjoyed by a related party of the fund is generally an in-house asset. Whether the use of that asset also contravenes the sole purpose test or not, the trustees must still ensure that the total market value of the SMSF's in-house assets does not exceed 5% of the market value of the SMSF's total assets.

In-house assets account for 19.1% of all ACRs lodged by SMSF auditors. The ATO considers it a high-risk contravention and will usually flag the SMSF for review. Both civil and criminal penalties can apply.

Section 71 SISA93 exemptions

One of the specific investment exemptions allowed under the in-house asset rules is when an SMSF invests in a related company or unit trust that meets the requirements of reg 13.22C SISR94 (or reg 13.22B SISR94 if the investment is pre-28 June 2000).

In real terms, although any non-permitted asset (such as shares in a related company) can be acquired at market value (otherwise, the acquisition will breach s 66 SISA93), the SMSF cannot exceed the 5% permitted level of in-house asset to remain compliant.

The 5% in-house asset rule

At the end of a financial year, if the level of an SMSF's in-house asset exceeds 5% of the fund's total assets, the trustees must prepare a written plan to reduce the market ratio of the in-house asset to 5% or below.

The plan must be prepared before the end of the next year of income. For example, if an SMSF exceeds the 5% in-house

asset threshold on 30 June 2020, a plan must be prepared and implemented before 30 June 2021.

Problems can arise when "savvy" SMSF trustees start manipulating the in-house asset rules and "play around the edges" of the 5% in-house asset limit. SMSF trustees think they are staying within the 5% in-house asset rules by using fund assets during the year, ensuring in-house asset levels are just under the 5% limit at the end of the financial year.

One example is where SMSF trustees dip into retirement savings to prop up a cash-strapped business during the year due to COVID-19. The transaction is classified as a "loan" in the fund's financials, paid down to just under the 5% in-house asset limit before the end of the financial year. To make matters worse, these "loans" are hidden as investment loans in the balance sheets of the SMSF trustee's businesses.

The ATO takes action against these SMSF trustees by imposing administrative penalties, ordering that fund assets be returned. Some funds have even been wound up.

The reason why this is a breach is due to s 85 SISA93 (prohibition of avoidance schemes), which specifically prohibits funds from participating in schemes that artificially reduce the value of in-house asset to avoid in-house asset contraventions.

As previously mentioned, other contraventions can get caught in the in-house asset net, such as the sole purpose test (s 62 SISA93) and the arms-length rule (s 109 SISA93), both of which come with their own set of administrative penalties.

One way to avoid in-house asset issues is for SMSF trustees to ask themselves a simple question before undertaking any related party transaction: "Could I enter into this type of arrangement with a stranger?"

If the answer is no, the likelihood of the transaction being compliant with s 109 SISA93 is virtually nil.

Ungeared unit trusts

An SMSF may invest in a related company or unit trust without it becoming an in-house asset if it meets the conditions of reg 13.22C SISR94 when the investment is acquired and at all times while the fund holds the investment.

The reg 13.22C conditions that are relevant for these entities include:

- the SMSF has fewer than five members;
- the only assets in the unit trust are cash and property;
- the unit trust cannot borrow or give a charge over the assets of the fund;
- the related party lease is only allowed for business real property;
- the related party lease must be legally binding; and
- the related party transactions must be at market value.

Where the fund fails to meet any of the conditions in reg 13.22C, a catch-22 situation arises, triggering reg 13.22D SISR94 which states that the related entity is required to meet the conditions of reg 13.22C at all times to be exempt from the in-house asset rules.

The reg 13.22D conditions that are relevant for these entities include:

- the entity must meet the conditions of reg 13.22C at all times;
- the entity cannot operate a business through the trust; and
- all transactions must be at arm's length.

Not meeting the conditions of reg 13.22C means that all investments held by the SMSF in that related company or unit trust, including all future investments, will become in-house assets.

The assets can never be returned to their former exempted status, even if the trustee fixes the issue/s that caused the assets to cease meeting the relevant conditions. Therefore, it can be difficult for SMSFs to meet and maintain these conditions while undertaking certain investments within reg 13.22C entities, such as property development.

Depending on decisions made by the SMSF trustees or whether a technicality has been overlooked, such as failing to have a legally binding lease agreement in place with a related party, can cause the exemption to cease. The regulations will require the fund to divest itself of the shares or units that it holds over the 5% limit within 12 months.

Where the fund holds 100% of the shares and the only asset in the ungeared entity is property, this may result in a fire sale of the property and winding up the unit trust or company.

COVID-19

A contravention of the in-house asset rules may occur where there has been a reduction in SMSF asset values since March 2020 due to COVID-19.

A downturn in asset values could result in a fund's in-house asset being more than 5% of the fund's total assets. As of 30 June 2020, the trustees of such funds must prepare a written plan to reduce the excess back down to 5% or below. The plan has to be prepared and implemented on or before 30 June 2021. However, the ATO has said that it will not be taking compliance action where the rectification plan cannot be implemented because the market has not recovered.

The same exemption has also been applied retrospectively to the 2018-19 and 2019-20 financial years. The reason is that, where there was a breach of the in-house asset 5% limit in 2019 for obviously unrelated COVID-19 reasons, the trustees may not have been able to rectify the issue as a result of market volatility due to COVID-19 in 2020.

From an audit perspective, the trustee may wish to include this as an addendum to their in-house asset plan because COVID-19 prevents it from being implemented. That would eliminate any queries that the auditor may have surrounding in-house asset breaches.

Once again, the ATO does not expect SMSF auditors to lodge an ACR in the 2019-20 and 2020-21 financial years because of COVID-19. However, the expectation should be that an SMSF auditor will continue to qualify their audit report under the auditing standards, with a mitigating comment about COVID-19 included in the management letter.

Liability for accountants and auditors

The outcome of the *McGoldrick* and *Baumgartner* cases has shifted the risk management landscape for SMSF auditors. The cases also provide a sobering lesson for accountants to meet their professional standards or face potential litigation from SMSF trustees when their investments fail.

One of the main reasons SMSF professionals are subject to more scrutiny and potential litigation is that SMSF trustees do not have access to industry compensation.

SMSF auditors have changed their processes and procedures due to both of these cases, directly impacting the type of information asked at audit.

There is a significant risk for SMSF auditors if they provide a misleading or deceptive opinion by not detecting fraud or inappropriate investments during the audit. Where SMSF auditors fail to audit in line with their professional obligations, they can be held liable.

For a professional negligence claim to be successful, an SMSF trustee must establish the following:

- there is a duty of care owed to them by the professional;
- the professional breached that duty of care; and
- the person has suffered an injury or damage owing to the breach of duty of care.

Where the loss remains undetected and is ongoing, the auditor can be held liable for many years.

McGoldrick case

Dr Bear and Ms Campbell were members of the Cam & Bear Superannuation Fund and directors of the corporate trustee established in 1996. Dr Bear was an unsophisticated investor who paid cash and cheques directly to Mr Lewis (the accountant) and thought he was investing in secured products, such as cash and shares.

Mr Lewis was a personal friend of Dr Bear, who then used the money to invest in Lewis Securities Pty Ltd, a company owned by Mr Lewis. All of the moneys paid in by Dr Bear were recorded as "Cash — LSL Holdings" in the fund's financial statements.

In September 2008, Dr Bear tried to withdraw money from the SMSF and could not do so. In November 2008, LSL Holdings went into voluntary liquidation, and the fund lost $950,000.

Mr McGoldrick audited the fund between 2003 and 2007. He initially queried the cash descriptions in the accounts but was told by Mr Lewis that the trustees were happy with the classification. He accepted the explanation and thought that the money was held in a cash management trust account, even though there was no evidence for this investment.

In 2016, the trustees of the fund, Cam & Bear Pty Ltd, sued Mr McGoldrick for negligent and misleading conduct. Mr McGoldrick did not qualify his audit report or communicate with the trustees personally regarding the fund's issues.

In 2018, the court found on appeal that Mr McGoldrick had breached his duty of care by making false and misleading statements.

Baumgartner case

Ms Crittle was the sole director of the corporate trustee and member of the Ryan Wealth Holdings Super Fund. She had received a $7m divorce settlement in 2006 and established an SMSF.

Ms Crittle, an unsophisticated investor, trusted her long-time solicitor, Mr Hill from Turnbull Hill Lawyers, to recommend a financial adviser. Mr Hill suggested Mr Moylan, licensed with Moylan Retirement Solutions, who recommended that her divorce proceeds should be deposited into the solicitor's account.

They all agreed that any investments would be made in consultation with Ms Crittle, and Mr Moylan invested $7m in four unsecured loans and two unit trusts.

Ms Crittle claimed to know about two of the loans, as they financed the development of projects associated with Mr Moylan and Mr Hill.

In 2013, a unitholder of one of the unit trusts contacted Ms Crittle and told her that the unit trust was facing litigation and bankruptcy. Ms Crittle acted immediately and engaged a forensic accountant and solicitor.

By 2014, all parties in the unsecured loans and unit trusts were either bankrupt or liquidated, but Ms Crittle managed to recover $3.28m.

Mr Baumgartner audited the fund between 2007 and 2009 and did not inform the trustees personally that the investments were not in line with the investment strategy. While he also knew that the loans and investments were high risk, he did not obtain any audit evidence to confirm the investments.

Ms Crittle sued for damages as the auditor's failure meant that the fund missed the opportunity to redeem the lost money.

The courts found that the auditor has breached his duties in contravention of his auditor obligations under the SIS, Commonwealth and state legislation.

There was no redress to Mr Moylan because his insurance had lapsed, and he was deregistered by 2013.

Liability lessons

The primary lesson for all SMSF professionals is not to cut corners as there will be increased litigation from SMSF trustees. The extent of litigation is not limited to trustees because disgruntled beneficiaries who end up inheriting less than they think they should due to financial loss can also trigger a lawsuit.

SMSF professionals should ensure that an appropriate level of professional indemnity insurance will cover any future claims. The terms of engagement letter and trustee representation letter must also be compliant and have the correct reference to the SIS legislation and relevant professional standards.

Communicating with trustees is critical. In both of the cases discussed above, the judges commented on the fact that the audit reports were unqualified and, in the *Baumgartner* case, they said that even adopting a narrow form of qualification would have provoked serious concern and alarm to the trustee once communicated.

SMSF professionals should review the scope of the engagement and discuss the contents to draw the trustee's attention to any risks or issues.

The letters must specify all trustees and that a key contact is listed and copied in on all communications. Ensuring that the trustees, or key contact, personally receives a copy of all communications is essential, especially where there is a conflict of interest with the adviser's interests and the interests of the SMSF.

All permanent documents, especially the investment strategy, must be reviewed and carefully saved. SMSF auditors, in particular, should scrutinise the investment strategy more closely and query the trustee when the fund's asset allocation and investments differ materially.

The auditor must document the trustee's response, which means that the trustee should provide either a revised investment strategy or advise the auditor when the assets will return to meet the conditions of the original investment strategy.

While asset allocation ranges are not a legislative requirement in an SMSF investment strategy, most trustees have them included in their signed investment strategies, which can cause delays at audit.

Also, consider the correct classification of assets and ensure that the notes to the financial statements reflect the actual situation. In the *McGoldrick* case, the notes to the accounts classified cash as being "cash at bank and deposit", which the judge considered a misrepresentation, and false and misleading.

It is also clear that investigating the nature, existence and valuation of each investment and having sufficient appropriate audit evidence on file concerning market value are extremely important.

Appendix 1. Summary of valuation requirements

Event	Requirement
Preparing the SMSF financial accounts and statements	An asset must be valued at its market value. The valuation should be based on objective and supportable data.
Collectables and personal use assets — acquired on or after 1 July 2011 Transfer or sale to a related party	Must be valued at market price as determined by a qualified independent valuer.
Collectables and personal use assets — acquired before 1 July 2011 Transfer or sale to a related party	For the period 1 July 2011 to 30 June 2016, transfers to related parties do not require valuation by a qualified independent valuer. However, these transfers should be made at an arm's length price that is based on objective and supportable data. From 1 July 2016, transfers to related party must be made at a market price determined by a qualified independent valuer.
Transfers between SMSFs and related parties (subject to collectables and personal use asset rules above)	Acquisitions of permitted assets must be made at market value. A valuation is not required when an asset is disposed of to a related party however it must occur on an arm's length basis.
Transfers between SMSFs and related parties	A valuation is not required however the transfer must occur on an arm's length basis.
Determining the value of assets that support a super pension This includes for calculating amounts that count towards the transfer balance cap	The market value of the account balance needs to be determined on the day the pension commences or moves into retirement phase or, for ongoing pensions, on 1 July of the financial year in which the pension is paid. The valuation should be based on objective and supportable data. In some circumstances a reasonable estimate may need to be made.
Testing whether the market value of the SMSF's in-house assets exceed 5% of the value of total assets held by the fund	The value of a fund's total assets needs to be determined on 30 June of the financial year that the in-house assets are held. The valuation should be based on objective and supportable data.
Determining the market value of assets that are eligible for transitional CGT relief in the 2016-17 income year	The assets' market values need to be determined on the date that their cost bases are reset. The valuation should be based on objective and supportable data.
Determining the market value of assets supporting members' retirement phase and accumulation accounts for the purposes of calculating the members' total super balances	The value of these accounts needs to be determined on 30 June each financial year, as the total super balance is calculated at this time for a number of purposes. The valuation should be based on objective and supportable data.

Source: ATO, QC 26343, 11 March 2021.

Appendix 2. Events and valuations requirements

Event	Requirement
Preparation of SMSF financial accounts and statements.	Based on objective and supportable data
Collectables and personal use assets — acquired on or after 1 July 2011 and transferred or sold to a related party after that date.	Qualified independent valuer
Collectables and personal use assets — acquired before 1 July 2011 and transferred or sold to a related party before 1 July 2016.	Transfer made at arm's length price that is based on objective and supportable data
Collectables and personal use assets — acquired before 1 July 2011 and transferred or sold to a related party after 30 June 2016.	Qualified independent valuer
Acquisition of an asset from a related party of the fund.	Acquired at market value that is based on objective and supportable data
Disposal of an asset to a related party of the fund.	Sale price should reflect a true market rate of return
Testing whether the market value of the SMSF's in-house assets exceed 5% of the value of total assets held by the fund	Based on objective and supportable data
Determining the value of assets that support a super pension or income stream and from 1 July 2017, count towards the transfer balance cap.	Based on objective and supportable data In some circumstances a reasonable estimate may need to be made.
Determining market values of assets that are eligible for transitional CGT relief.	Based on objective and supportable data
Determining the market value of assets supporting members' retirement income streams and accumulation accounts for the purposes of calculating the members' total super balances.	Based on objective and supportable data

Source: ATO, QC 26343, 11 March 2021.

Developing a relationship with a client will provide the right balance to investigate and ask the right questions and ensure that they continue to be informed about practical SMSF compliance matters. Keeping records and supporting evidence through file notes is essential to demonstrate that an adequate and proper service was undertaken.

A greater understanding of these issues will enable SMSF professionals to employ more effective communication mechanisms and undertake thorough procedures to minimise the expectations gap and mitigate litigation risk.

Conclusion

The complexities surrounding litigation risks mean more onerous obligations and responsibilities for SMSF professionals.

Several recurring mistakes by SMSF trustees continue to put the superannuation industry under the microscope, which means that keeping on top of the legislation will be critical to ensure that funds continue to operate in a compliant manner.

The SMSF auditor cases demonstrate that any auditor or adviser not meeting their professional standards should expect future litigation from trustees looking to recoup losses when their investments go south.

To avoid spending time, money and emotional energy trying to get back on the path to SMSF compliance, most SMSF trustees would prefer to be made aware of potential compliance issues up front. Sometimes, though, the journey to this peace of mind will come with a slightly higher price tag.

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An earlier version of this article was presented at The Tax Institute's 2021 Queensland Tax Forum held on 27 to 28 May 2021.

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Tomorrow's tax practice: part 1

by Steve Healey, CTA (Life), Director and Partner, RSM Australia, and Adrian Cartland, Principal, Cartland Law

While change is confronting, at times difficult and often creates significant challenges, it can also be viewed as a gateway to opportunity, learning and insight. We can see change in a negative light and resist it, or we can embrace the opportunities that it brings to us. There is no doubt that both the nature and the rate of change in our world today affects all facets of our lives, including our work lives. So what does this mean for us as tax professionals and for our practices? This two-part series considers the views and personal insights of two experienced tax professionals who have a long association with The Tax Institute. In part 1, Steve Healey shares his own perspective and the development of the "trusted concierge" model. In part 2, Adrian Cartland highlights how we can take advantage of living with the changes of automation.

The ATO's change agenda

Just six short years ago, during my term as president of The Tax Institute, I first seriously pondered the changes impacting our profession and the need for us to adapt to the rapidly changing world around us. I developed my white paper on the topic, "the future tax professional", and presented it for the first time at the Institute's 2017 National Convention.[1] At that time, we were seeing the first wave of the ATO's digital transformation agenda, with the Digital Transformation Office setting out that:[2]

> "The government is committed to making it quicker and more affordable for business to transact with government online and will deliver a number of significant new services for business."

In his address to the PwC global tax symposium in Paris in November 2019, Second Commissioner Jeremy Hirschhorn provided an insight into the future of tax administration in an Australian context. In relation to the use of data and analytics, he noted that the ATO is collecting more data than ever before and that it continues to monitor advances in data, analytics, artificial intelligence (AI) and automation, in addition to investing in predictive analytic tools to leverage its data.[3]

More recently, presenting his keynote address at the Institute's Tax Summit 2020, Commissioner Chris Jordan outlined how far the administration has come in embedding digital solutions in its services. There is no doubt that the ATO's systems and processes have improved markedly since first embarking on its digital change agenda. The Commissioner noted that the biggest digital change driven by the ATO for tax agents has been online services, replacing the much maligned (and deservedly so) portals that we had all had to accept as a less than perfect way of life. I think it is fair to say that the administration has come a long way in five years, with the implementation of single touch payroll and improved integration with other processes, and simplified GST reporting, just to name two.

Of course, the ATO's investment in technology and data solutions is not just about improving the compliance process and the customer experience. As a very significant investor in data and analytics, coupled with automation and AI, the ATO has capability like never before to interrogate data and develop insights. To paraphrase the ATO website:[4]

> "Our use of data is transforming how we assess work-related expenses. Data and insights underpin our culture of service, our early intervention activities and our goal of prevention rather than correction."

In March 2020, the ATO called for tenders to procure an enterprise grade graph database (commercial-off-the-shelf) software product. The invitation to tender described this software as a "key component of Automated Network & Grouping Identification Engine (affectionately known as ANGIE) and other ATO use cases including various Joint Chiefs of Global Tax Enforcement solutions".[5] ANGIE will be applied to assist the ATO's tax avoidance taskforce to discern complex, multi-layered relationships between clients using a sophisticated database developed as part of its data and analytics program. It will automatically identify and group clients to understand their relationship to each other. While it is beyond the scope of this article (and, indeed, the technical capability of the author) to explore this initiative in further detail, an investment such as this clearly demonstrates where our Australian tax administration is heading. The investment by the ATO in data and analytics is, and will no doubt continue to be, substantial.

One thing then is for certain, the ATO and other government agencies around the world will continue to invest heavily in automation, analytics, and data-driven solutions. As tax professionals, it is critical that we remain cognisant of this and keep pace with the changes happening around us.

A new model is (still) needed

Coupled with the changes driven by the digital agenda, the COVID-19 pandemic is having an immediate and, no doubt, lasting impact on our profession, as it is with all businesses. It is easy then to focus on the challenges and difficulties. However, it is often said that the corollary of challenge is opportunity. As I noted in my earlier white paper, with change comes uncertainty, and I believe there is no doubt that traditional business models across many industries, ours included, will continue to be challenged well beyond the more immediate impact of the pandemic, but at the same time, these challenges will continue to create opportunities for those willing enough to embrace them.

As tax professionals and tax agents, many of our traditional services, particularly those relating to compliance, are being rapidly and permanently disrupted. COVID-19 is only adding

to that disruption, but I suggest potentially in a positive sense. While I am certain there is no one (including myself) that would suggest a global pandemic is a good thing, it does represent a "black swan event"[6] of significant proportions, meaning that it creates a sense of urgency to respond and potentially embrace new ways of doing things.

We are all experiencing the pandemic and adapting our lives accordingly. Some of these adaptations are certainly not desirable (at least from my perspective) – who among us had ever heard of the term "social distancing" just a few short months ago? Yet this is now part of the vernacular and, for all intents and purposes, it does seem that we will be living with this concept for some time yet. At the same time, we have all been forced to adapt our businesses, systems and processes to deal with the impact of the pandemic on our people and our clients. In a very short space of time, many of us have come to the realisation that working from home can be both effective and efficient, and that the existing technologies within our businesses can be stretched effectively to deal with this paradigm shift.

To remain relevant and indeed to increase our relevance to our clients, we must act with a sense of urgency. Our business models have been challenged this year due to unforeseen circumstances. With both our own businesses and those of our clients, we have had to respond, react and pivot to new ways of working. This, I believe, underlies the importance of being able to embrace change but, even more importantly, has also shown that we are resilient beings and capable of adapting quickly and effectively.

In putting a positive spin on the pandemic, one thing it is forcing us to do is act quickly.

In this article, I return to the notion of the "trusted concierge", a term I first used in my 2016 white paper, *The future tax professional*. While we will no doubt continue to experience exponential change in many facets of our lives (and certainly have experienced this over the past five years), the importance of the human element is more important than ever before. I believe the future truly belongs to those who embrace that which cannot be disrupted by the digital agenda — the importance of "being human" and human connectivity.

The future will, I believe, belong to those who can demonstrate empathy but at the same time embrace new solutions to deliver traditional services to their clients. Rather than seeing the revenue authorities as negatively impacting on the services being able to be delivered, we need to see them as creating an opportunity to liaise with and advise our clients in real time, and to use traditional compliance processes to deliver data-driven, future-focused insight. To those in a compliance-rich business, the opportunity is to use the compliance process (through the adoption of contemporary digital solutions) to gain a more timely and deeper understanding of the client's business in order to deliver something much more valuable — human-centric insight.

Possible future model: the "trusted concierge"

In developing my white paper in 2016, I settled on a term that I believe encompasses where we need to be as tax professionals in the future. That term is the "trusted concierge" and I believe it is more relevant than ever in the current environment.

It is critical that we adopt such a mindset, as the guardians of a body of knowledge that's no longer exclusive to us as tax professionals.

The concepts of "knowledge guardians" and trusted practitioners are not exclusive to accountants, lawyers and tax practitioners, but span all professions (such as the medical and education professions). With the expansion of technology solutions, the unfettered access to knowledge via the internet, and the ever-increasing capability of machines (and therefore increasing client empowerment), traditional models for delivering professional services and engaging practitioners will continue to disintegrate.

That said, these changes are also creating new platforms and paradigms for professional services practitioners and do not mean there will no longer be a role for practitioners. Rather, practitioners are beginning to play an even more important role in distilling a plethora of information, unstructured data and knowledge to deliver forward-looking insights, using tools and connections across a far wider spectrum than traditionally possible. The ATO's digital transformation agenda alone demonstrates the importance of being agile and the need to adapt our business processes and systems to remain relevant to our clients

Why "concierge"?

When we think of a concierge, we think of someone who may work in a hotel or, perhaps, a personal concierge performing errands for their affluent employer. That said, the word "concierge" evokes thoughts of connectivity, resourcefulness, cooperation, problem-solving, advising, empathy and effective communication.

The concierge also seeks to ask questions to target customer needs more accurately. It is a word that embodies trust, although, given the importance of trust in any profession (including our own), it is worth reinforcing that. Hence, the term "trusted concierge" represents a model in which the professional occupies a privileged position with the client (a position of absolute trust), is able to facilitate solutions to a wide range of complex problems, and, while not necessarily having all the answers, has the ability to source and deliver those answers.

It is critical we continue to recognise that our clients are far more empowered and armed with much greater knowledge than they have been historically. They are increasingly demanding and are also determined to pay far less than they once did for what might be described as the provision of traditional services. With the ever-increasing amount of information available, it is essential to change both the services we deliver to clients and the way we deliver these services.

What the pandemic is teaching us is that responsiveness and agility are key. We need to be able to act quickly and decisively, to alter the traditional modes of doing things, and to embrace new and more effective ways of working. We all have greater expectations of our governments and businesses, and their ability to adapt and quickly deal with change.

Consumers, and therefore our clients, have much greater expectations and these expectations are fuelled from their personal experiences in all facets of their life, including responsiveness to dealing with the pandemic but also through such things as Netflix, Google and Amazon. Communication channels have also fundamentally shifted to "real time" through Twitter, Facebook, and other social media platforms. Not only will our clients demand more, but they will also want services to be delivered faster.

We will need to continue to be more inquisitive of our clients and seek information faster and more efficiently using a combination of technology and human connectivity. We need to shift our mindset from the "expert who has all the answers" to the "trusted concierge who listens and works with clients and other sources to provide the answers". For many, this is a fundamental but critical shift in thinking and in the way we approach the relationship we have with our clients, our people and the broader connected community.

Unprecedented change

No matter which direction we turn, change is happening. This of course is somewhat of an understatement, with the impact of the pandemic. The pandemic is forcing all of us to change not only the way we go about our day-to-day lives, but also how we work and how businesses continue to remain relevant.

Obviously, this is just an additional (and very significant) change on top of the broader change agenda. Whether it be in the sphere of retail, travel, health, transport, accommodation or business in general, we are witnessing a fundamental shift in the way we interact with each other and the way we solve problems and generate new ideas. The pandemic is exacerbating that change in ways we could not have contemplated just a few short months ago.

It is, of course, not just change that we need to acknowledge but, even more importantly, the rate of change. Many fail to appreciate just how quickly things are changing in the world and therefore fail to understand the resulting impact on their businesses and the businesses of their clients. It is essential that we appreciate this if we are to seize the opportunity that change affords us.

As accountants, lawyers and tax advisers, we are not immune to what is happening around us. It is incumbent on all of us to understand what this means for our clients, our people and our businesses if we are to thrive or, indeed, survive.

Traditionally, we have been custodians of a body of knowledge that comprises enormous complexity. Tax is not a simple profession, and it is widely recognised that Australia is blessed with one of the world's most complex tax systems. As our laws have developed, together with the global economy, that level of complexity has only increased and will no doubt continue to do so.

Does this mean "happy days" for the tax profession and for you, as a tax professional? This may well be the case, but what we may be doing in five to 10 years from now and how we do it is likely to look very different to the way we currently serve our clients. Five years ago, we were beginning to embrace technology and, as discussed earlier in this article, the ATO was embarking on its digital transformation agenda. At that time, I suggested that the human element would become more important, and that technology would create a significant shift in our role as tax professionals. I pondered the impact of the sharing economy on the professions more broadly (a concept that I will return to in this article). Additionally, I contemplated the role of AI and the need to avoid our "Kodak moment". I believe that we have indeed experienced a shift, although I acknowledge that it may not have been as palpable as I expected. Having said that, a few of the more significant changes observed that have had an impact are:

- cloud computing applications have become increasingly sophisticated, enabling greater efficiencies in the delivery of compliance services (coupled with increasing client expectations and a reduced propensity to "pay" for traditional compliance services);
- improved connectivity, internet speeds and security protocols such as virtual private networks (VPNs) have enabled more effective remote working; and
- AI has become ubiquitous.

We must remain vigilant and do our best to keep up with the changes happening around us. These changes will continue to impact what we do, how we do it, where we do it and how we interact with our clients, the revenue authorities, our people and our peers. The notion of interaction and the significance of the human relationship will be key to remaining relevant as tax advisers into the future.

We will need to continue to adopt technology to automate the many systems and processes that have traditionally required the human touch, together with emerging technologies such as machine learning, AI, virtual reality and augmented reality, that will over time supplement (but, I suggest, never replace) human intellect and emotional intelligence.

Exponentiality of change and embracing uncertainty

We do not live in a linear world. Linear growth seems to be a concept that is firmly embedded in the past, although I believe growth has never been linear. The pandemic has underscored the concept of "exponentiality" in terms of just how fast the COVID-19 virus has spread but, equally, how quickly human beings can adapt and pivot to new ways of doing things. Responses globally have attempted to battle the exponential growth in the virus by acting with an exponential sense of urgency. From the implementation of broad and deep social distancing policies by governments to quickly pivoting manufacturing resources towards the production of ventilators and masks, what we have seen is dealing with an adverse exponential threat by adopting an exponential response.

Clearly, the responses of governments and businesses worldwide have demonstrated that human beings are both resilient and capable of adapting to a new environment very quickly. In effect, we can bring an exponential response to deal with exponential changes happening around us.

While I am not in any way comparing the sense of urgency in dealing with a global pandemic to that required in

dealing with change more broadly, it is, I believe, relevant in the context of dealing with the changes confronting our profession. These changes will doubtless continue to gather momentum and our response, as professionals, will need to mirror that momentum.

Uncertainty as opportunity

We can of course view the change happening around us and, more specifically, the rate of such change as a challenge, and indeed to do so would not be wrong. As I mentioned earlier in this article, the corollary of change is opportunity. Although the changes happening around us may be described as exponential, we have proven that we can respond both quickly and effectively.

We have all questioned, for some time, the future of work. This of course is not just limited to our profession but applies to all fields of endeavour. In responding to the pandemic, many businesses, and certainly those in the professional services sector, had implemented changes to their operating model arising from the need to work remotely. Working from home forced us to evaluate how we stay connected to our clients and teams without physical proximity, and how we embrace new and sometimes previously untested technology solutions to that end.

Although somewhat of a generalisation, in response to the pandemic, I believe that the professional services sector has adapted its business models quickly and effectively and, in my own experience, productivity did not decline. On the contrary, productivity in many instances improved. As businesses, we were forced to bring forward change that we may have been contemplating over a two to three-year timeframe into two to three weeks. While we had to challenge our own paradigm of work, we embraced it and used it as an opportunity; initially, perhaps, to remain relevant but ultimately to augment our traditional face-to-face business models with digitally driven solutions.

Citing a personal experience and recognising the importance of the human connection in our business (a theme that I will return to a little later), our team had implemented a client roundtable luncheon series some 18 months ago. The intent of this series was to connect with our clients and, importantly, with people we wished to become our clients. Of course, the critical piece in this approach was a personal, face-to-face connection among peers. So, when we were forced to close our doors and work from home (as were our clients), surely that represented the end of this initiative?

Turning to the concept of embracing change to drive opportunity, we continued by adopting digitally driven solutions. We hosted a "virtual" roundtable luncheon event, using Zoom as the medium and Uber Eats as the provider. We continued to connect with our clients and facilitated a peer-to-peer connection among those participating, albeit through a different medium.

The purpose of that short story is to demonstrate that either we could see change forced on us as merely a challenge (and give up on the concept of "not possible") or we could embrace change as the opportunity to do something truly different and, in the process, differentiate ourselves from our competitors.

It is often said that the only certainty in life (apart from death and taxes) is uncertainty. So, we have a choice when faced with uncertainty — fear it or embrace it. We must be nimble, agile and open to change. Rather than fearing change, I believe what the global pandemic has done for us is to force us to embrace change.

Remote working is here to stay

In my 2016 white paper, I set out a number of challenges and opportunities for our profession (and I will return to those shortly). While these remain, one very significant factor that I failed to fully recognise at that time was the impact of remote working. This is now raising many additional considerations, including:

- how to attract and retain talent in a distributed, remotely enabled workforce;
- how to mentor, educate and supervise individuals, particularly those new to the business;
- how to build and maintain a strong culture;
- reimaging the connection between productivity and physical presence;
- reviewing office space needs and the configuration of that space, including the creation of physical and technologically enabled "collaboration hubs";
- the prevention and management of mental health issues brought about by prolonged and sometimes enforced periods of remote working;
- redirecting business infrastructure cost savings (eg through a reduced real estate footprint) to employee and team wellbeing initiatives; and
- resisting "returning to the norm", that is, where operational efficiencies are identified, continue to embrace those and resist the temptation to return to the "norm".

This list of course is not exclusive, but I do believe it represents just a few of the opportunities before us as professional service practitioners. The contemporary physical tax practice has been radically and permanently changed.

The sharing economy

We are all aware of the sharing economy, the emergence of which is a direct illustration of the exponentiality of growth.

The term "sharing economy" was only coined in 2010. Just seven years later, it is now ubiquitous. In her blog post, first published in 2012 and updated in 2016, Benita Matofska defines the sharing economy as:[7]

> "… a socio-economic ecosystem built around the sharing of human, physical and intellectual resources. It includes the shared creation, production, distribution, trade and consumption of goods and services by different people and organisations."

At its core, the sharing economy embraces the notion of wide collaboration across borders. Although in its infancy, its impact on traditional business models is already significant.

Matofska identifies the following key characteristics of the sharing economy:

- people: at its core, the sharing economy enables peer-to-peer (or person-to-person or P2P) interaction

and collaboration. It is founded on the notion of people interacting directly with each other without the need for a traditional intermediary;

- production: in the sharing economy, goods and services are produced collaboratively by active participants;
- values and systems of exchange: as a hybrid economy, value is not seen only in terms of financial value. Of equal significance is economic, social and environmental value. Non-material and social rewards are important aspects of the sharing economy, as are alternative currencies and concepts such as social investment and social capital;
- distribution: shared ownership models and distribution networks that are not hampered by traditional boundaries or borders and facilitated by the internet are an important aspect. The notion of fairness in the ownership and distribution of knowledge, products and services is an essential aspect of the sharing economy;
- planet: in addition to having people at the heart of the economic system, the sharing economy also has the planet at its core. The reuse of resources, the reallocation and repurposing of waste, and the concept of sustainability rather than obsolescence in the development of products and services are important aspects;
- power: people are naturally empowered in the sharing economy as traditional boundaries are eliminated. A natural consequence of this is the redistribution of economic and social capital and power, and the broader access by the general population facilitated by freely available infrastructure (the internet) to knowledge and services that may have been traditionally denied through the creation of barriers;
- shared law: rules are made in the sharing economy through a natural process that is democratic, public and accessible. They are not hindered by traditional models and, rather than a top-down approach, may be thought of as a "bubble-up" or mass participation approach. By way of example, P2P accommodation and car sharing services are very recent developments and the rules, regulations and policies underpinning these have been effected largely by the participants in the system;
- communication: the open sharing of knowledge via publicly and freely available infrastructure and the destruction of traditional "knowledge" boundaries is at the heart of the sharing economy;
- culture: at its heart is a collaborative culture where the individual is but part of the wider solution and where notions of trust and sustainability are fundamental. The culture of the sharing economy transcends geographical, racial and other demographic borders and promotes active participation from all segments of the wider community who have access to the underlying infrastructure; and
- future: given that sustainability is a core concept embedded in the sharing economy, it focuses on working towards the creation of a long-term vision and sustainable future state.

The professions

The Australian Council of Professions defines a "profession" as:[8]

> "… a disciplined group of individuals who adhere to ethical standards and who hold themselves out as, and are accepted by the public as, possessing special knowledge and skills in a widely recognised body of learning derived from research, education and training at a high level, and who are prepared to apply this knowledge and exercise these skills in the interest of others.
>
> It is inherent in the definition of a Profession that a code of ethics governs the activities of each Profession. Such codes require behaviour and practice beyond the personal moral obligations of an individual. They define and demand high standards of behaviour in respect to the services provided to the public and in dealing with professional colleagues. Often these codes are enforced by the Profession and are acknowledged and accepted by the community."

If we accept this definition and the core concepts underlying it, the evolution of the sharing economy (still in its infancy) creates some cause for concern for the traditional practitioner.

A profession, by definition, is a subgroup of society that possesses special knowledge and training. Members of the profession are essentially the custodians of such knowledge. All traditional professions have long-established barriers to entry (principally through education and satisfying stringent membership criteria for the relevant professional body or bodies).

The tax profession is certainly no exception. It comprises people who have undergone rigorous graduate and post-graduate training, who are members of a relevant professional body (eg The Tax Institute, Chartered Accountants Australia and New Zealand, CPA Australia etc), and who have become "experts" in their chosen field of endeavour. The professional bodies impose and enforce strict rules and barriers to entry, principally through maintaining appropriate standards of education and experience and ensuring adherence to ethical principles.

These barriers are designed not just to protect the public from rogue practitioners and to mitigate the risk of unqualified or underqualified individuals practising, but equally to protect the tax professional and the profession itself. In this sense, the professional bodies have both a public-serving and self-serving purpose.

A core principle of any profession (and, consequently, the relevant professional body or bodies governing that profession) is trust, and bodies such as The Tax Institute are widely regarded as highly trusted and ethical organisations. Trust is also at the heart of the sharing economy, although, in the latter case, trust is often established as a result of P2P interaction, such as ratings established and shared as a result of individual and personal experiences (eg Uber and Airbnb).

Given the notion of individual empowerment that is central to the sharing economy, the professional bodies appear to have a challenge. Certainly, this would be seen as a controversial statement but, with the evolution of the sharing economy, the relevance of professional bodies arguably becomes less important for the public (and perhaps more important for the practitioner).

It may be said that the emergence of the sharing economy creates a significant threat to the tax profession as we know it — principally, as knowledge becomes more freely available, infrastructure becomes more sophisticated, people in general become more empowered and communication channels change, enabling the further progression of P2P engagement. It may, however, be equally said that the sharing economy will create significant opportunities for the entrepreneurial professional for precisely the same reasons.

Susskind and Susskind, in their book *The future of the professions*,[9] suggest that there are two possible futures for the professions.

The first future is that professionals will continue to do what they always have done, but will do it more efficiently through the adoption of technology and other enhancements to systematise and streamline traditional systems and processes.

The second future is that the work professionals do in the future will be fundamentally transformed as knowledge becomes more widely shared and available and as systems become increasingly capable of delivering what professionals have traditionally been engaged to do.

The authors argue that the second future will ultimately prevail in that we will continue to find new, improved ways to share expertise and the professions as we know them will become progressively dismantled.

All professions have a number of common characteristics and therefore are equally susceptible to being disrupted. Some of these common characteristics are that:

– they are custodians of a specialised body of knowledge and they occupy a place of privilege and esteem in society;
– their members are highly educated and respected in society;
– they wield significant economic and social significance;
– they are often considered a “labour of love” by the practitioner; and
– they can be regarded as elitist.

Given these characteristics, when one considers the characteristics of the sharing economy, there can be no doubt that the accounting, legal and tax professions will be significantly disrupted. The only question is: to what extent and by when?

Returning briefly to the concept of the trusted concierge, the sharing economy and the resulting ease of access to a wider, ever-increasing body of knowledge enables sufficiently connected individuals to access and deliver solutions faster than ever before.

A new paradigm of trust

A seminal work in the sphere of professional services is The trusted advisor, first published in 2000.[10] A key contention in this book is that the technical mastery of one’s discipline is not enough, given the fast-paced, networked economy of the day. Bear in mind that this was the position espoused by the authors some 20 years ago. I’m sure not even they would have been able to predict some of the advances in the economy we have witnessed since then (including, perhaps, the rise of the sharing economy).

The authors formed the view (widely accepted as a mantra by many) that the key to professional success is the ability to earn the trust and, therefore, confidence of clients. There’s no doubt that the notion of trust referred to by the authors was primarily at the level of the individual adviser, but it also spanned the firm and the profession more broadly.

Trust was, and is, personal. Earning the trust of our clients and our people requires the investment of time, the creation of intimacy and the sharing of experiences, both personal and business-related. That said, it is relevant to consider how the trust paradigm more broadly appears to have shifted away from institutions and towards strangers.

Considering the current significant shift in the political landscape globally (particularly, I suggest, the result of the 2016 United States presidential election and the outcome of the Brexit vote), it seems that individuals are far less trusting of traditional political institutions. Banks, churches and professional institutions are also, apparently, suffering an erosion of trust. This is of relevance to members of all professions.

While trust is shifting away from institutions, it appears to be shifting towards individuals and even strangers. Technology is creating new ways for us to trust strangers and we are more accepting of this paradigm through platforms such as Airbnb, Uber and The House Sitters through shared peer experiences and ratings.

The old adage “Don’t get in a car with a stranger” seems to have changed forever. We now trust strangers, getting into cars with them, and staying in their residences. We increasingly take a chance on the unknown, based on our trust of strangers.

A thought leader in the area of trust, Rachel Botsman, believes that technology is changing the way we interact and therefore how we build trust — every time we interact on the internet and have a positive experience, we develop further trust in the platform and therefore those that are using the platform.[11] This appears to be the case notwithstanding the increasing global concerns around cyber security.

What does this mean for the professions? It seems that trust will be more about technology-enabled trust and less about trust in the institutional guardians. In one sense, trust is becoming even more personal as institutions become less trusted and the mechanisms of how the individual earns and builds trust evolve.

While, in the case of Airbnb, a guest is rated by the host and the guest rates the host via the internet without ever meeting in person, it is very personal and (some may say) intimate, given that each party sees the other’s photo, reads a personal story and interacts directly via social media or email.

Something to ponder is whether we will see something similar evolve in the professional services environment.

Robotics, automation and AI

Many, including myself, continue to hypothesise about the impact of robotics and AI on the professions, including the tax profession. One thing that this article is not, is

a comprehensive analysis of these tools and emerging technologies — there are many others much more qualified than me who can provide this. That said, it is important to reflect on the changes happening around us in these fields of endeavour and the impact that those changes (and the associated emergent technologies) may bring with them.

One thing for certain is that robotics and AI are creating disruption to the professions. Often this is seen in a negative context in terms of being a net displacer of jobs, but, taking a more positive view, the impact of these and other developing technologies may be more accurately assessed as a net creator of jobs.

The Pew Research Center undertook a study in 2014 and anticipated that robotics and AI would be embedded in many aspects of daily life by 2025. Although there is consistency in the Center's predictions for the evolution of AI and other technologies, there are very wide divisions in views as to how AI and robotics will impact the economy. That study canvassed 1,896 experts and asked the following question:[12]

> "**The economic impact of robotic advances and AI** — Self-driving cars, intelligent digital agents that can act for you, and robots are advancing rapidly. Will networked, automated, artificial intelligence (AI) applications and robotic devices have displaced more jobs than they have created by 2025?"

In relation to white-collar workers, approximately half of the respondents expressed the view that technology will not displace more jobs than it creates by 2025 (rather, technology will be a net creator of jobs). That said, this group did anticipate that a substantial number of jobs that have traditionally been undertaken by humans will be taken over by robots or other digital agents by 2025.

The other half of the respondents, however, saw a future where robots and digital agents will displace a significant number of human workers, which could lead to a significant deterioration in the social order.

It is important to note that both groups envisioned a future workforce that is very different to the workforce of today.

More recently, McKinsey estimated that in excess of 90 million workers across Europe (representing some 40% of the workforce) will need to develop significant new skills within their current roles in the next 10 years and, further, that 51 million current jobs are at risk.[13] Having said that, the news is not all bad, with the report also highlighting that employment growth in other sectors will largely compensate for overall job losses. Significantly, and perhaps welcome news for the reader, is that McKinsey's modelling suggests that three sectors will account for 70% of Europe's potential job growth through 2030:

- human health and social work;
- professional, scientific and technical services; and
- education.

Although it may seem that the professional services sector will be a net beneficiary into the future as roles are altered, McKinsey has also estimated "that 22% of a lawyer's job and 35% of a law clerk's job can be automated".[14] Looking at these two scenarios together (but of course at the risk of significantly over-simplifying things), it may be that AI will be a net creator of jobs in the legal profession as technology drives down costs, meaning that a wider range of consumers will have access to legal advice.

This conclusion is predicated on the assumption that machines will not take over human endeavour completely, but rather that machines will assume tasks that are labour-intensive and repetitive, thus leaving humans to pursue more creative and constructive careers and roles within existing careers.

In its white paper released in 2018,[15] LexisNexis identifies the following four areas within the legal profession where AI can supplement (rather than take over) human endeavour:

- due diligence: machine learning tools can be trained to recognise concepts in contracts, enabling firms to contain costs, reduce risks and speed up the time required in the contract review process;
- predictive analytics: AI can analyse legal precedent to provide indicative future outcomes through the application of predictive analytics (eg AI can reveal when judges reuse similar language or follow certain patterns, which can increase the likelihood of getting to the right outcome);
- legal analytics: using machine learning, vast quantities of data can be analysed in a very short timeframe using natural language processing to identify insights from legal data and help the end-user make quicker, smarter, evidence-based decisions; and
- practice management: smarter solutions using AI at their core mean that mundane practice management tasks can be automated, with the result of reduced costs and freeing up time for professional staff to focus on value-added services and client solutions.

There is no doubt that robots and digital agents will continue to grow in sophistication and capability and, while we may not see a future encompassing drone-delivered tax advice, such developments will cause significant disruption to the accounting, legal and tax professions. This disruption has already commenced.

The future of tax compliance

Many tax professionals have served as the compliance provider for their clients through the application of a combination of bespoke and off-the-shelf systems and processes to ensure that their clients comply with the law and relevant regulations, and to keep the gatekeepers satisfied. Compliance has been (and will continue to be) a necessary assurance exercise, and one that has historically been delivered by individual practitioners who are members of a trusted professional body.

However, I suggest that traditional compliance is a rear-looking assurance exercise — a "necessary evil" but not necessarily in itself seen by our clients as value accretive to their business. It may be said that traditional compliance is viewed through the rear vision mirror. What our clients want, and will increasingly insist on getting, I believe, is "future-focused insight" (ie the view through the windscreen — the identification of future opportunities and obstacles). When considered in this way, the compliance process presents the tax professional with a unique opportunity to look deeply into the client's data (using appropriate tools) and, while the assurance aspect will always

remain important, it is the future-focused insight and the "human delivery" that, I believe, will add greatest value.

The means of delivering compliance into the future will continue to evolve. In addition to the rise of AI (which is relatively recent), we are seeing the rise of automated systems and cloud computing, together with standard business reporting (SBR) (in which business information that has been recorded in accounting and business software is effectively extracted into pre-filled government reports (including tax returns)).

The ATO is one of the world's leaders in terms of SBR adoption. SBR has significantly reduced the preparation and processing time of documentation lodged with government agencies and, in many cases, human intervention will no longer be required (as envisaged by Second Commissioner Geoff Leeper).

The capability of SBR will no doubt expand over time, as will its adoption outside government agencies. Indeed, in the Netherlands, three major banks (ABN AMRO, ING and Rabobank) mandated the use of SBR for all credit reporting from 1 January 2017. This followed its adoption by the Netherlands' Tax Administration (in respect of the electronic filing of tax returns and declarations) and the Chamber of Commerce (in respect of the electronic filing of company accounts).

It follows, therefore, that any business which has tax compliance at its core will suffer (and indeed is suffering) significant disruption. The challenge for such a business is to fundamentally rethink its client value proposition and service model in such a way as to embrace the changes happening around it.

One such business is H&R Block. Considering the extent of change and automation occurring in the tax compliance space, it would be easy to jump to the conclusion that the H&R Block business model is no longer relevant. I suggest that this is the right conclusion. Interestingly, so does H&R Block. In February 2017, IBM Watson announced a partnership with H&R Block such that its AI capabilities would be extended to tax preparation. With this partnership, H&R Block not only hopes to remain relevant but also to expand its reach, with the stated objective of having its tax professionals:[16]

> "… deliver the best outcome for each unique tax situation, while helping clients better understand how different filing options can impact their tax outcome."

In summary, the future tax compliance function and process must look very different to what we have come to know. Whether machines and AI will together replace the compliance practitioner completely in the future, I now think is unlikely. In the foreseeable future, however, all compliance-based businesses face a unique opportunity — to reinvent themselves with a knowledge of where the future is heading.

The EQ/IQ balance

While we are all familiar with the importance of IQ (intelligence quotient), and indeed have all developed a career in a field seen as technically challenging and intellectually stimulating, we have in more recent times become accustomed to hearing about the importance of EQ (emotional quotient). I think the following quote is worth pondering in this regard:[17]

> "When dealing with people, remember you are not dealing with creatures of logic, but with creatures of emotion …"

Given the historical characteristics of the professions, most notably that professionals have been the "guardians of expertise or knowledge" and relatively highly educated members of society, the professions have valued human intellect very highly, and rightly so. Professional services firms have therefore recruited the "best and brightest" intellects and IQ has been highly valued. Being an "expert" in one's field of endeavour has been admired and technical expertise sought after greatly, by both clients and firms.

That said, with the rapid rise of new technologies such as robotic process automation, AI and machine learning, the traditional position of the "expert" is changing. Traditionally, professional services firms and individual practitioners have sought to differentiate themselves based on their technical capability and mastery of their areas of expertise. In each profession, there are the gurus and the "technically sound" — the gurus have often been sought after by both the firms and clients.

The question now is whether emerging technologies that supplement the human intellect have the potential to elevate the "technically sound" practitioner to the level of the guru, in order to "level the playing field". If this is in fact the case, it will no longer be sufficient to differentiate based on technical expertise alone (or potentially at all). While still important, IQ would seem to become relatively less important, at least as a point of differentiation.

It has long been recognised that emotional intelligence is a greatly appreciated attribute of the professional services practitioner, although some would say (particularly the gurus) it is less important than human intellect. Initially developed by Salovey and Mayer in 1990 but popularised by Daniel Goleman in 1995, emotional intelligence has been described as reflecting:[18]

> "… abilities to join intelligence, empathy and emotions to enhance thought and understanding of interpersonal dynamics."

The terms, emotional intelligence (EI) and emotional quotient (EQ) have gained significant traction in all fields of endeavour since that time. Daniel Goleman has identified five key elements to it:[19]

– self-awareness: the ability to recognise and understand our own emotions and their effect on those around us. Self-aware individuals can be thought of as those who can monitor their own emotions, recognising different emotional responses and correctly identifying each emotion type. Significantly, self-aware individuals are open to new information and experiences, learn from their interactions with others, and readily recognise both their strengths and limitations;

– self-regulation: the ability to manage and express our emotions appropriately. High self-regulating individuals are described as flexible and adapt well to change. They are good at managing conflict and dealing effectively with difficult situations. They take responsibility for their own actions and are often described as thoughtful of others;

- motivation: being motivated by internal factors rather than external rewards (such as wealth, position, public recognition). Emotionally intelligent individuals are often described as being motivated by an inner drive, that is, a drive to meet their inner needs and goals. They are also described as action-oriented and achievement-driven, as well as being highly committed to the task at hand and good at taking the initiative;
- empathy: often described as the "critical" element to emotional intelligence, empathy is the ability to recognise and understand how others are feeling and how to respond appropriately in the circumstances. Those with high levels of empathy can "understand people" and the dynamics between people. They can readily sense the power balance in relationships and understand how that balance influences feelings and behaviours in others; and
- social skills: the ability to interact appropriately with others, build relationships and establish connections. Those with highly developed social skills are capable of building trust quickly and effectively and can readily develop strong rapport with co-workers and others around them. They demonstrate highly developed listening skills, verbal and non-verbal communication skills, and often occupy positions of leadership through their ability to persuade others.

More recently, with the rise of robotics, automation and AI, we have come to focus on the importance of emotional intelligence, particularly as it is a differentiator for human beings (from the machines) and is commonly viewed as something that cannot be readily disrupted by technology.

Given the ever-increasing abundance of information and the need to distil that information to produce knowledge, with the assistance of enabling technologies coupled with the need to work with the knowledge-empowered client and to understand their particular challenges, interpersonal dynamics seem to become absolutely fundamental. The importance of "being human", and being able to engage with our clients, ask the right questions and apply professional judgement, become even more significant. The "trusted concierge" is one who will do just that — they work with the client to co-design outcomes using a combination of technology and multi-disciplinary teams. They are not the "expert that has all the answers", but rather they are the emotionally connected, inquiring individual.

It does seem that EQ is much less susceptible to disruption than IQ. Consequently, the new differentiator between professional services firms and their practitioners seems to be shifting — the balance is moving and those who understand this will be able to profit as they realise the ever-increasing value of that which seemingly cannot be readily digitally disrupted.

Again, this is not to say that IQ is unimportant. Although machines will undoubtedly get smarter and more capable, the future tax adviser will use that technology, coupled with their own intellect, to develop deep areas of specialisation, but the human-centric delivery of that expertise, I believe, will become even more critical.

Returning to the trusted concierge

Like my 2016 white paper, this article (still) does not give answers. It prompts the reader to consider the changes happening around them and to ponder the impact of those changes on themselves and their business.

As tax professionals, we have built our careers, reputations and businesses by providing answers to complex problems, based on our education, our experience and our ability to interpret our clients' queries and apply the relevant law.

Hence, if I were to ask whether, as a tax professional, you are currently in the business primarily of providing answers or, alternatively, asking questions, you are more likely to say, *"providing answers to my client's questions".* If we were to consider why our clients have engaged us, historically one may answer along the lines of: because we have expert knowledge in a difficult field of endeavour and can provide answers to our clients most challenging problems (in the field of tax, of course).

The pre-eminent tax advisers in our community (and we can all think of who they are) would generally be described as being of high intellect and capable of delivering the answers to those difficult issues in a timely and effective manner. They would not have seen the need to use "supplementary tools" such as AI to deliver those answers.

"It does seem that EQ is much less susceptible to disruption than IQ. Consequently, the new differentiator between professional services firms and their practitioners seems to be shifting."

Looking forward, however, I would argue that the pre-eminent tax advisers will be those who are constantly searching for better questions rather than having all the answers. They will use the tools at their disposal to do just that.

This is the future professional. In the new world of emerging technologies such as machine learning and AI, we continue to hurtle towards a place where knowledge is so abundant and accessible that, for those of us who have built a career, a business and a reputation as an expert in a particular field, our income-generating days are seriously numbered unless we rethink what our clients will require of us and how we provide our services to them.

I believe that the future is bright and that our clients will rely on us even more, but they will be increasingly informed, demanding and, at the same time, appreciative of those who show they truly care and can interpret and understand their needs through the application of their highly developed EQ.

We find ourselves living in a hyper-connected world, with access to more information and insight than ever before, where we will need to know more about our clients and our people than perhaps they know about themselves.

Our clients and our people will continue to embrace new ways of interacting (and building trust) as a result of the rise and rise of the sharing economy, social media to digital change, AI and the constant barrage of information delivered to their smart devices in real time. In the future, we may interact with our clients and people differently (eg through social media channels), but interaction will be key.

Considered holistically, the combination of all these developments means that we will have more time to interact with our clients and work with them to determine and solve their more difficult, individualised problems.

The "T-shaped" professional

I firmly believe that, going forward, professional service firms and their members will need to embrace a different mindset and to use the increasingly sophisticated tools at their disposal to create a different experience for both their people and their clients. At the same time, it is critical to focus on the importance of the human condition and to identify those human qualities that are not subject to disruption — it follows that that which cannot be readily disrupted stands to become extremely valuable.

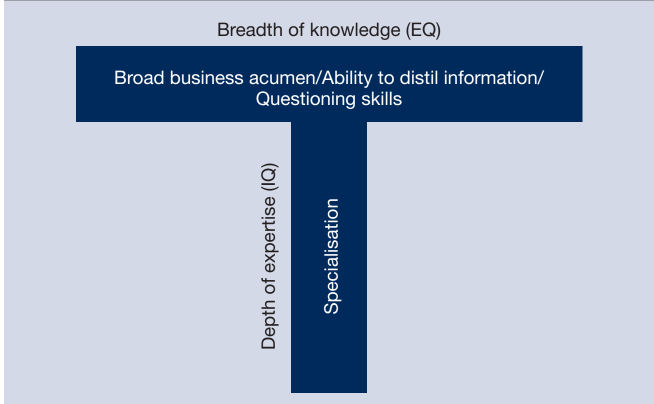
The underlying message here for the professional practitioner is that it is becoming more important to embrace the concept of niche specialisation, coupled with having a breadth of understanding across many facets of the client's world. One may think of this as the "specialist general practitioner", which sounds a little like an oxymoron.

What is somewhat intriguing to me in this regard is that advances in technology are providing us with the ability to be just that — to deepen our ability to provide specialist insight where our personal experience and expertise are increasingly augmented by the use of emerging technologies such as AI and machine learning, while at the same time providing us with the ability to access a very broad range of knowledge through freely available infrastructure and the rapidly expanding "internet of things" (IoT).

The cost of knowledge that was once exclusive to the professions is becoming lower every day. At the same time, it is becoming more accessible by the general public (which of course includes our clients and our competitors). The barriers are eroding very quickly and the playing field is levelling. This represents a fundamental challenge to the professions, each of which was created out of the need to solve complex problems and therefore required (and still requires) its members to have an advanced education and specialist knowledge — they were (although no longer are) the custodians of knowledge.

So, what will our clients need from us as they become more empowered and knowledgeable and how will we be able to differentiate from our competitors as the IoT levels the playing field? The key is in the "T" — it is what our clients will value more and more, and those who truly embrace the concept will stand out from the competition (see Diagram 1). Again, it is the EQ that is the predominant piece here; it is that which

Diagram 1. The "T-shaped" professional



cannot be readily disrupted by technology. That said, this is all about building the very best client experience — the experience that your clients will want tell others about and that experience is a very human experience.

Conclusion

I sincerely believe that the future is indeed bright for the tax profession and for all of us who have built our careers as members of it. There is no doubt that we live in a time of immense change and challenge, but throughout history, human beings have been adept at dealing with change and adapting to take advantage of the opportunities it brings — one can think of the shift from a largely agrarian economy brought about by the industrial revolution from the mid-18th century by way of example. In a modern context, we can think of how the global economy is dealing with the COVID-19 pandemic and the rapid changes that have been made out of necessity to our way of working.

We should not be afraid of change and disruption, but rather embrace it and ask ourselves the question: "How can we turn change to our advantage and embrace that which cannot be readily disrupted?"

In part 2 of this article, Adrian Cartland discusses how humans can best take advantage of living with the changes of automation.

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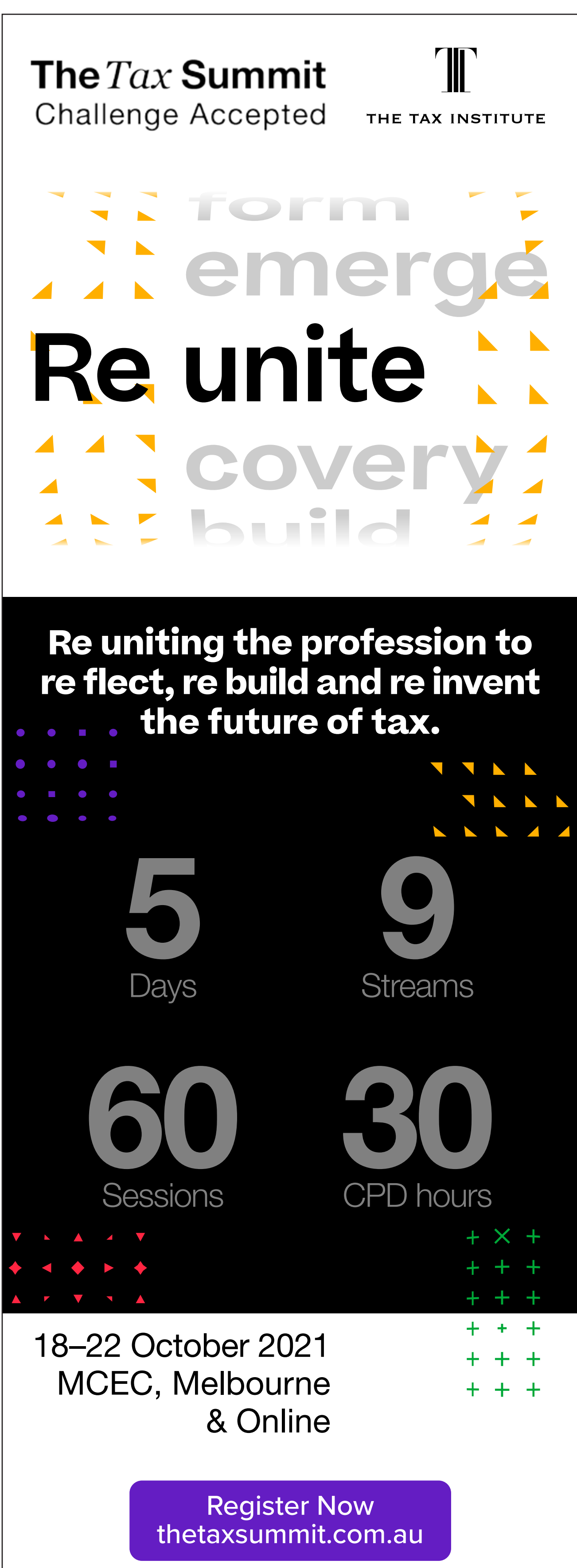


A Matter of Trusts

by Thomas Abraham, Sladen Legal

Landholder duty aggregation

Do the aggregation of interests in a landholding unit trust include exempt transfers?

In this article, we explore the *Razzy* decision[1] which looks at the application of the landholder provisions in Ch 3 of the *Duties Act 2000* (Vic) (the Duties Act) relating to the aggregation of interests in a private unit trust, including where exempt transactions are involved. In addition, this article examines two other aspects of the *Razzy* decision: the applicability of the superannuation fund to superannuation fund duty exemption in s 40 of the Duties Act in the case of non-land transfers (here, a redemption of units), and what satisfies the roll-over requirements for that exemption.

In practice, it is often the case that an adviser will assume that an exempt transfer under the Duties Act will not be deemed by the Commissioner to constitute part of what constitutes a dutiable acquisition under Ch 3 of the Duties Act.

The Supreme Court of Victoria's decision in *Razzy* is seminal as it provides much sought clarification on whether the aggregation of interests in a landholder, in this case, a private unit trust, includes exempt transfers.

The Supreme Court's decision provides clarification on the application of various aspects of the Ch 3 landholder provisions of the Duties Act which deal with landholder duty, as well as s 40 of the Duties Act which deals with an exemption for the transfer of property from one superannuation fund to another.

This article will first provide a brief factual summary of the decision, followed by the three key takeaways that a tax adviser should take note of when dealing with acquisitions or redemptions of units in private unit trusts that are classified as a "landholder" under the Duties Act.

Facts

A settlement deed was entered into between members of three self-managed superannuation funds and entities connected with them, which, among other things, restructured the three superannuation funds of which the members were the only members.

The settlement deed had the effect of parties rearranging their superannuation funds in a way that resulted in one member controlling and being the sole member of one fund, and the other member controlling and being the sole member of the other two funds.

As a result of this restructure, units in "private unit trust" schemes[2] were transferred between the superannuation funds and a related trust. Relevantly, they included a transaction in which a superannuation fund increased its interest in a unit trust by 10.25%, and the related trust increased its interest in the unit trust by 12.09%. The superannuation fund increase was ultimately found to be exempt (under s 40 of the Duties Act). The related trust's acquisition, in isolation, was below the 20% threshold[3] for triggering landholder duty but would be dutiable if that acquisition was aggregated with the superannuation fund's exempt acquisition.

The particular details of the restructure are best appreciated through the representation in Diagram 1.[4]

Takeaway 1: Aggregation of interests in a landholder includes exempt transfers

The court found that the aggregation of the two separate acquisitions constituted an "associated transaction",[5] resulting in the 20% threshold being met, therefore resulting in a "significant interest" being acquired.

It was held that the approach to be adopted in relation to the calculation of duty when an exempt acquisition is aggregated with a dutiable acquisition is that any changes in equitable ownership "however achieved" are subject to duty.

Consequently, as a result of the aggregation of the increases by both the superannuation fund and the related trust, the 20% threshold was exceeded and the acquisition by the related trust was found to be dutiable.

This finding means that taxpayers must be extra diligent when determining whether the transactions are aggregated for the landholder duty regime, including where exempt transactions are or have been involved.

Takeaway 2: Section 40 exemption – application to redemptions as well as transfers

It should be noted that the redemptions of units in the private unit trust schemes occurred to effect the transfer of member interests between superannuation funds.

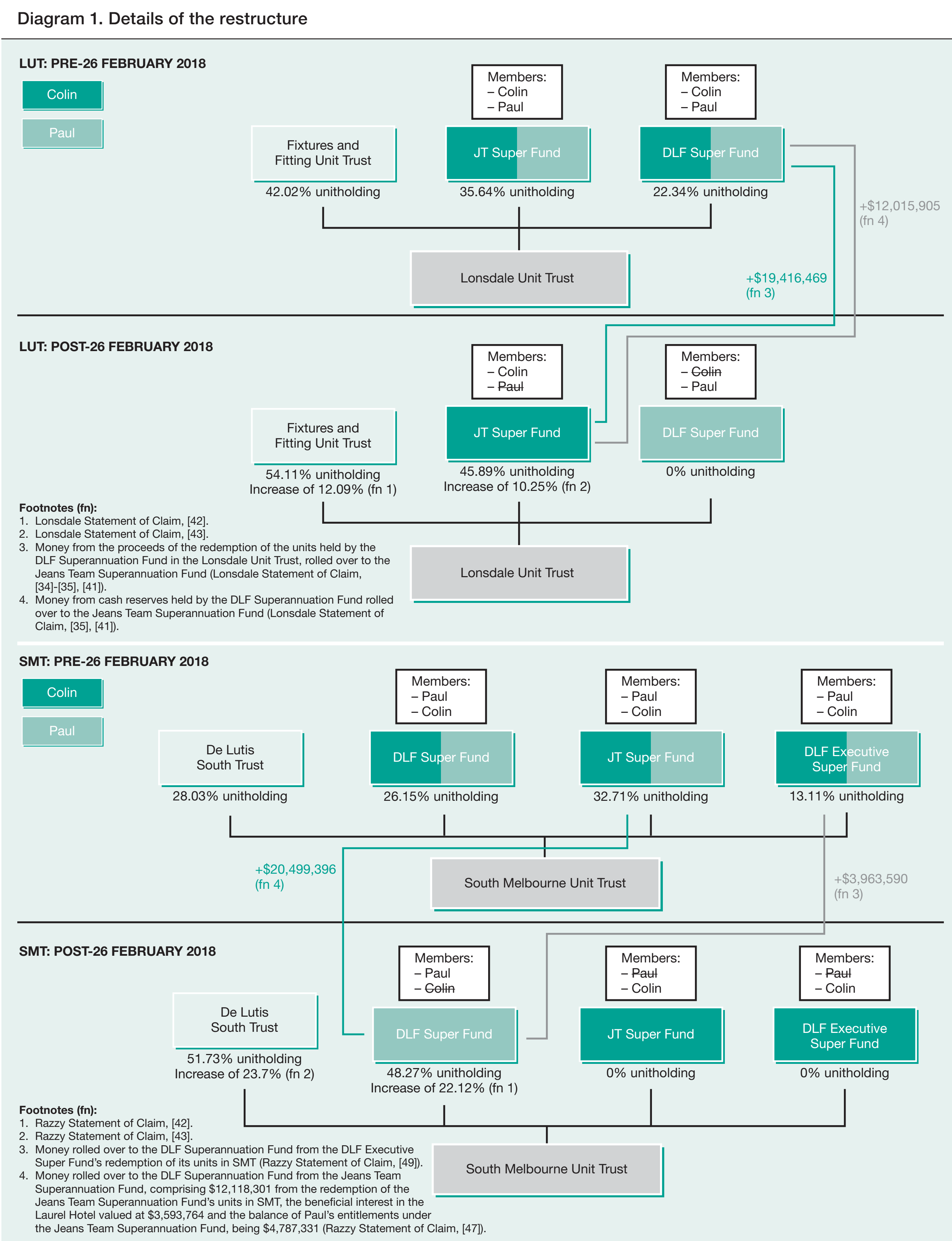
The Commissioner contended that notional transfers (in this case, the redemptions of units) did not satisfy the requirement in s 40(1)(a) of the Duties Act and, therefore, the increase in unit holding percentages as a result did not qualify for the exemption under ss 89D(a) and 40 (for transfers between superannuation funds).

The court found that, except in the case of "excluded transactions", duty is payable under Ch 2 of the Duties Act on "transactions" referred to in s 7(1)(b) as if they involved a transfer.

The court rejected the Commissioner's arguments which impermissibly sought to dissect what took place in the settlement deed into separate parts, which was an argument of form over substance that ignored s 89D(a) of the Duties Act.

The court held that, in the context of s 89D(a) which provides an exemption irrespective of the "means by which" the interest was acquired, "transfer" in s 89D(a) includes notional transfers, which therefore includes redemptions.

Diagram 1. Details of the restructure



While the application of the s 40 exemption to redemptions of units is not likely to have a significant relevance for most taxpayers, the principle that duty exemptions have a broader application than to transactions that involve transfers of land or units is an important finding that will have a broader relevance in dutiable matters.

Takeaway 3: Transfers "in connection with" ceasing to be a member of a complying superannuation fund

The court determined that the meaning of the word "connection" is both wide and imprecise and its exact ambit will depend on the statutory context.

In the context of the factual circumstances in this case, the court highlighted that the requisite connection must be between the notional transfer, here being the redemption of units, and the person ceasing to be a member of one fund while becoming entitled to benefits in respect of the fund to which the dutiable property is transferred to.

Contrary to the Commissioner's contentions that there was no connection, the court held that the requisite connection existed for the following reasons:

- a precise matching between funds redeemed and funds rolled over is not required;
- the roll-over of cash and the redemption of units are related to the purpose of achieving the stated objectives in the settlement deed;
- the separation of events by short time intervals does not detract from the requisite degree of connection being made out; and
- the existence of a non-exempt transaction within the overall scheme of transactions effected requires separate consideration and attracts duty, but it is not relevant to whether the "connection" requirement is satisfied in s 40(1)(c) of the Duties Act.

This a welcome finding by the Supreme Court of Victoria, as superannuation fund to superannuation fund transfers as a result of a roll-over can involve a number of "moving parts", and it can be difficult to ensure that the transfer of all assets and member entitlements occur at once. This finding also gives superannuation fund trustees some comfort that the exemption will apply even if there is some delay with the relevant member ceasing to hold benefits in the transferor superannuation fund.

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Senior Associate
Sladen Legal

References

1 *Razzy Australia Pty Ltd v Commissioner of State Revenue* [2021] VSC 124.

2 Defined as "landholders" in s 71(1) of the Duties Act.

3 S 79(2)(a) of the Duties Act.

4 See annexures A and B in the *Razzy* decision.

5 Ss 78 and 3(1) of the Duties Act.

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Superannuation

by Daniel Butler, CTA, and
Bryce Figot, CTA, DBA Lawyers

SMSFs with units in unit trusts and NALI

Careful consideration should be given to ensure that there is appropriate remuneration for services provided in relation to a unit trust where an SMSF holds units.

Introduction

A considerable number of SMSFs invest in private unit trusts. These unit trusts may include pre-99 unit trusts, unrelated unit trusts, and non-geared unit trusts (under Div 13.3A of the *Superannuation Industry (Supervision) Regulations 1994* (Cth)).

LCR 2021/2 outlines, among other things, the ATO's view in relation to when a loss, outgoing or expense (expense) invokes non-arm's length income (NALI) in relation to non-arm's length dealings with fixed or unit trusts. In particular, this article focuses on paras (b) and (c) of s 295-550(5) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Where a lower than arm's length expense gives rise to NALI, this is commonly referred to as NALE (ie non-arm's length expenditure). There is not much guidance relating to how NALE applies to unit trusts and this article is designed to bridge this gap.

NALI: fixed entitlements to trust income

From 1 July 2018, an important change occurred to s 295-550(5) ITAA97 by the addition of paras (b) and (c). Broadly, these paragraphs assess distributions from fixed trusts or unit trusts as NALI where a lower (or nil) expense is incurred in relation to acquiring the entitlement in the trust or producing the income from the trust.

Section 295-550(5) states:

> "Other income derived by the entity as a beneficiary of a trust through holding a fixed entitlement to the income of the trust is ***non-arm's length income*** of the 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 acquiring the entitlement or 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 acquiring the entitlement or 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."

NALE: lower than arm's length expense

Broadly, for a distribution to be assessed as NALI under s 295-550(5)(b), the following criteria must typically be satisfied:

- the SMSF derives income as a beneficiary of a fixed trust, eg by holding a fixed entitlement;
- the parties were not dealing with each other at arm's length in relation to the scheme; and
- in acquiring the entitlement or in gaining or producing the income, the SMSF incurs an expense that is less than an arm's length amount. The acquisition of the entitlement would be in relation to the SMSF acquiring the units. The words "in gaining or producing the income" should be read in the context of the income derived from the units or entitlement in the trust.

NALE: nil expense

The key difference between paras (c) and (b) of s 295-550(5) is that para (c) is invoked where the SMSF does not incur any expense. In contrast, para (b) is invoked where the SMSF incurs an expense that is lower than an arm's length amount.

Given the similarity between paras (b) and (c), we will not discuss para (c) any further and will focus on paras (a) and (b) for the remainder of this article.

NALI: lower than arm's length expense

This is a good time to discuss s 295-550(5)(a) and to contrast it with s 295-550(5)(b).

Broadly, for a distribution to be assessed as NALI under s 295-550(5)(a), the following criteria must typically be satisfied:

- the SMSF derives income as a beneficiary of a fixed trust, eg by holding a fixed entitlement;
- the parties were not dealing with each other at arm's length in relation to the scheme; and
- the SMSF derives more income from the trust as a result of the parties not dealing at arm's length. Two typical examples that would invoke NALI under para (a) include:
  - a related party tenant agreed to pay a higher rent for the business real property held by the trust compared to its arm's length value; and
  - a related party provided a loan to the trust that did not incur interest and was not on arm's length terms.

Paragraph (a) has been law for a considerable period and was in place well before the 1 July 2018 changes. As noted above, paras (b) and (c) were only introduced as law from 1 July 2018 but have retroactive effect (as they apply regardless of when the "scheme" was entered into).

Unit trust example

Example 12 of LCR 2021/2 involves Scott's SMSF acquiring $50,000 of units in a stock exchange-listed unit trust at market value, with a flexible related party limited recourse borrowing arrangement (LRBA). The loan is interest-free, it is repayable in 25 years, and it has a 100% loan to valuation ratio (ie it is 100% geared). The unit trust distributes $8,000 to Scott's SMSF for FY2019.

The ATO concludes that, in addition to distributions of income being assessed as NALI, any capital gain from a CGT event relating to a disposal of the units will also be assessed as NALI to Scott's SMSF.

This example is the only example relating to a unit trust in LCR 2021/2, and it relates to an SMSF "acquiring the entitlement" to units in a unit trust at market value. LCR 2021/2 thereby provides limited guidance in relation to how paras (b) and (c) apply to unit trusts. Further, the ATO does not provide any analysis on why any capital gain derived by Scott's SMSF should be subject to NALI once a CGT event occurs in relation to the units — which may occur many years after the loan has been repaid.

Indeed, query whether there is a sufficient relevant nexus between any future capital gain that may eventually arise in respect of the disposal of the units (which are listed on the stock exchange) and the flexible LRBA provided to acquire the units. For instance, the flexible loan may only last for several years, whereas the units may be held for many more years after the loan is repaid. Why should the entire capital gain for the entire holding period be tainted? Moreover, any capital gain that may eventually arise is largely due to movements in the trust's performance as reflected via the stock exchange.

On the other hand, a relevant nexus would exist where the eventual capital gain would not have arisen if Scott's SMSF did not have the funds to acquire the units at the relevant time but for the flexible related party loan. This view is based on the argument that the fund would not have derived any income or capital gain from the units but for the (flexible LRBA) scheme.

What if an SMSF trustee/director provides services to a unit trust?

An important question which is not dealt with in LCR 2021/2 is: what is the status if an SMSF trustee/director provides services to a unit trust? For example, consider an SMSF that is invested in a non-geared unit trust that owned a factory, and the SMSF trustee/director oversaw the collection of rent and dealings with the tenant (which may be a related party where the property constitutes business real property), attended to bookkeeping, and instructed the accountant regarding the trust's annual financial statements.

First, it is worthwhile noting that ss 17A and 17B of the *Superannuation Industry (Supervision) Act 1993* (Cth) do not apply to a unit trust. Broadly, s 17A precludes an SMSF trustee/director from being remunerated for trustee duties in respect of an SMSF, and s 17B authorises an SMSF trustee/director to be remunerated for non-SMSF trustee/director duties subject to certain criteria (eg the person is qualified/licensed, the person carries on a business of providing such services to the public, and the remuneration is arm's length). Thus, ss 17A and 17B only apply at the SMSF level.

The position relating to remuneration for a trustee/director of a unit trust that an SMSF invests in depends on a range of factors, including the unit trust's governing rules (eg the unit trust deed and the constitution of the corporate trustee of the unit trust).

In relation to a trustee or director of a corporate trustee of an SMSF, the ATO acknowledges that:

- a trustee or director of a corporate trustee of an SMSF will be required to perform particular actions in order to satisfy a range of obligations imposed on them, eg any conditions imposed by statute, as well as fiduciary duties and obligations (see para 44 of LCR 2021/2);
- the trust deed may also provide a trustee or director of a corporate trustee the power to perform certain actions (see para 45 of LCR 2021/2); and
- an individual's business, profession, life experiences or employment may result in the individual having skills and knowledge that can assist the individual in performing their duties in their capacity as trustee, or as a director of a corporate trustee, of an SMSF. Utilising such skills and knowledge of itself does not indicate that the individual is not acting in their capacity as trustee, or as a director of a corporate trustee (see para 46 of LCR 2021/2).

While the three points referred to above relate to the trustee or director of a corporate trustee of an SMSF, there appears to be no reason why these same principles should not also apply to a trustee of a unit trust, eg a director of a corporate trustee of a unit trust is required to perform a range of obligations both at law and under the trust deed. Such a director may also possess special skills and knowledge.

The compendium issued with LCR 2021/2 provides responses to comments received on LCR 2019/D3 (which was finalised as LCR 2021/2). The following is a relevant extract in relation to services which are provided by a related party at the unit trust level:

"Issue number	Issue raised	ATO response
23	Further clarification is needed for SMSFs that invest in unit trusts as the guidance provided so far is not sufficient. The draft Ruling does not provide any examples where an SMSF trustee is assisting with managing the activities of a unit trust that owns real estate. We query whether these would be treated in a similar manner to the situation where the trustee provides internal or trustee type services directly to an SMSF.	We consider the Ruling provides sufficient guidance on the key principles to assist trustees to determine how the provisions apply. Trustees may seek certainty on their specific circumstances through the private ruling process."

Thus, the ATO did not use LCR 2021/2 as an opportunity to clarify this topic. The ATO has suggested that trustees may wish to seek a private ruling instead. However, as paras (b) and (c) of s 295-550(5) ITAA97 appear to relate to the SMSF acquiring the entitlement or in gaining or producing the income from the units in a unit trust, it would seem that any services provided by an SMSF trustee/director in relation to a unit trust would need to be considered under para (a) of s 295-550(5) ITAA97. That is, if the SMSF trustee/director has provided services for lower than market value in relation to the unit trust, that would appear to be a scheme that could result in more income flowing to the unit trust.

This issue may relate to a number of SMSFs with investments in unit trusts, particularly closely held and unlisted unit trusts where some services are provided. Careful consideration should therefore be given to the types of services that might give rise to a NALI risk, including the provision of financial support to a unit trust's activities in the form of guarantees in respect of borrowings by the trustee of a unit trust.

In short, careful consideration should be given to ensure that there is appropriate remuneration for services provided in relation to a unit trust where an SMSF holds units. However, there may be certain formalities that need to be satisfied before remuneration can be paid to a trustee/director, including a shareholders' resolution and ensuring that there is express power in the trust deed that authorises payment (see *Re Cuesuper Pty Ltd*,[1] where the trustee of a large superannuation fund was required to vary its deed to authorise remuneration for its trustees).

Conclusion

SMSFs that invest in unit trusts, especially closely held unit trusts, need to carefully monitor the impact of LCR 2021/2 and make any necessary changes to minimise NALI risks. Some unit trusts may need to outsource some of their activities moving forward, eg appoint a real estate agent to manage the property owned by the unit trust, which may currently be undertaken by the SMSF trustee/directors. Expert advice should be obtained if there is any doubt.

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DBA Lawyers

Reference

1 [2009] NSWSC 981.

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Alternative Assets Insights

by Ross Malone and Sonia Kew, PwC

TR 2021/D4: software draft ruling

The ATO considers that certain payments for software distribution rights are royalties.

The ATO has released draft tax ruling TR 2021/D4 which sets out the Commissioner's preliminary views on the income tax treatment of receipts from the distribution and licensing of software, as distinct from "simple use" by end-users of the software. TR 2021/D4 has a particular focus on the circumstances where receipts will be treated as royalties under arrangements involving the distribution of packaged software, digital software distribution, and cloud computing arrangements including software-as-a-service (SaaS). This has the potential to be quite broad such that any business where software is fundamental to the delivery of services should also consider the draft ruling.

TR 2021/D4 adopts a highly technical approach to the identification and valuation of the royalty element of any software payments and will be relevant to software distributors, software owners and end-users, particularly where there is a cross-border element where transfer pricing and withholding tax obligations become important. However, the draft ruling does not address the impact of Australia's tax treaties which will be critical in many cases.

TR 2021/D4 replaces a widely used and accepted tax ruling issued in 1993 dealing with computer software which has now been withdrawn. Once finalised, the draft ruling is proposed to apply both before and after its date of issue. However, it is recognised that taxpayers will be entitled to rely on the 1993 ruling which applied to some arrangements covered by TR 2021/D4.

In detail

On 25 June 2021, the ATO released draft TR 2021/D4. The 17-page ruling deals with the circumstances in which receipts from the licensing and distribution of software will be royalties as defined under Australian domestic tax law. Royalties paid offshore will generally be subject to a final withholding tax.

TR 93/12 has now been withdrawn. TR 2021/D4 seems intended to clarify a key element of TR 93/12 concerning the use of a local distributor in respect of the "simple use" of software. This element of TR 2021/D4 may attract a degree of controversy and is expected to have a wide impact, particularly if the position expressed in the draft ruling applies to prior years as appears to be intended.

TR 2021/D4 adopts a highly technical approach based on Australian copyright law. According to the draft ruling, an amount is a royalty to the extent that it is paid or credited as consideration for the grant of a right to "do something in relation to software that is the exclusive right of the owner of the copyright in the software".

Eight examples are provided in TR 2021/D4: three dealing with licences to reproduce, modify and provide simple use of software, three dealing with software distribution arrangements, and two dealing with ancillary services.

The key aspect of TR 2021/D4 relates to the circumstances where the use of a local distributor may generate payments that are considered to be royalties. There seems to have been an evolution since TR 93/12 in the ATO's approach in relation to this business model and the operation of the royalty withholding tax rules.

In this respect, TR 2021/D4 seeks to interpret the domestic law royalty definition and distinguish the following circumstances:

- **simple use of software:** a payment for the simple use of software is not considered to be a royalty. This would include payments made under standard licensing arrangements known as "click-wrap", "click-through" or "browse-wrap" end-user licence agreements (EULA) where, as part of the download and installation process, the end-user either accepts or rejects the terms by selecting "accept" or "cancel". TR 2021/D4 concludes that payments for simple use are payments for the right to use the software itself for the purpose of which the software was designed or intended to be used. This includes the use of copyright which is necessary to facilitate the use of the software as a functional product (eg reproducing or communicating software when downloading software, but not modifying or adapting the software);
- **software distribution agreements conferring copyright:** a payment by a software distributor for the right to do something in relation to the software which is the exclusive right of the copyright owner will be considered to be a royalty. Such rights to use the copyright in the software may be granted to distributors whether the software is distributed by way of physical carrying media, digital download, or cloud-based technology such as SaaS. For example, a payment for the right for a distributor to copy, reproduce, modify or adapt the software, or to communicate the software to the public (eg by merely making it available online for users in Australia), will be characterised as a royalty.

  This is also the case where the payment by the distributor is for the right to sub-licence simple use of the software to end-users. According to TR 2021/D4, such a payment is considered to be a royalty because the simple use of the software will necessarily involve the use of copyright and the right to authorise an end-user to use the copyright in the software is an exclusive right of the copyright owner.

  TR 2021/D4 also states that, as a general proposition, where the grant of the right to use the copyright in software is central to the rights the distributor is given

to perform its distribution function, and the other rights granted are ancillary in comparison, it is considered that the whole of the payment will constitute a royalty. However, there is a subsequent statement in the draft ruling that apportionment is to be done on a fair and reasonable basis, taking into account all of the facts and circumstances of a particular case; and

- **software distribution agreements not conferring copyright:** TR 2021/D4 also explains that it is not always the case that payments made by a software distributor for distribution rights will be royalties. There may be instances in which a software distributor makes payments to a copyright owner for the grant of distribution rights which do not involve the right to do anything that is the exclusive right of the copyright owner. For example, a distributor may enter into a distribution agreement under which it is granted the right to market and distribute packaged software but not to sub-licence the use of the software to end-users or to otherwise use the copyright in the software. In such cases, the licence to use the software is granted directly to end-users by the software developer.

  This may also be the case where software is distributed by way of digital download or cloud-based technology. That is, depending on the circumstances of the particular case, the distributor may not be granted the right to sub-licence the use of the software or to otherwise use the copyright in the software. In such cases, the payments made by the distributor will not be royalties.

TR 2021/D4 seeks to distinguish situations where the distributor is granted a right to "do something that is the exclusive right of the owner of the copyright" (eg a right to copy, reproduce, modify or adapt the software, communicate the software to the public, or sub-licence the right to use the copyright in the software) and situations where the distributor is not permitted to do "anything that is the exclusive right of the owner of the copyright". This distinction may be difficult to determine in practice and will depend on the terms (both express and implied) of the licensing or distribution arrangement.

However, based on the simple examples in TR 2021/D4, a key distinction appears to be whether the Australian distributor is a party to the EULA. This aspect of the draft ruling relies heavily on the view that the EULA will necessarily involve the distributor exercising an exclusive right of the copyright owner by authorising an end-user to use the copyright in the software. Another key distinction is whether the Australian distributor is granted a right to communicate the software to the public (eg by making the software available online or by electronically transmitting the software). According to TR 2021/D4, communication may occur in the relevant sense when software is made accessible to, or is used by, an end-user via cloud-based technology such as SaaS, that is, without being downloaded on the end-user's computer or device.

Other aspects of TR 2021/D4 dealing with licences to reproduce or modify software, sale of goods, and payments for know-how and services broadly align with the approach adopted in TR 93/12. TR 2021/D4 provides a new and helpful explanation that the proceeds from the sale of a mobile handset which comes pre-installed with operating system software is not a royalty (ie no "embedded" royalty).

The most noteworthy aspect of the draft ruling relates to the treatment of foreign multinational companies involved in the distribution of software to the Australian market. Our observations below focus on this.

Observations

The consideration of whether a payment in respect of a software distribution arrangement is a royalty, and, in certain cases, then gives rise to royalty withholding tax, is complex and, as TR 2021/D4 notes at the outset, is dependent on the terms of the relevant agreements and all of the facts and circumstances of the case. There are a number of matters that need to be considered carefully, both through the consultation period and once the draft ruling is finalised. Some of these are set out briefly below.

The interaction with Australian copyright law

The question of whether an amount is paid for the use of, or the right to use, copyright (and therefore a royalty as defined under s 6(1) of the *Income Tax Assessment Act 1936* (Cth)) must be answered by considering whether any of the rights provided under the arrangement are otherwise the exclusive rights of the copyright owner, as set out in the *Copyright Act 1968* (Cth).

In the context of software distribution arrangements which operate through an Australian distributor, this involves consideration of the rights provided implicitly or explicitly to the distributor to perform its activities. In our experience, this can be a challenging task, particularly as business models have evolved and become more complex.

Scope of TR 2021/D4

TR 2021/D4 seems to be confined to payments relating to software. However, it is not clear if this approach founded in intellectual property law could mean that other "digital" businesses (eg a payment that may involve the use of software in the delivery of services or businesses that deal in digital media, such as pictures, templates, music, sound or video) could also be impacted.

Multinational anti-avoidance law

The multinational anti-avoidance law (MAAL) was effective from 1 January 2016 and targets multinationals with annual global income of A$1b or more that supply goods or services to Australian customers and record the revenue from those sales overseas. The MAAL was designed to encourage multinationals to restructure and the ATO has stated that "… as a direct response to the MAAL, 44 taxpayers have brought or are bringing their Australian sourced sales back onshore". Those companies that have moved sales onshore will now need to consider whether TR 2021/D4 may have application.

Apportionment and transfer pricing

TR 2021/D4 acknowledges that apportionment may be required to isolate amounts that are characterised as royalties. There are a number of transfer pricing methodologies that could be used to apportion payments

between royalty and non-royalty components. However, TR 2021/D4 provides limited guidance on this issue, other than to suggest that any apportionment should be done on a fair and reasonable basis.

Retrospective nature of TR 2021/D4

When the final ruling is issued, it is proposed to apply both before and after its date of issue. However, TR 2021/D4 also acknowledges that TR 93/12 applies prior to the time of its withdrawal to the extent that it has been relied on. We note that, to the extent that a public ruling is withdrawn, it continues to apply to schemes to which it applied that had begun to be carried out before the withdrawal, but does not apply to schemes that begin to be carried out after the withdrawal.

We expect that, for those impacted by TR 2021/D4, it will be important to consider whether TR 93/12 provides protection from the intended retrospective operation of TR 2021/D4.

Tax treaties and OECD commentary

TR 2021/D4 focuses on the definition of a "royalty" as set out in domestic tax legislation but helpfully acknowledges that the definition in a tax treaty will prevail to the extent of any inconsistency. This is important because the Australian domestic definition of "royalty" may not align with the tax treaty definition. For example, when considering the application of Australia's tax treaties, it may be relevant to consider commentary in relation to the Organisation for Economic Co-operation and Development (OECD) *Model Tax Convention on Income and on Capital* (MTC). The OECD MTC commentary considers software distribution arrangements and notes that the rights provided in relation to the acts of distribution should be disregarded when characterising the payment for tax purposes, such that payments made solely in respect of exclusive distribution rights should not be considered to be a royalty.

Accordingly, the interaction with tax treaties will be critical in many cases when determining whether an amount is wholly or partly a royalty and, accordingly, whether withholding tax is applicable and a foreign tax credit available in the foreign jurisdiction.

If the ATO view regarding the "royalty" definition does not align with a tax treaty partner, double taxation may arise. In these cases, any difficulties in the application of the tax treaty may be resolved through mutual agreement procedures, including, in some cases, binding arbitration made available by the OECD *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting*.

We would observe that the proposed ATO view has the potential to give rise to inconsistencies with the approach adopted in most other countries following the OECD MTC. In addition, we note that, earlier this year, the Indian Supreme Court denied the tax authority's endeavour to categorise payments for the use or purchase of computer software as royalties under India's tax treaties. The UN Tax Committee has also recently decided against including software payments in the definition of royalties for the purposes of the UN model tax convention.

Financial statement impact

Since TR 2021/D4, once finalised, is stated to apply both before and after the date that it is finalised, it may be necessary to consider whether the draft ruling could have any impact on taxes reported in financial statements.

The takeaway

Foreign companies involved in the software industry and other "digital" businesses should review the potential application of TR 2021/D4. This may require a detailed consideration of existing legal agreements and specifically the rights provided to the relevant parties under those agreements. This should include consideration of how Australian intellectual property law applies to arrangements involving the distribution of packaged software, digital software distribution, and cloud computing arrangements including SaaS. In many cases, it will be necessary to consider whether apportionment is required.

Since TR 2021/D4 is intended to apply retrospectively, companies potentially impacted will also need to consider whether TR 93/12 provides protection for positions adopted in the period up to its withdrawal and potentially for a period thereafter.

The ATO had invited comments in relation to TR 2021/D4 by 30 July 2021. The expected ATO completion date is to be advised.

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Events Calendar

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Online		
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Victoria		
2021 National Transfer Pricing Conference	9/9/21	10
2021 National Superannuation Conference	7/10/21	12

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