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The Tax Institute

Taxation *in* Australia

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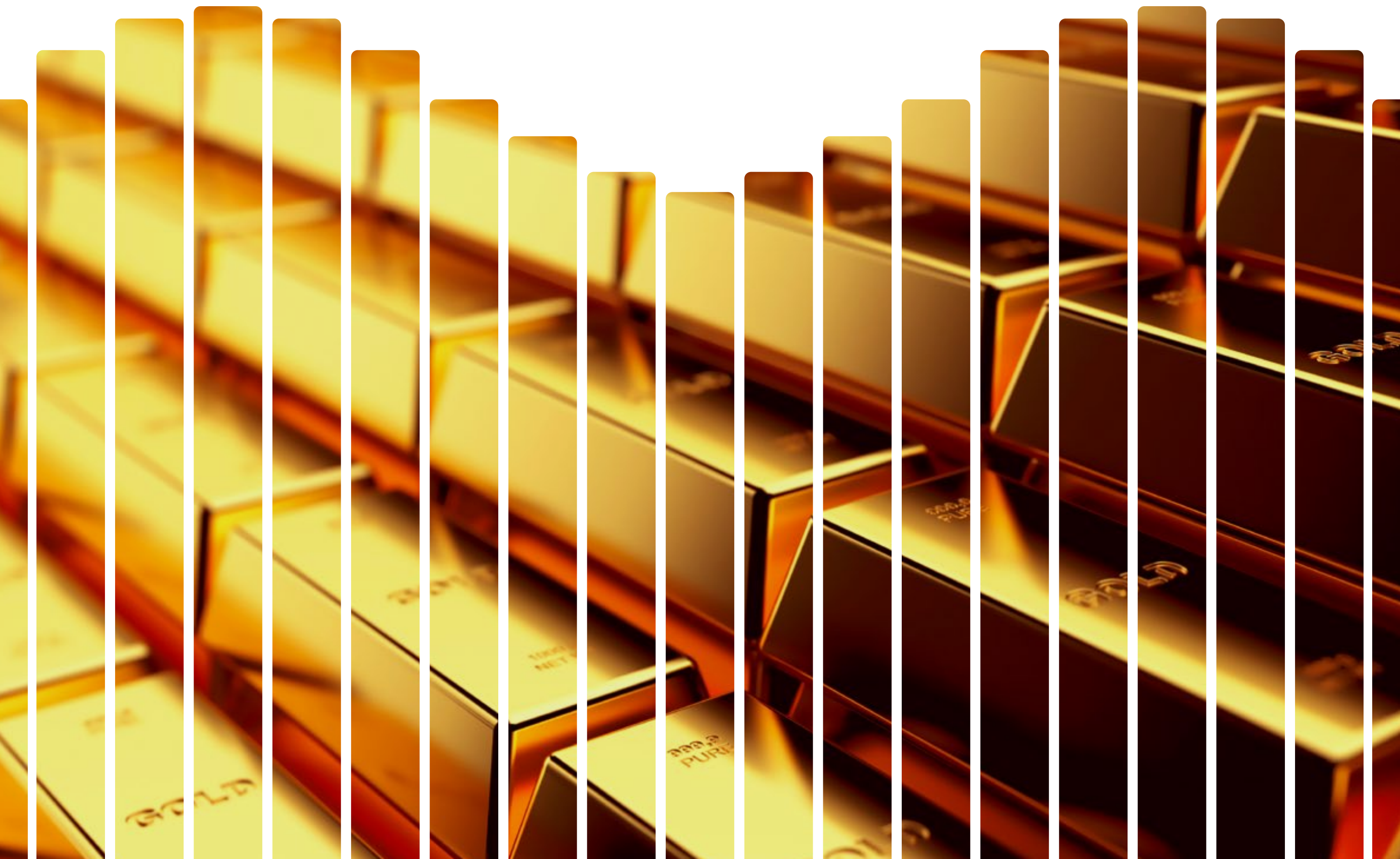

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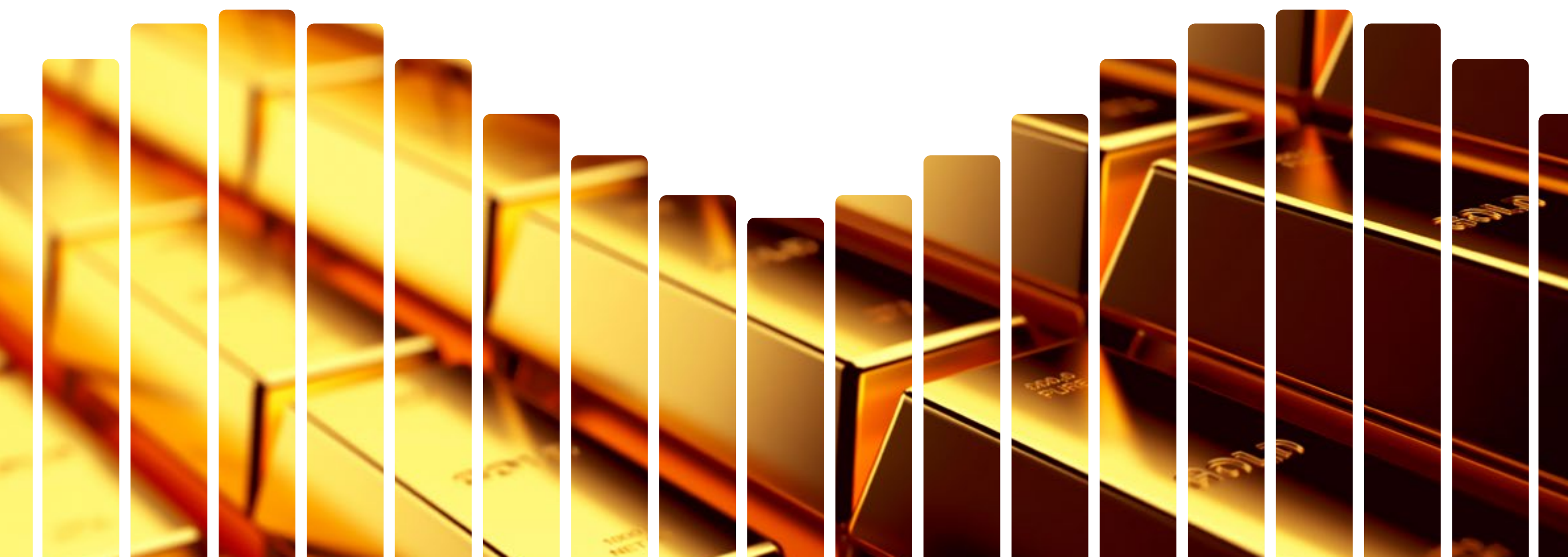

Tax News – at a glance

by TaxCounsel Pty Ltd

October – what happened in tax?

The following points highlight important federal tax developments that occurred during October 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 225 (at the item number indicated).

Superannuation concessions: amendments

The government has released draft legislation and explanatory material in relation to the changes to the superannuation tax concessions that were announced in the 2023–24 Budget. **See item 1.**

PwC measures

The government has released exposure draft legislation and explanatory material in relation to the significant measures that were announced on 6 August 2023 in response to the PwC revelations. **See item 2.**

Self-education expense deductions

The Commissioner has released a draft ruling that sets out the principles that govern the deductibility of self-education expenses incurred by an individual under the general deduction provision (s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)), and discusses the types of expenditure that can be deductible as a self-education expense, as well as those that cannot (TR 2023/D1). **See item 3.**

Composite asset: relevant depreciating asset

The Commissioner has released a revised draft ruling that sets out guidelines intended to assist in identifying the relevant depreciating asset or assets where an asset consists of a number of components (TR 2023/D2). **See item 4.**

ATO communication protocols for objections

The Commissioner has released a practice statement that sets out the framework governing the communications between ATO objection officers and officers involved in making the original decision (PS LA 2023/2). **See item 5.**

GST and prepared meals

The Federal Court (Hespe J) has held that certain frozen food products supplied and imported by the taxpayer in the tax period from 1 July 2021 to 31 July 2021 were not GST-free (*Simplot Australia Pty Ltd v FCT* [2023] FCA 1115). **See item 6.**

Div 7A loan issues

In a recent decision, the AAT has held that a private company which was presently entitled to income of a discretionary trust that remained unpaid did not make a loan to the trust within the definition of "loan" that applies for the purposes of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (*Bendel and FCT* [2023] AATA 3074). **See item 7.**

Reimbursement agreements

The Commissioner has issued an addendum which amends TR 2022/4 to reflect the recent Full Federal Court decisions in *FCT v Guardian AIT Pty Ltd ATF Australian Investment Trust* [2023] FCAFC 3 and *B&F Investments Pty Ltd as trustee for the Illuka Park Trust v FCT* [2023] FCAFC 89 (TR 2022/4A1). While the decisions do not substantially alter the Commissioner's views on the operation of s 100A ITAA36, the changes clarify that advisers may be a party to a reimbursement agreement and explain when a beneficiary may need to be a party to a reimbursement agreement.

Vacant land deductions

Subject to exclusions, from 1 July 2019, s 26-102 ITAA97 has limited deductions for losses or outgoings that relate to holding vacant land. The Commissioner has released a ruling that explains his view of the application, and some of the exclusions, of this section (TR 2023/3). The ruling is discussed in the Tax Tips column of this issue of the journal (see "Tax Tips" on page 231).

President's Report

by Marg Marshall, CTA

New leadership to move us forward

President Marg Marshall welcomes our new CEO and strategic direction for the Institute.

As you are no doubt aware by now, we have recently appointed Scott Treatt, CTA, as CEO of The Tax Institute. My congratulations and support go to Scott as he embarks on this exciting new role.

I am very pleased to have been part of the selection process and to have found a wonderful fit in Scott. When we set out to select a new CEO, the Board agreed that selecting a candidate with passion for and knowledge of not only the tax profession, but also our organisation and its role within the profession, was crucial. We wanted to ensure that our strategic vision was being steered by someone who knows what it is to be a tax practitioner and how best we can support them.

Scott has been part of The Tax Institute's community for many years now, as a member, a volunteer, General Manager of Tax Policy and Advocacy, and now as CEO. He has held leadership positions in private practice, regulatory bodies and, of course, The Tax Institute itself. I could not be more confident that our members and our organisation's future are safe in his capable hands.

An internal appointment for CEO makes absolute sense for our organisation at this juncture. There has been considerable change at the Institute as we implement a strategic review of our organisational structure and operating model. Having one of our own step up to the helm provides a certainty and familiarity that is important for our volunteers, team and members alike.

Scott's long-time association with the Institute also means that he is incredibly well-placed to see where the most value can be created moving forward. He has spoken to the Board and myself of his vision for our organisation's future, which puts members voices squarely at the centre of it all — which is exactly where they belong.

I'm pleased to see support for Scott flooding in, and trust that our members will continue to support him in the coming months and years as he works to improve our member benefits, resources and experience overall. I know that he, in turn, has big plans to engage and support you.

Our investment in you

Over the last financial year, we have invested strategically and aggressively in key areas to bolster our member value. This includes a new education offering, improved digital experience for our website and Tax Knowledge Exchange platform, and increased opportunity for local engagement with members. We have already begun the process of getting to know you better and listening more closely to your feedback. Scott's leadership will ensure that this is kept front and centre.

As we continue these projects to deliver better member value and explore new opportunities to do so, now is the time to be actively involved in the Institute. We are listening and I encourage you to speak to us and have your voice heard. If there are ways you would like us to support you, we would love to hear them.

Annual General Meeting

Our Annual General Meeting (AGM) will be held this month and I encourage you all to attend if possible. Every voting member has the right to attend the AGM and I encourage you to utilise this right in order to have your say about our organisation. You will receive official notification of the AGM 30 days in advance of the meeting.

CEO's Report

by Scott Treatt, CTA

Leading and listening as CEO of the Institute

In his first CEO's Report, Scott Treatt outlines his vision for an Institute where your voice is at the centre of the tax conversation.

I am delighted to be writing to you today as CEO of The Tax Institute. Having been a member of the Institute for the majority of my career, many of you know me well and know how sincere I am about making fellow members proud in this role.

I'd like to thank our President, Marg Marshall, our National Council, and our Board for their support. They are a talented and passionate group of people who have the Institute's best interests at heart and front of mind. Backing from them is much appreciated as I lay out a vision for the future that aligns with our overarching organisational strategic plan.

I'd also like to thank those members who have kindly reached out to welcome me to the role. Your support and confidence in my appointment are the best endorsement I could ask for.

Centring your voice in the tax conversation

One of the greatest – if not the greatest – assets that The Tax Institute has is our members.

Tax as a specialty is broad and nuanced, touching every aspect of our economy. We are incredibly lucky to have a membership that spans all facets of tax and includes experts from across the array of tax specialties. We are also fortunate that our members are so generous with their time and insights.

The Tax Institute needs to be equally generous in giving time, effort and resources to listen to all of our members. To me, the number one priority in how we now set a direction for the Institute is that we listen to all voices and take a balanced and considered approach. As an organisation, we are proud of the diversity in our membership. Our membership is unique, comprising accountants, lawyers, academics, in-house tax practitioners and government employees. While we represent varying sizes of organisations, two-thirds of our members operate in the SME and microbusiness sectors. These segments of our membership alone represent an incredible array of diverse thought and experience, an understanding of which should be at the forefront of any vision for our future.

We are currently reviewing numerous options to better engage you on a personal level and to ensure that your voice is heard. Some developments may happen quickly, while others will take time and planning to implement correctly, but please rest assured that work is being done to open new lines of communication. At times, we may call on your support to assist our initiatives, as it is through working together that we can make our Institute more effective and successful.

In the coming weeks and months, I will be working on new member engagement opportunities to enable you as members to regularly give feedback on your concerns, ideas and challenges, so they are heard and understood. Once shared with us, we will make key issues available to other members, other tax practitioners in the wider community, and regulators.

This will ensure a transparent representation of your views. Our Tax Policy and Advocacy team works tirelessly to represent your voice, and the tax system more broadly, in educating not only the profession on technical issues and tax administration, but also the regulators on the consequences of their legislative and administrative decisions across the profession and within the tax system. The diversity of our membership, all of whom we must fairly represent, gives us a unique perspective that will continue to shape our approach.

Looking forward

Over the last few weeks, I have been working closely with Clare Mazzetti, Chair of the Board and (over the past few months) our acting CEO, to ensure that the transition of leadership is as seamless as possible. I'd like to thank her for the wonderful work she has done with our Board and our internal team to put us in a stable position.

The important work that the Institute does – educating the profession, educating the government and administrators on issues and priorities within our tax system, providing opportunities and resources for professional development, and advocating for reform of the tax system – will continue. The way that we deliver on these goals will evolve for the better as we focus on listening to you and amplifying your voice.

One thing I have observed and been part of in my time as an employee of the Institute is a genuine desire to do right by our members. Our volunteers and our staff want to support you in meaningful ways. So I encourage you to get involved. The more you talk to us and tell us what matters, the better we will understand how to best support you.

I look forward to hearing from you.

Associate's Report

by Abhishek Shekhawat, ATI

Setting the framework for superannuation stability

Australia's approach to superannuation requires a re-think to ensure that it provides the necessary stability and certainty for superannuants.

Superannuation plays a fundamental role in Australia's economy to support the future needs of older Australians, with almost $3.5tr was invested. The 2023 Intergenerational Report and previous reports highlight that superannuation is intended to play a primary role in funding retirement, reducing government spending on age, and service care pensions.

Superannuants need stability and confidence in Australia's superannuation system. It can take the average wage earner many decades of making compulsory and voluntary contributions to ensure that their fund balance sufficiently supports them in their retirement. Despite the pressing need for stability, superannuation is one of the most frequently amended areas of Australia's tax and transfer system and is subject to mountains of ever-changing regulations. In 2023 alone, proposals are underway to make significant changes intended to:

- amend the non-arm's length income provisions;
- legislate an objective for future superannuation rules;
- introduce an additional 15% tax on earnings on superannuation balances above $3m; and
- implement payday super – requiring employers to pay their employees' superannuation guarantee (SG) entitlements on the same day they pay salary and wages.

There are also constant amendments to the multitude of thresholds, limits and caps. There isn't a consistent approach to their indexation or review.

Many of these changes are driven by political factors or perceived, and often subjective, notions of what is deemed "fair". Unfortunately, the constant tinkering leaves all Australians in a state of uncertainty. With the goalposts constantly shifting, it is difficult for Australians to appropriately plan and implement the most effective strategies for their future. This may even have the effect of eroding confidence in the system, inadvertently necessitating individuals to draw on their own private wealth outside superannuation or government support.

The system operates over the working life and into the retirement of superannuants, so having confidence that the rules will not change each year is paramount to building trust with the community and encouraging investment in superannuation. However, ensuring that the superannuation system remains fit for purpose should entail regular reviews and alterations of the settings, where appropriate. As highlighted in the Case for Change, many aspects of the superannuation regime are complex, inefficient and inequitable, including:

- proportionate indexation of the personal transfer balance cap;
- the draconian penalties under the SG regime for employers who are slightly late (noting that this is subject to potential reform); and
- navigating the minefield of caps, limits and thresholds.

Australia needs to address existing issues. Key to the success and effectiveness of the superannuation system is how future changes are designed, legislated, implemented and administered.

The first, and arguably most important, step is to ensure that there is timely and meaningful consultation on the policy aspects of proposed changes, not just on the mechanics of implementing proposed changes. Too often, the community is given only a few weeks to provide feedback on complex concepts and draft legislation. This can unwittingly create the perception that the consultation is not genuinely considering alternatives or the issues raised. Undertaking meaningful targeted consultation at an early stage of the process ensures that ultimate policy decisions are fully considered.

Priority should also be given to changes that promote the core principles of an effective tax and transfer system, namely, simplicity, efficiency and equity — such as the examples identified above. Changes of this nature would result in a more efficient system and promote confidence. Employers and superannuants would also be encouraged to participate and rectify errors, better serving the objectives of the superannuation system.

Changes should generally also only take effect after the legislation is enacted, allowing superannuants to better plan for the financial and administrative implications of those changes. A greater lead time would also allow the ATO to create better-timed guidance, ensure that ATO systems and processes are fit for purpose, and limit the effective retrospective impact of legislation that remains unenacted for lengthy periods.

Consideration should be given to whether amnesties are appropriate where changes reduce or otherwise negatively impact a superannuant's balance. For example, superannuants could be provided a one-off opportunity to alter their fund balances or contributions in order to limit the impacts of any change. This would ensure that people are not adversely affected by making decisions based on the law that applied at the time.

Tax News – the details

by TaxCounsel Pty Ltd

October – what happened in tax?

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

Government initiatives

1. Superannuation concessions: amendments

The government has released draft legislation and explanatory material in relation to the changes to the superannuation tax concessions that were announced in the 2023–24 Budget.

When enacted, the proposed amendments in the draft legislation will reduce the tax concessions for individuals with a total superannuation balance (TSB) above $3m by imposing an additional 15% tax on certain earnings based on the percentage of the TSB exceeding the $3m threshold. The tax is to be imposed directly on the individual and is separate from the tax arrangements of the superannuation fund or scheme. The main provisions are to be contained in a proposed new Div 296 of the *Income Tax Assessment Act 1997* (ITAA97).

For each income year from 2025–26, the Commissioner will calculate a Div 296 tax liability and notify individuals of their tax liability for a given income year. Division 296 tax is to be levied at a rate of 15% on a percentage of the individual's superannuation earnings equal to the percentage of their TSB above $3m. Division 296 tax will be levied directly on individuals and imposed separately to personal income tax and superannuation fund tax. Individuals will have the option of paying their tax liability by either releasing amounts from their superannuation or using amounts outside of the superannuation system. Tax associated with a Div 296 tax on defined benefit interest may be deferred.

Negative superannuation earnings from balances above $3m will be carried forward and used to reduce the amount of superannuation earnings subject to Div 296 tax in future income years.

The draft legislation also proposes amendments to several other Acts to include provisions relating to the calculation of earnings, withdrawals and contributions, modifications for earnings of certain constitutionally protected interests, debt deferral provisions for defined benefit interests in the pre-end benefit phase, and changes to the definition of "total superannuation balance".

Special rules for modified treatment of defined benefit and some retirement phase interests, including the valuation of such interests, is to be addressed through specific provisions in subsequent regulations.

2. PwC measures

The government has released exposure draft legislation and explanatory material in relation to the significant measures that were announced on 6 August 2023 in response to the PwC revelations.

Tax promoter penalty regime

The government will make it easier for the ATO to apply the promoter penalty laws by broadening the scope of important definitions, including:

- broadening the meaning of a "promoter" to capture those that receive "benefits" from their promotion of a scheme ("benefits" is a broader concept than the current "consideration" requirement);
- expanding the meaning of "tax exploitation scheme" to cover schemes that breach, or would breach, the multinational anti-avoidance law or the diverted profits tax rules; and
- expanding the coverage of the rules prohibiting the misrepresentation of a tax scheme's conformance with an ATO product ruling, whether the scheme is implemented or not, to all types of ATO rulings — private, public and oral rulings.

Also, the time within which the ATO can commence civil penalty proceedings related to the promotion of tax exploitation schemes or schemes not conforming to ATO rulings is being extended from four to six years. The law currently imposes no time limitation for the promotion of schemes involving tax evasion and this is to remain unchanged.

The maximum penalty under the promoter penalty laws is to be increased to the greatest of:

- 5,000 penalty units (for an individual) or 50,000 penalty units (for a body corporate or significant global entity (SGE));
- three times the benefits received or receivable (directly or indirectly) by the entity and associates of the entity in respect of the scheme;
- for a body corporate or an SGE, 10% of the aggregated turnover of the entity for the most recent income year to end before the entity engaged in conduct that contravenes the promoter penalty laws, capped at 2.5 million penalty units.

In addition, the government has tasked Treasury to conduct a comprehensive review of the promoter penalty laws to ensure that the ATO has the tools to adequately address the types of promoter activity today, that is, where tax avoidance schemes are bespoke, complex and/or operate across jurisdictional boundaries.

Whistleblower reforms

Whistleblower protections are being extended to eligible whistleblowers who wish to disclose alleged misconduct to the Tax Practitioners Board (TPB).

Also, the ATO and the TPB will be authorised to share information that they have received from whistleblowers with the Australian Charities and Not-for-profits Commission, as well as each other, where the information received relates to their regulatory responsibilities.

Tax Practitioners Board reforms

A proposed amendment will extend the period of time that the TPB has in which to conclude investigations into potential breaches of the *Tax Agent Services Act 2009* (Cth) from six months to 24 months. This time frame can still be extended further if the TPB is satisfied that, for reasons beyond its control, a decision cannot be made in 24 months.

In addition to the extension of the investigation time frame, a new option is being created for the TPB following the conclusion of an investigation. This will allow the TPB not to pursue administrative sanctions or civil penalties, and instead to publish the findings of the investigation on the TPB Register. When a TPB investigation finds that conduct has breached the *Tax Agent Services Act 2009*, it must either decide to take no further action or take one or more of the following actions:

- impose one or more sanctions;
- terminate an entity's registration;
- apply to the Federal Court for an order to pay a pecuniary penalty;
- apply to the Federal Court for an injunction; and/or
- decide that specific details about a contravening entity (defined as an entity engaged in the misconduct) must be published on the Register in accordance with the *Tax Agent Services Regulations 2022* (Cth).

The decision to publish findings of investigations on the Register will be able to be reviewed by the AAT.

Further reviews

The government has tasked Treasury with developing a package of reforms to respond to emerging fraud threats, which will improve the ATO's ability to detect, prevent and address fraud.

Also, the government has tasked the Attorney-General's Department and Treasury to jointly review the use of legal professional privilege in Commonwealth investigations, and present the government with options for possible reform.

The Commissioner's perspective

3. Self-education expense deductions

The Commissioner has released a draft ruling that sets out the principles that govern the deductibility of self-education expenses incurred by an individual under the general deduction provision (s 8-1 ITAA97), and discusses the types of expenditure that can be deductible as a self-education expense, as well as those that cannot (TR 2023/D1).

For the purposes of TR 2023/D1, self-education includes:

- courses undertaken at an educational institution (whether leading to a formal qualification or not);
- courses provided by a professional or industry organisation;
- attendance at work-related conferences or seminars; and
- self-paced learning and study tours (whether within Australia or overseas).

TR 2023/D1 is intended to be read in conjunction with TR 2020/1 which provides the foundation of the general deductibility principles for work-related expenses under s 8-1.

TR 2023/D1 does not address:

- s 8-1(1)(b), which deals with outgoings necessarily incurred by a business. The ATO considers that s 8-1(1)(a) applies to individuals when claiming self-education expenses regardless of whether they are employed, contracted, or carrying on a business; or
- substantiation and record-keeping requirements.

A partial deduction may be appropriate where only part of a taxpayer's expense is for self-education connected with their income-earning activities, or where only part of the self-education is relevant to the taxpayer's current income-earning activities.

The Commissioner considers self-education expenses to be incurred in gaining or producing a taxpayer's assessable income if either or both of the following apply:

- the taxpayer's income-earning activities are based on the exercise of a skill or some specific knowledge, and the self-education enables the taxpayer to maintain or improve that skill or knowledge; and/or
- the self-education objectively leads to, or is likely to lead to, an increase in the taxpayer's income from their current income-earning activities in the future.

Self-education expenses are not incurred in gaining or producing a taxpayer's assessable income if:

- the self-education will enable the taxpayer to get employment, to obtain new employment, or to open up a new income-earning activity (whether in business or in their current employment). This includes studies relating to a particular profession, occupation or field of employment in which the taxpayer is not yet engaged. These expenses are incurred at a point too soon to be regarded as incurred in gaining or producing the taxpayer's assessable income; or
- the taxpayer is not undertaking income-earning activities to derive assessable income at the time they incurred the expenses;

TR 2023/D1 gives a considerable number of examples, including where expenditure relates to a personal development course, a stress management course, self-education to get a new income-earning activity, or interest on a loan.

4. Composite asset: relevant depreciating asset

The Commissioner has released a revised draft ruling that sets out guidelines intended to assist in identifying the relevant depreciating asset or assets where an asset consists of a number of components (TR 2023/D2).

Identifying the relevant depreciating asset is important for working out its effective life and therefore the rate at which deductions can be claimed. A depreciating asset that is the composite item as a whole may have an effective life that is different to the effective life of any individual component or components. This enquiry may also be relevant when testing an asset's eligibility for certain immediate tax write-offs and concessions.

TR 2023/D2 sets out the Commissioner's views on:

- relevant principles to assist in determining whether a composite item is itself a depreciating asset or whether its components are separate depreciating assets for the purposes of Div 40 ITAA97 (about capital allowances); and
- whether an "interest in an underlying asset" for the purposes of s 40-35 ITAA97 requires an entity to have an interest in all parts of a composite item that is itself a depreciating asset, or whether an interest in any part of the asset is enough.

TR 2023/D2 does not address Div 43 ITAA97 which provides deductions for certain capital works expenditure. Some points from the draft ruling are set out below.

A "composite item" is an item that is made up of a number of components that are each capable of separate existence. Section 40-30(4) ITAA97 directs an objective consideration of whether a particular composite item is itself a depreciating asset, or whether one or more of its components are separate depreciating assets – it is a question of fact and degree to be determined in the circumstances of the particular case. TR 2023/D2 gives a number of examples to illustrate the propositions made in the draft ruling.

For a component (or more than one component) of a composite item to be a depreciating asset, it is necessary that the component is (or the components are) capable of being separately identified and recognised as having commercial and economic value.

Purpose or "functionality" is generally a useful guide to the identification of an item. The main principles that are taken into account when determining whether a composite item is a single depreciating asset, or more than one depreciating asset, are:

- the depreciating asset will ordinarily be an item that performs a separate identifiable function, having regard to the purpose it serves in its business context;
- an item may be identified as having a discrete function, and therefore as a depreciating asset, without necessarily being self-contained or used on a stand-alone basis;
- the greater the degree of physical or functional integration of an item with other component parts, the more likely the depreciating asset will be the composite item;
- when the effect of attaching an item to another item (which itself has its own independent function) varies the function or operational performance of that other item, the attachment is more likely to be a separate depreciating asset; and
- when various components are purchased (whether via one or multiple transactions) to function together as a system and are necessarily connected in their operation, the depreciating asset is usually the system (the composite item).

The relevant function considered in this context is the actual function that the item is to serve in the particular taxpayer's income-producing activity. Any theoretical function to which the item could be put in other circumstances is irrelevant.

A single depreciating asset is not necessarily the smallest possible component which can be identified within a composite item. Several components or parts of a composite item which work together with other components may be parts of a larger functional item, particularly where those components are integrally linked.

The fact that an item cannot operate on its own and has no commercial utility unless it is linked or connected to another item or items does not preclude it from being a separate depreciating asset. Where such items are designed to be used in a range of settings, or in conjunction with a wide range of equipment or systems, and are not acquired with other items as part of a system, this may indicate that they are separate depreciating assets.

A modification or alteration to an existing depreciating asset can itself be a separate depreciating asset. Such modifications can be of varying degrees.

TR 2023/D2 replaces an earlier draft ruling (TR 2017/D1).

5. ATO communication protocols for objections

The Commissioner has released a practice statement that sets out the framework governing the communications between ATO objection officers and officers involved in making the original decision (PS LA 2023/2).

The ATO is committed to treating all taxpayers fairly and improving their experience with the ATO when they lodge an objection. This includes objection officers being open and transparent about their decisions and decision-making processes, and providing a fair, objective and impartial review.

An objection process involves the objective and impartial reconsideration of how the law applies to the taxpayer's circumstances. This involves a balance of ensuring that decisions are made independently from the original decision-maker and that the objection officer is fully informed when coming to their decision.

When making an objection decision, the objection officer must ensure consistency and coherency in interpreting and applying the law and administration of the tax and superannuation system.

Better objection decisions are made when objection officers are fully informed through open and transparent communications. Objection officers are expected to take steps to be as informed as possible on the relevant facts, circumstances and supporting evidence. This may include engagement with the original decision-makers.

Objection officers must seek to understand the basis of the original decision and the reason it has been objected to. This should include an appropriate appreciation of the broader context of the case, including any relevant ATO strategies and risks.

PS LA 2023/2 considers: the responsibilities of objection officers; what are open and transparent communications; the responsibilities of an officer involved in the original decision-making process; and the circumstances where the ATO will modify its approach to the communication protocols.

Recent case decisions

6. GST and prepared meals

The Federal Court (Hespe J) has held that certain frozen food products supplied and imported by the taxpayer in the tax period from 1 July 2021 to 31 July 2021 were not GST-free (*Simplot Australia Pty Ltd v FCT*[1]).

A supply of "food" is GST-free pursuant to s 38-2 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99). An importation is a non-taxable importation if it would have been a supply that was GST-free (s 13-10(b) GSTA99). However, a supply is not GST-free if it is a supply of food of a kind specified in the third column of the table in cl 1 of Sch 1 to the GSTA99 (s 38-3(1)(c) GSTA99). The issue in the case was whether the frozen food products were foods of a kind specified in item 4 of that table under the category "Prepared food", being "food marketed as a prepared meal, but not including soup". Hespe J rejected the taxpayer's contentions.

At a general level, Hespe J said that an examination of the statutory context of item 4 of the table in cl 1 of Sch 1 did not reveal a coherent policy that was of assistance in the present case. One might speculate that the forms of the specific carve-outs from the rule that food is GST-free were the product of compromise and lobbying. In such circumstances, her Honour said, there was a danger to attempt to construe the items by reference to some supposed legislative purpose rather than solely by reference to the text. Hespe J then went on:

> "94. … There is, for example, no clear rationale as to why soup marketed as a prepared meal should be GST-free but other types of food not. It is not clear why food sold unrefrigerated in vacuum-sealed or canned form is not GST-free but the same sort of food (e.g. Irish stew) sold in frozen form is subject to GST. The issue for determination in this case is not assisted by reference to a concept of food being 'sufficiently basic'. Rather the words are to be construed in accordance with their ordinary meaning."

Hespe J considered issues that were raised by the expressions "food of a kind", "marketed as" and "prepared meal". After considering each product in question and concluding that each involved a prepared meal, her Honour said:

> "141. The legislative scheme with its arbitrary exemptions is not productive of cohesive outcomes. It has left the Court in the unsatisfactory position of having to determine whether to assign novel food products to a category drafted on the premise of unarticulated preconceptions and notions of a 'prepared meal'. It may be doubted whether this is a satisfactory basis on which taxation liabilities ought to be determined."

7. Div 7A loan issues

In a recent decision, the AAT has held that a private company which was presently entitled to income of a discretionary trust that remained unpaid did not make a loan to the trust within the definition of "loan" that applies for the purposes of Div 7A of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) (*Bendel and FCT*[2]).

The discretionary trust was the Steven Bendel 2005 Discretionary Trust (the 2005 Discretionary Trust) and the private company beneficiary was Gleewin Investments Pty Ltd. For each of the 2013 to 2016 income years, Gleewin Investments Pty Ltd became presently entitled to income of the 2005 Discretionary Trust. This led to the emergence of unpaid present entitlements to the income of the 2005 Discretionary Trust for those years.

Clause 3(5) of the trust deed that established the 2005 Discretionary Trust provided:

> "Any amount set aside for any beneficiary … shall cease to form part of the Trust Fund and upon such setting aside … shall thenceforth be held by the Trustee on a separate trust for such person absolutely with power to the Trustee pending payment over thereof to such person to invest or apply or deal with such Fund or any resulting income therefrom or any part thereof in the manner provided for in Clause 6(5) hereof."

And cl 6(5) provided that:

> "where the Trustee holds any amount upon separate trust for any person pursuant to Clauses 3(5) … but the amount is left in the hands of the Trustee [the Trustee may] invest on behalf of such person that amount and the resulting income thereof in any of the investments hereby authorised …at any time or times and from time to time in their absolute discretion resort to such amount and the income thereof and pay apply or deal with the same or any part thereof (but not so as to infringe the rule against perpetuities) in such manner as the Trustee in its absolute discretion thinks fit for the benefit of such person in the terms of the powers contained in sub-clauses (3) and (4) of this Clause."

A basic issue that arose for decision was whether the non-payment of an unpaid present entitlement could constitute a loan as defined for the purposes of Div 7A.

The AAT acknowledged that the definition of a "loan" in s 109(3) ITAA36 that applies for the purposes of Div 7A uses very wide language. However, the statutory settings where a similar definition of "loan" has been given a wide or ambulatory construction did not have an equivalent to the former s 109UB ITAA36 and the current Subdiv EA ITAA36.

The AAT also said that, to accept the Commissioner's proposition that there was a loan to the trustee meeting the terms of s 109D(3) feeding into an assessable dividend through the combined operation of Div 7A, s 44 and Div 6 ITAA36, raised the spectre of taxing two people in respect of precisely the same underlying circumstance, namely, the same unpaid present entitlement. Two people would be taxed, one through Div 6 and the other through Div 7A, where a trustee has an unpaid present entitlement to a corporate beneficiary of the trust and, within the prescribed time frames, the trustee has lent money to a shareholder of that corporate beneficiary (or to an associate of such a shareholder). If that same shareholder or shareholder's associate were the relevant beneficiary of the trust, and properly taxed under Div 6, that person would have two amounts included in assessable income and would not be saved by s 6-25 ITAA97.

The AAT rejected the contention that Subdiv EA did not apply in the present circumstances because the relevant unpaid present entitlements were held on a separate trust, with the entitlement to income of the 2005 Discretionary Trust being satisfied or paid.

The AAT said that the Subdiv EA pathway to a Div 7A assessable dividend was not intended to create a second taxable dividend in addition to a s 109D ITAA36 dividend arising out of the same unpaid present entitlement. Nor was Subdiv EA expressed or intended to operate in a limited way, only taxing those circumstances that fell within its terms which did not otherwise fall within s 109D, for example, because the corporate beneficiary was unaware of the unpaid present entitlement and therefore could not be said to have taken any steps that might be said to be a loan attracting s 109D.

After referring to the various considerations that it saw as relevant, the AAT said that:

> "101. … the necessary conclusion is that a loan within the meaning of s 109D(3) does not reach so far as to embrace the rights in equity created when entitlements to trust income (or capital) are created but not satisfied and remain unpaid. The balance of an outstanding or unpaid entitlement of a corporate beneficiary of a trust, whether held on a separate trust or otherwise, is not a loan to the trustee of that trust."

It will be appreciated that the decision of the AAT in this case is in conflict with the Commissioner's views as to the operation of Div 7A where an unpaid present entitlement of a beneficiary of a trust remains unpaid. For the Commissioner's expression of his views, see TD 2022/11 which replaced TR 2010/3 (withdrawn).

It is to be hoped that this conflict is resolved as quickly as possible.

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References

1 [2023] FCA 1115.

2 [2023] AATA 3074.

Tax Tips

by TaxCounsel Pty Ltd

Vacant land deductions

The Commissioner has released a final ruling in relation to the statutory restrictions on deductions relating to the holding of vacant land.

Background

The enactment of s 26-102 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) by the *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019* implemented a 2018–19 Budget proposal that, from 1 July 2019, the integrity of the tax system would be improved by denying certain deductions for expenses associated with holding vacant land.

It was officially stated that this measure was intended to address integrity concerns that deductions were being improperly claimed for holding vacant land (for example, deductions for interest expenses) where the land was not genuinely held for the purpose of earning assessable income. As the land was vacant, there was often limited evidence about the taxpayer's intent, other than statements by the taxpayer. The reliance on a taxpayer's assertions about their current intention led to compliance and administrative difficulties.

It was also stated that the measure would reduce tax incentives for land banking, which denies the use of land for housing or other development.

The Commissioner has recently released a final ruling that explains his view of the application of, and the exclusions from, s 26-102 (TR 2023/3). The ruling has an appendix that sets out a practical administration approach to assist taxpayers in complying with s 26-102.

Section 26-102 raises issues of some complexity, but this article is confined in its scope to the aspects of the section considered in TR 2023/3.

Apart from the example attributed to the explanatory memorandum, the examples in this article (including their numbers) are from TR 2023/3.

For convenience, s 26-102 is also referred to as the "vacant land deduction provision".

Broad function of s 26-102

Broadly, s 26-102 denies a deduction for losses or outgoings relating to holding land on which there is no substantial and permanent structure in use or available for use. In certain circumstances, the taxpayer may be excluded from the operation of the section, for example, if the land is used in carrying on a business, the taxpayer leases the land to an entity carrying on a business, the land is held by a primary producer, or the taxpayer is a particular kind of entity.

The denial of deductions provided for by s 26-102 applies in relation to losses or outgoings incurred on or after 1 July 2019, regardless of whether the particular land was acquired before, on, or after 1 July 2019).

CGT implications

An amount that is not an allowable deduction because of the operation of s 26-102 could potentially qualify to be included in the third element of the cost base of the land for CGT purposes, provided the land was acquired after 20 August 1991.[1] However, the amount would not be included in the reduced cost base of the land.[2]

Affected entities

Not all kinds of entity are affected by the vacant land deduction provision. The most fundamental question in a particular situation is, therefore, whether the particular entity seeking to claim a deduction is of a kind that is affected.

The specifically excluded entities *include*:

- a corporate tax entity (for example, a company);
- a superannuation plan (other than a self-managed superannuation fund); and
- a unit trust or partnership of which each member is an entity that is an excluded entity.[3]

Any entity that is not of a kind that is excluded is potentially affected by the vacant land deduction provision. For example, a trust other than a unit trust that falls within the last bullet point above will be potentially affected, even if it has a corporate trustee.[4]

The operative provision

The main operative provision of s 26-102 is subs (1) which reads as follows:

> "**26-102 Expenses associated with holding vacant land**
>
> Limit on deduction
>
> (1) If:
>
> (a) at a particular time, you incur a loss or outgoing relating to holding land (including interest or any other ongoing costs of borrowing to acquire the land); and
>
> (b) at the earlier of the following (the ***critical time***):
>
> (i) that time;
>
> (ii) if you have ceased to hold the land — the time just before you ceased to hold the land;
>
> there is no substantial and permanent structure in use or available for use on the land having a purpose that is independent of, and not incidental

to, the purpose of any other structure or proposed structure;

you can only deduct under this Act the loss or outgoing to the extent that the land is in use, or available for use, in carrying on a business covered by subsection (2) at the time applying under subsection (3).

Note 1: The ordinary meaning of structure includes a building and anything else built or constructed.

Note 2: The land need not be all of the land under a land title."

For the purposes of applying subs (1), the time applying under subs (3) is generally the critical time.[5] Provision is made for the situation where the particular business referred to in subs (1) has ceased before the critical time.

Carrying on business exclusion

The vacant land deduction provision does not limit deductions for holding costs of vacant land to the extent that the land is in use, or available for use, in carrying on a business for the purpose of gaining assessable income of the taxpayer, the taxpayer's affiliate, any entity of which the taxpayer is an affiliate, the taxpayer's spouse, the taxpayer's child under the age of 18, or an entity connected with the taxpayer.[6]

In addition, the vacant land deduction provision does not apply to limit deductions where the land is leased at arm's length to another entity and that land is used, or available for use, by that entity in carrying on a business.[7]

Where vacant land has mixed uses, the vacant land deduction provision will not apply to limit a deduction to the extent that the land is in use, or available for use, in carrying on a business. If only part of the land is used, or available for use, in carrying on a business, the taxpayer will need to apportion the holding costs on a fair and reasonable basis in the context of that use. An example of this is given in example 13 of TR 2023/3.

Property developers will generally not be affected by the vacant land deduction provision provided they are carrying on a business. There is no requirement for the land to be in active use in the business. Land held by a developer for future development would be considered "available for use".[8]

However, where the land is held separately from the property development business, for example, by a special purpose vehicle, regard must be had to whether the special purpose vehicle is subject to the limitation in s 26-102(1).

Example 8. Carrying on a business

The John and James Smith Partnership operates a property development business and, as part of its business, acquires land in preparation for the development of a new apartment complex. As the land is being used in carrying on a business,[9] s 26-102(1) does not limit the holding costs that can be deducted by the partnership. It does not matter whether the land is being developed currently or is being held for future development.

Example 9. Land used in family business

Amanda owns 1,000 hectares of bare cropping land over multiple titles. Amanda leases her land to a trading entity that is controlled by her parents. The trading entity runs a business selling the produce from the land. Amanda is employed by the trading entity but is not an affiliate of, or connected with, the trading entity. Assuming that Amanda is neither "connected with" nor an "affiliate" of the trading entity and that the rent on the land is at market value, the exception in s 26-102(9) applies to Amanda as the lease was a result of an arm's length dealing and the lessee is using the land in carrying on a primary production business. Accordingly, the vacant land deduction provision will not prevent Amanda from claiming deductions in relation to her land.

Primary production exclusion

The vacant land deduction provision does not limit a taxpayer's deductions for holding costs of vacant land where the taxpayer or a related entity carries on a primary production business (as defined in s 995-1(1) ITAA97) and the taxpayer leases, hires or licenses the land to another entity. For this exception to apply, the land must not contain residential premises (including residential premises that are under construction).[10]

Example 10. Land held in carrying on a primary production business

A family trust holds 200 acres of farming land and carries on a business of primary production. The trustee leases 10 acres of vacant land on commercial terms to a family member for their personal use. Section 26-102 does not limit any otherwise deductible holding costs that the trustee can claim in relation to the land used by the lessee because of the exception in s 26-102(8).

To the extent that

The use of the expression "to the extent that" in s 26-102(1) requires an apportionment of the use of the land and, hence too, of a loss or an outgoing by reference to the use or availability for use of the land in appropriate circumstances. The relevant explanatory memorandum gives the following example:

"Howard owns one hectare of land in Queensland. He uses one third of the land for carrying on his firewood sales business. He stores all his firewood in the open and there are no structures on the land. Howard has set aside the remainder of the land to construct a rental property. The remaining part of the land is separately fenced off and has been subject to site work including earthworks to clear the land ready for construction.

Howard is eligible to claim losses and outgoings relating to holding the part of the land that he uses for carrying on his firewood business, to the extent that the loss or outgoing is necessarily incurred for the purpose of gaining or producing the assessable income.

The remainder of his land is not used or held available for use in carrying on his firewood business. Further, as there are no structures on Howard's land, it cannot contain a building or other structure that meets the requirements of [s 26-102]. As a result, Howard is not entitled to claim any deductions relating to the costs of holding this part of the land even though he intended to derive income from it in the future as a rental property."

Basic tests

Leaving aside the issues that arise out of the kind of entity, the carrying on of a business and the primary production exclusions,[11] the following three tests determine whether the vacant land deduction provision applies to a land holding:

1. Is there a substantial and permanent structure on the land?
2. If there is a structure, is it in use or available for use?
3. 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?

Substantial and permanent structure

The Commissioner's view in TR 2023/3[12] is that a substantial structure is a structure that is significant in size, value or some other criteria of importance in the context of the property, and that, to be permanent, a structure needs to be fixed and enduring. Also, the Commissioner must consider whether any substantial and permanent structure has an independent purpose in the context of the land on which it is located. Structures that have the purpose of increasing the utility of another structure are not considered independent.

For example, in the context of primary production, fencing, silos and sheds are substantial and permanent structures that serve independent purposes. By contrast, in the context of residential land, fencing or a garage (although substantial and permanent structures) do not have a purpose independent of the residence. Rather, the purpose of these structures is to increase the utility of any existing or proposed residence on the land.

Example 1. Manager's residence

Jamilla owns a 100-hectare block of farmland on a single title that includes an established house previously used as a manager's residence. The house is currently vacant but is capable of being occupied.

The house is a substantial and permanent structure with an independent purpose that is not incidental to the purpose of any other structure. It enables someone to live on the land and oversee farming activities.

Section 26-102(1) does not apply to deny a deduction for the holding costs in relation to the land as the land is not vacant. This is the case even though the area that contains the home is minimal compared with the farming land.

Example 2. Residential vacant land

Lien owns a vacant block in a residential area on which she intends to build a rental property. The block is fenced on three sides and has a small shed. Lien stores tools and equipment in the shed to maintain the block. The fence and shed are not substantial and permanent structures with a purpose that is independent of any other proposed structure on the residential block. They exist to support the use and function of the proposed rental property. For the purposes of s 26-102(1), the land is considered vacant, and deductions for the costs of holding the land are denied.

Structure in use or available for use

In addition to there being a permanent and substantial structure on the land, s 26-102(1) requires the structure to be "in use or available for use". The purpose of the structure will partly determine what "in use or available for use" means in context.

In the context of premises that are capable of being occupied (whether residential or commercial), those premises will be considered available for use unless they have been deemed unsafe to occupy by a council, relevant body or relevantly qualified professional.

Residential premises[13] constructed or substantially renovated while the taxpayer holds the land must be "lawfully able to be occupied",[14] and this would occur when the certificate of occupancy (or other local council approval) is received. They must also be leased, hired or licensed, or available for lease, hire or license.[15]

Example 3. Demolishing an established house

Arun purchased an established house which he has used as a rental property for several years. On 1 July 2019, he decides to demolish the existing house to build a townhouse. The tenants vacate the property in October 2019. The house is demolished in December 2019. The property was in use or available for use until the date of demolition. Any holding costs that Arun may otherwise be entitled to deduct until the property was demolished would not be limited by the vacant land deduction provision.

Example 4. Existing residential premises that are not in use or available for use are demolished

Continuing from example 3, the tenants vacate the property in October 2019 because the residential premises have been declared by the local council as being structurally unsafe to occupy. Arun demolishes the property in December 2019. Any holding costs that Arun would otherwise be entitled to deduct from October 2019 when the residential premises were not legally able to be occupied would be limited by the vacant land deduction provision as the house is not "in use or available for use".

Example 5. New construction

Harry purchases vacant land on 1 July 2019 and builds a house on the land. He obtains an occupancy certificate on 9 February 2020. Harry lists the property with a real estate agent for lease on 1 March 2020. Any holding costs that Harry would otherwise be entitled to deduct from 1 March 2020 will not be denied by s 26-102 as, from this date, the house is lawfully able to be occupied and is available for lease.

Loss or outgoing relating to holding land

Where the vacant land deduction provision potentially applies, the most basic requirement for the provision to apply is that the taxpayer "incurs a loss or outgoing relating to holding land" (s 26-102(1)(a)). It is expressly provided that this includes interest or any other ongoing costs of borrowing to acquire the land. Other relevant outgoings would include council rates and land tax.

The expressions "loss or outgoing" and "incurred" are fundamental to the operation of the general deduction provision,[16] and it would seem to be clear that the meanings of the expressions that have been adopted in relation to the general deduction provision would be relevant for the purposes of applying s 26-102.

In the context of s 26-102, the Commissioner does not consider the costs of repairing, renovating or constructing a structure on the land, or any interest or borrowing costs (to the extent that they are associated with repairs, renovation or construction), to be a loss or an outgoing related to holding land.[17]

Example 6. Interest expense for multiple purposes

Giovanna takes out a mortgage to purchase a vacant block of land in September 2019. Giovanna intends to build a house on the land (which she will rent out). Giovanna does not carry on a business. Giovanna takes out a separate loan for the construction of the house. Giovanna will not be able to claim a deduction for her interest expense which relates to acquiring the land until the house is lawfully able to be occupied and leased or available for lease. If a deduction is otherwise available for the construction loan interest expense, Giovanna will not be prevented from deducting the expense by s 26-102.

Interest incurred after land is sold or business activity has ceased

TR 2004/4 considers the deductibility of interest expenses incurred before income-earning activities have begun and after they have ceased.

Paragraphs 10 and 11 of TR 2004/4 note that, where interest has been incurred over a period after the relevant borrowings (or assets representing those borrowings) have been lost to the taxpayer and relevant income-earning activities (whether business or non-business) have ceased, it is apparent that the interest is not incurred in gaining or producing the assessable income of that period or any future period. However, the outgoing will still have been incurred in gaining or producing the assessable income if the occasion of the outgoing is to be found in whatever was productive of assessable income of an earlier period.

If the land is sold, the critical time for considering the application of s 26-102 to deductible expenses is just before the taxpayer ceased to hold the land.[18] The interest will continue to be deductible if the land was not vacant immediately before the taxpayer ceased to hold the land.

If the taxpayer ceases to carry on a business and a cost of holding vacant land relates to an earlier time or period, the expense will still be deductible to the extent that the land was being used to carry on a business at that earlier time or period.[19]

Example 7. Land vacant immediately before sale

Michael owns a residential investment property which he constructed on vacant land that he purchased. Michael decides to sell the property and, on the advice of his real estate agent, he waits until the tenants move out in order to offer vacant possession to potential buyers. The residential premises are the only substantial and permanent structure on the land.

Pursuant to s 26-102(4), once the current lease ends, the structure is disregarded and the land is considered vacant for the purposes of s 26-102(1). Any interest expense associated with purchasing the land is not deductible from the time the premises are no longer leased, or available for lease, and will not be deductible after the property has sold.

However, interest expenses associated with the construction of the residential premises is not a cost of holding land and will be deductible after the property has sold if it continues to be incurred and is otherwise deductible in accordance with TR 2004/4.

Relevant area of land

The particular loss or outgoing will determine the area of land that is relevant for the purposes of s 26-102.

TR 2023/3 points out[20] that, in most cases, holding costs will relate to land covered by a single property title, in which case, the relevant land will be the land under that title. However, some holding costs may relate to only part of the land under a property title, while others may relate to land covered by multiple titles.

If a loss or an outgoing relates to only part of the land under a property title, then, for the purposes of determining whether there is a substantial and permanent structure on the land, it is sufficient that such a structure exists somewhere on that part of the land.[21] The structure does not need to take up all of that part of the land or all of the land under the property title.

Similarly, if a loss or an outgoing relates to land held under multiple titles, the taxpayer would need to determine whether that land contains a substantial and permanent structure. Again, it will be sufficient that such a structure exists somewhere on the area of land to which the loss or outgoing relates.

Example 11. Multiple titles, residential premises

James purchases a vacant block of land in October 2019 and subdivides the block into two lots shortly thereafter (lot A and lot B). James intends to build a new house on each of the new lots (which he will rent out). James does not carry on a business and each of the lots is on a separate title. The house on lot A is completed in August 2020 and the certificate of occupancy is issued in September 2020. James immediately lists the house for rent with a local real estate agent.

James first needs to distinguish between holding costs that relate to the individual titles (such as council rates) and holding costs that relate to both titles (such as interest on the loan obtained to purchase the land). James needs to consider, for each cost, whether s 26-102 applies to limit any deductions that would otherwise be available.

Holding costs associated only with lot B will not be deductible as the land remains vacant and s 26-102 applies. Holding costs associated with lot A are not deductible until September 2020 when the house can be lawfully occupied and is available for lease. Holding costs associated with both lots will not be deductible until September 2020.

Example 12. Multiple titles where all land titles are used in carrying on a business

A family trust holds 10,000 hectares of farming land. The land is on five separate titles which are not co-located. The land is leased, at arm's length, to Allan and Mary who, in partnership, carry on a wheat-growing business on the land. Allan and Mary have reduced their capacity to farm the land over several years. In the current year, they have left two of the five titles to rest because access to external water sources on those titles is expensive. Section 26-102 does not limit any otherwise deductible holding costs that the trustee can claim in relation to the land used by the partnership in carrying on its wheat-growing business. The exception in s 26-102(9) applies, even though two of the individual titles are not presently being used, because they remain available for use in carrying on a business.

Example 13. Multiple titles where only some of the land titles are used in carrying on a business

Continuing from example 12, rather than leaving the two titles of land to rest, the trustee as owner of the land terminates the lease in relation to those titles so that it

Example 13. (cont)

can construct a residential rental property on each title. The exception in s 26-102(9) does not apply to those two titles of land as they are no longer leased and available for use in carrying on a business.

Assuming that the trustee is not in the business of property development, it will need to apply s 26-102 to each holding cost to determine whether the provision limits any otherwise deductible holding costs associated with the vacant titles. The trustee will also need to determine when the two titles cease being used or available for use in carrying on a business so that, if necessary, any expenses can be apportioned. Any apportionment should be done on a fair and reasonable basis. Once the residential premises are complete and the conditions in s 26-102(4) are satisfied, any otherwise deductible holding costs would no longer be limited by s 26-102.

Commissioner's compliance approach

The appendix to TR 2023/3 sets out a practical administration approach to assist taxpayers in complying with the vacant land deduction provision. The appendix does not form part of the binding ruling. However, provided a taxpayer follows the advice in the appendix in good faith and, in accordance with the binding section of the ruling which is set out above, the Commissioner will administer the law in accordance with the administrative approach.

Newly-constructed property temporarily unavailable for lease, hire or license

The Commissioner recognises that there will naturally be short periods of time when residential premises are unavailable for lease, hire or license 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.

These circumstances are outside the contemplation of s 26-102(4) and the ATO will not apply resources to review compliance with s 26-102(4) provided the taxpayer continues to meet the requirements for deductibility under s 8-1 or another provision of the tax law.

Example 14. Short absence to undertake repairs

Mohammad owns a residential rental property that he constructed on land that he holds. The tenants vacate the property, leaving minor damage to some of the walls and fixtures. Mohammad is keen to maximise the amount of rent from the property and decides to repair the damage to the property before relisting it for rent. The property is off the market for four weeks while the

Example 14. (cont)

repairs are undertaken. Mohammad's intention is always to lease the property and his holding costs remain deductible under s 8-1. This short period of vacancy is a normal incidence of the transition between tenancies. In these circumstances, the Commissioner would not seek to apply compliance resources to determine whether s 26-102(1) applies to deny Mohammad's deductions for holding costs during the vacant period.

Determining if a lessee is using land to carry on a business

The Commissioner accepts that, when leasing vacant land to an unrelated 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 an unrelated entity, the taxpayer should make a reasonable assessment of the other entity's use of the land. The appendix, by way of illustration, lists some possible relevant considerations.[22]

This compliance approach is designed to give a taxpayer confidence that, if they make a reasonable assessment that the lessee is carrying on a business having regard to these factors, and where the land is leased to an unrelated entity, the Commissioner will not allocate additional compliance resources to determine whether a lessee is carrying on a business for the purposes of s 26-102(1) and (9), except to confirm that the taxpayer's assessment is reasonable.

Example 15. Lease to an unrelated entity in business

Jill is a retired primary producer. She owns a 2-acre paddock that is completely vacant. Jill enters into a formal agreement with an unrelated entity to lease the land. The lease agreement outlines the lessee's intention to store excess farm machinery and appliances on her land, for use in their farm equipment sales and repairs business. The lease amount is commensurate with normal commercial rates. Based on these factors, Jill makes a reasonable assessment that the lessee is using the land in the course of carrying on a business.

Observations

It will be appreciated that, like many legislative interventions into the tax law, the vacant land deduction provision is capable of giving rise to significant issues, and practitioners must be vigilant to identify situations where the possible operation of the provision may need to be considered.

One point to note is that s 26-102 can, by its terms, apply in relation to a loss or an outgoing. While in most, if not all, cases it will be apparent whether there is an outgoing, it is not clear in what circumstances there would be a loss that could be relevant.

TaxCounsel Pty Ltd

References

1 S 110-25(4) ITAA97.
2 S 110-55 ITAA97.
3 S 26-102(5) ITAA97. The other excluded entities are managed investment trusts and public unit trusts.
4 S 26-102 ITAA97 uses the term "you" which means that the section applies to entities generally, unless its application is expressly limited (s 4-5 ITAA97). A trust is a different entity to the trustee in its own right (s 960-100 ITAA97).
5 S 26-102(3) ITAA97.
6 S 26-102(1) and (2) ITAA97. The expressions "affiliate" and "connected entity" take the meanings they have under ss 325-130 and 325-125 ITAA97.
7 S 26-102(9) ITAA97. This exception will not apply if the land contains residential premises, or such premises are being constructed on it.
8 Para 39 of TR 2023/3.
9 It is assumed that the carrying on business requirement noted above is satisfied.
10 S 26-102(8) ITAA97.
11 It should be noted that there is also an exclusion that may apply where a structure is affected by natural disasters or other exceptional circumstances: see s 26-102(6) and (7) ITAA97.
12 Paras 7 to 10 of TR 2023/3.
13 As defined for the purposes of GST.
14 S 26-102(4) ITAA97.
15 S 26-102(4) ITAA97. See paras 20 to 22 of TR 2023/3.
16 S 8-1 ITAA97.
17 See para 26 of TR 2023/3.
18 S 26-102(1)(b)(i) ITAA97.
19 S 26-102(3) ITAA97.
20 Para 46 of TR 2023/3.
21 Para 47 of TR 2023/3.
22 Para 62 of TR 2023/3.

Mid Market Focus

by Troy Smith, HLB Mann Judd

Early-stage innovation company scheme

The early-stage innovation company tax incentives aim to encourage investment in Australian start-ups by offering incentives to eligible investors.

Investor benefits

The early-stage innovation company (ESIC) scheme provides eligible investors who purchase new shares in an ESIC with:

- a non-refundable carry forward tax offset equal to 20% of the amount paid for their eligible investment (a cap on the offset applies, depending on whether the investor is a sophisticated or an unsophisticated investor);
- exemptions from tax on capital gains where the purchased shares are held for a period of more than one year and up to 10 years; and
- a market value cost base from the 10th year onwards.

For an investor to be eligible for the ESIC tax incentives, they must receive shares in a company which meets the components of an ESIC immediately after the shares have been issued (the "test time").

As a result of the investor benefits, early-stage investors are increasingly interested in whether innovative companies are eligible ESICs.

The ESIC tax incentives are a self-assessment scheme. Company management must research the incentive and make a diligent assessment of whether they are able to register as an ESIC.

When is a company innovative?

To be an eligible ESIC, a company needs to be an innovative company in its early stages, with high-growth potential, a geographically broad offering, and the ability to scale-up.

Eligibility as an ESIC can be a complex issue, with various factors to consider. This article discusses the ESIC incentive and how to meet the eligibility requirements, with a focus on the information required to satisfy the principles-based innovation test.

Section 360-40(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) states that an Australian unlisted company will be "innovative" where either: at the test time (being the time immediately after the relevant equity interests are issued), the company has at least 100 points under s 360-45 ITAA97 (the 100-point innovation test); or the company satisfies the principles-based innovation test under s 360-40(1)(e) ITAA97.

To qualify as an ESIC, a company must meet the following tests:

1. the early-stage test; and
2. either of the following "innovation limbs":
   a. the 100-point innovation test; or
   b. the principles-based innovation test.

The early-stage test

Under s 360-40(1)(a) ITAA97, the early-stage test requires a company to meet all of the following requirements:

- the company must have been incorporated in Australia less than three years prior to the date the shares were issued (the test time). If the company has been incorporated for three or more years, it may still satisfy the early-stage test if the following two requirements are met:
  - the company was incorporated less than six years prior to the issue of the shares; and
  - the company and its wholly owned subsidiaries had expenses of $1m or less across the last three income years;
- the company, and its wholly owned subsidiaries, must have had total expenses of $1m or less in the tax year prior to the issue of the shares;
- the company, and its wholly owned subsidiaries, must have had assessable income of $200,000 or less in the tax year prior to the issue of the shares. If the company received an accelerating commercialisation grant in that year, this would be disregarded; and
- the company cannot be listed for quotation on any stock exchange, either in Australia or a foreign country.

The 100-point innovation test (objective)

The first of the innovation tests is the 100-point test, which allows a company to obtain points based on meeting certain objective criteria. Each criterion is awarded a certain number of points. If the company obtains at least 100 points under this test, it will qualify as an innovative company for the purposes of the ESIC tax incentives (see Table 1).

The principles-based innovation test (subjective)

If a company is unable to meet the 100-point test, under s 360-40(1)(e) ITAA97, a company *must meet each* of the following five components to be considered an ESIC:

1. the company is genuinely focused on developing for commercialisation one or more new, or significantly improved, products, processes, services or marketing or organisational methods (component 1);

2. the business relating to those products, processes, services or methods has a high growth potential (component 2);
3. the company can demonstrate that it has the potential to be able to successfully scale that business (component 3);
4. the company can demonstrate that it has the potential to be able to address a broader than local market, including global markets, through that business (component 4); and
5. the company can demonstrate that it has the potential to have competitive advantages for that business (component 5).

Component 1 has three concurrent elements that the company must meet. The company is genuinely focused (element 1) on developing for commercialisation (element 2) one or more new, or significantly improved (element 3), products, processes, services or marketing or organisational methods.

Examples of being genuinely focused (element 1) include:

- a company profile which is formulated for internal and external stakeholders, describing the history, product/service/innovation offering and expertise of those involved;
- statements by directors of the company documenting the intention of the company with respect to the innovation;
- the engagement of specialist staff/third parties;
- investing (or plans to invest) in equipment; and
- taking action to protect IP rights/trade secrets for the innovation.

"Developing for commercialisation" (element 2) has two limbs which need to be satisfied:

- "developing" refers to activities that show that the company is preparing for the launch of the product/process/service/method, such as:
  - proof of concept activities/prototype development/pilot testing/commercial trials;
  - why the customer wants the "innovation";
  - market research/market analysis/pathway to the addressable market;
  - a commercialisation plan; and
  - an IP strategy;
- "commercialisation" refers to the innovation and if it can create economic value and be exploited for sale through its addressable market.

Implicit on the definition of "innovation" is the requirement that the company is developing something new or significantly improved (element 3). The new or improved component is relative to the applicable addressable market for the ESIC.

"New" means novel to, or introduced to, the addressable market for the first time. "Significantly improved" means having a significant degree of improvement in relation to the addressable market but would exclude minor changes or improvements.

Table 1. Points test

Points	Innovation criteria
75	At least 50% of the company's total expenses for the previous income year constitute expenses which are eligible for the tax offset for R&D activities.
75	The company has received an accelerating commercialisation grant.
50	At least 15%, but less than 50%, of the company's total expenses for the previous income year constitute expenses which are eligible for the tax offset for R&D activities
50	The company is undertaking or has completed an eligible accelerator program.
50	A third party has previously invested at least $50,000.
50	The company has one or more enforceable rights on an innovation through a standard patent or a plant breeder's right that has been granted in Australia or an equivalent intellectual property (IP) right granted in another country.
25	The company has one or more enforceable rights on an innovation through an innovation patent or a design right or an equivalent IP right granted in another country.
25	The company has a collaborative agreement with a research organisation or university to commercialise an innovation.

The addressable market identified by the ESIC must be objective and realistic.

Component 2 refers to a company's ability to expand its market in the future, increase production and its workforce, and generate larger profits when compared to other businesses within a broad addressable market.

A company can show high growth potential via:

- evidence of interest from potential customers;
- development of strategic relationships in the market;
- development of a market strategy/plan which shows:
  - who the potential/target customers are and where they are located;
  - whether the business will attract one-off or repeat customers;
  - the potential size of the market and how it is trending;
  - the level of growth that the company projects and the drivers of this growth;
  - the research that has been undertaken (eg surveys/interviews) to support the above; and
  - the strategies that the company has in place to expand, including as a business.

Component 3 refers to a company's ability to scale-up the business through its "operating leverage". Operating leverage refers to a company's ability to expand production, which results in revenue multiplying at the same time as its operating costs are either reduced or minimally increased. This can be shown through a business plan/strategy that includes:

- cost and price modelling showing operating leverage;
- expansion strategies; and
- how the company will scale up its production to serve broader markets.

Component 4 is the ability of the ESIC to supply to broader markets, including national, multinational or global markets.

While the company does not need to have a serviceable market at the test time, it needs to be able to demonstrate that it has the capability to meet this broader than local market component. A company can show this is through having a business plan/marketing plan which addresses:

- if and how it intends to address a potential national, global or multinational market and adapt its business as it grows; and
- third-party arrangements that demonstrate potential or established relationships with suppliers, manufacturers, distributors and customers operating in the broader market that it intends to serve.

Finally, for a company to be an ESIC, it needs to be able to show that it can have a competitive advantage (component 5) and outperform its competitors (including new competitors) which will generate greater economic value for the company.

Broadly, competitive advantage can be achieved through:

- cost advantage – where the company's innovation can be produced at a lower cost or lower cost per unit than its competitors, eg the company has gained efficiencies through the use of technology in its manufacturing process;
- differential advantage – this refers to where the company's innovation is superior to that of a competitor, and it can be exhibited though a unique advantage, rarity/imitability, quality or feature;
- the level of value for customers; and
- substitutability of the advantage.

A company can show that it has a competitive advantage by addressing:

- how the company has the potential to have a competitive advantage in the market;
- how the company expects to sustain its competitive advantage; and
- identifying the barries to entry in the addressable market, and explaining how it plans to address these.

Eligibility requirements for investors/shareholders

In addition to the requirements for the company to qualify as an ESIC, the investor/shareholder must also meet certain requirements to claim the ESIC tax incentives. These requirements include:

- the shares must be purchased directly from the ESIC as newly issued shares;
- the shareholder cannot be a widely held company, or the subsidiary of a widely held company (for this purpose, a widely held company is a listed company, or a company with more than 50 shareholders);
- the shareholder cannot be an affiliate of the ESIC at the time the shares are issued;
- immediately after the issue of the new shares, the shareholder must not have interests in the ESIC which carry the right to:
  - receive more than 30% of any distribution of income or capital by the ESIC, or its connected entities; and
  - exercise, or control, more than 30% of the total voting power in the ESIC, or its connected entities; and
- the shareholder must not receive their shares under an employee share scheme, or through the exercise of a right or an option received under an employee share scheme.

A shareholder's total investment in ESICs for the income year must not exceed $50,000 unless they are a sophisticated investor.

There is no limit on the investments that a sophisticated investor can make in any year. However, the maximum ESIC tax offset which they can claim is capped at $200,000 per year.

Do I need a private ruling for ESIC eligibility?

A private ruling by the ATO is how an entity can seek the ATO's binding view on how tax laws apply to its specific situation.

Companies do not need an ATO private ruling to qualify as an ESIC. However, if the company does not pass the 100-point innovation test, an ATO private ruling, when applying the principles-based innovation test to become an ESIC, will provide assurance to the company and its investors.

If the company does not have a private ruling, and investors lodge their income tax returns to obtain the ESIC tax benefit but the ATO disagrees with the self-assessment of the ESIC, investors will not obtain the tax incentives and the directors of the company may be liable for significant penalties. It is therefore highly recommended that companies apply for a private ruling when using the principles-based innovation test to determine whether they qualify as an ESIC.

Troy Smith
Innovation Specialist
HLB Mann Judd

Higher Education

CTA3 Advisory broadens tax technical understanding

The national Dux of CTA3 Advisory for 2023 shares what this challenging subject has taught him and how his steady pace led to success.

Mitchell Bird
Manager, Deals Tax team, KPMG, Melbourne

How did you get started in tax?

I started my career as a graduate at KPMG in February 2018. As part of the graduate program, I rotated through different areas of the firm (including Deals Tax) during my first 12 months. I returned to the Deals Tax team in February 2019 and have remained in the team since then.

In terms of formal study, in 2018–19, I completed the CTA2A Advanced and CTA2B Advanced units to assist with developing my foundational tax technical understanding. During 2020–21, I completed the CA program and was admitted as a member of the Institute of Chartered Accountants. During 2022, I completed the final CTA3 Advisory subject and received the CTA designation.

What learnings from the subject do you value most?

I undertook CTA3 Advisory because I wanted to broaden my tax technical understanding and thought that the subject would provide an opportunity for me to learn about areas of the tax law I haven't yet considered in detail in professional practice. CTA3 Advisory also provided an opportunity for me to practice applying difficult tax technical concepts to case studies and receiving feedback on my work.

Have you applied this new knowledge in your work?

I have applied what I learnt, particularly some of the topics covered as part of the international tax module. As examples, I have recently considered the application of Div 855 and the interest withholding tax provisions as part of preparing written advice for clients. Both matters were covered in the international tax module of CTA3 Advisory.

How did you find CTA3 Advisory subject differed to the other Tax Institute Higher Education subjects you've completed?

I completed CTA2A Advanced and CTA2B Advanced prior to undertaking CTA3 Advisory. The key difference between the units was the significant focus that CTA3 Advisory places on applying tax technical matters to case study problems. I found drafting written advice during the semester a helpful opportunity to practice explaining how a particular area of the tax law works, applying it to a case study and considering potential alternative options/solutions.

How did you manage the additional workload required by study?

I set aside time before my normal working hours a few days per week throughout the semester to help keep on top of the subject requirements and reduce the amount of work required on weekends. I found working steadily throughout the semester made the demands of work and study less overwhelming.

What advice do you have for other tax professionals considering studying?

I found formal study helpful in developing my tax technical understanding, which has given me a more rounded knowledge to assist clients with. Given the benefits of additional study, I would encourage others to consider opportunities to study, particularly early in their careers when you have the most to learn and demands/commitments outside work might be more manageable. Carefully considering existing work and other commitments before committing to study is also very important to ensure that you don't take on more than can be reasonably managed.

Deceased estate taxation: Frankenstein's monster?

by Lyn Freshwater, Senior Tax Adviser, and Ian Raspin, CTA, Managing Director, BNR Partners

The taxation of deceased estates sits at the intersection of succession and trust taxation laws. As wills and estates become more complex, so to do the related tax issues. Given that executors may be personally liable for payment of the deceased's outstanding tax and that of their estate, the complexity can become the stuff of nightmares. Those nightmares are made worse by the general uncertainty that exists in relation to the application of the tax law and the lack of guidance from the ATO as to how it believes the law operates. With the increasingly rapid changes to people's personal circumstances, for example, through migration, greater wealth and asset mix, those nightmares are not likely to abate. This article considers some specific complexities that arise in scenarios that are not uncommon.

Overview

You could be forgiven for thinking that the taxation of a deceased estate is something that is relatively straightforward. After all, since the CGT provisions were introduced in 1985, there have not been any major changes to the relevant legislation.

While that may be true for many estates, the tax position for others can be far from clear (even akin to Frankenstein's monster). Uncertainty can arise for a range of reasons, including:

- deficiencies in the law;
- changes to related legislation;
- changes in the interpretation of the law by the courts;
- the changing personal circumstances of deceased individuals – greater wealth, asset mix, migration patterns etc; and
- a lack of guidance by the ATO as to how it believes the law applies.

This article considers some specific complexities in the following contexts:

- present entitlement and who pays the tax;
- residency of an estate and foreign resident beneficiaries;
- the main residence exemption; and
- specific legacies and life and remainder interests.

Present entitlement and who pays tax

Estate taxation overview

For tax purposes, a deceased estate is treated as a trust and the legal personal representative (LPR) a trustee.

A trust is not a separate taxable entity in the same way as a company. Rather, liability for tax on a trust's "net income" (which is essentially the amount that would be the taxable income of the trust if it were assumed that the trustee was a resident taxpayer) is allocated to the trustee or the beneficiaries depending on the "entitlement" of beneficiaries to the estate's income or capital gains.

If there is no beneficiary that is specifically entitled to the trust capital gains and there is some income to which no beneficiaries are presently entitled (or if there is no income), the trustee will be assessed on some (or all) of the net income.

While that sounds simple enough, it masks many complexities, which are considered immediately below, as well as in the "Residency of an estate and foreign resident beneficiaries" section of this article.

When is a beneficiary relevantly entitled?

Traditionally, the trust assessing provisions[1] have operated by looking at the extent to which beneficiaries are presently entitled to the income of the trust for a particular tax year. However, amendments were made in 2011 to allow for the streaming of capital gains and franked distributions.[2] The effect of the streaming rules is that beneficiaries to whom amounts are validly streamed are assessed on those amounts (with the character of a capital gain or franked distribution) and only the remaining net income is assessed under the present entitlement rules.

Present entitlement: what is income?

The "income" and "net income" of a trust are two separate concepts. As noted above, net income is a tax concept and is defined in legislation.[3] However "income" is a trust law concept.[4] Generally, the income of a trust will be determined in accordance with the trust deed. In the context of a deceased estate during administration, there is no such deed.

In the authors' experience, it is rare for a will to specify how the estate income is to be determined. Having said that, they have noticed some cases recently where a will did define the income of the estate. This may be a new trend.

If there is no definition of "income" in the will, it will take its ordinary trust law meaning (under the trust apportionment rules for income and capital entitlements). An analogy that is commonly used to distinguish income from capital is that income is like the fruit from a tree and the tree is capital. That is, interest from a bank deposit or rent from a property would be regarded as income.

Present entitlement: when is a beneficiary presently entitled to income?

A beneficiary is presently entitled to trust income for an income year if they have, by the end of that year, a present or immediate right to demand payment of the income from the trustee. The application of the rules in the context of a deceased estate is considered by the ATO in IT 2622.[5]

IT 2622 is outdated and needs to be rewritten as a matter of priority to address things like the specific entitlement rules. It was also written before the decision of the High Court in *Bamford's* case which confirmed the proportionate approach to trust taxation.

IT 2622 adopts the approach of the High Court in *Whiting's* case[6] which says broadly that a residuary beneficiary cannot be presently entitled to income until the administration of an estate is complete. However, that is qualified such that a residuary beneficiary can be presently entitled when provision has been made for the payment of debts.

Whiting's case was unusual in the sense that, although the trustees had paid the funeral expenses and death duties (and had set aside money for further duties that would arise on the death of the deceased's spouse), the trustees were not in a position to pay their share of the significant debts of a partnership of which they were a partner. Accordingly, although the trustee purported to make the residuary beneficiaries presently entitled to the estate income, it was not clear that those beneficiaries would ever be paid the amount (because of the existence of the debts). Thus, the court concluded that, although the beneficiaries had a vested interest in the residue, they could not presently demand the estate income and could not therefore be presently entitled for tax purposes.

The authors see many estates where executors refrain from paying a small debt, with a view to ensuring that tax on the estate net income is assessed to the LPR. The LPR's argument is that as all of the estate debts have not been paid, the administration is not complete, and the beneficiaries cannot be presently entitled to estate income.

However, the authors question whether this is a proper application of the test. In their view, present entitlement can exist prior to the administration as a whole being complete (since the executors can always discover other assets, it may be that administration is never really complete). The better view seems to be that the test looks to the administration of the estate vis à vis particular amounts of income. If the LPR has assented to the distribution of an amount of income to a beneficiary, the beneficiary can demand payment of it and can be presently entitled for tax purposes.

Present entitlement: proportionate approach

Under the present entitlement rules, a beneficiary who is presently entitled to a share of trust income is taxed on that same proportionate share of the trust's net income. So, for example, if a beneficiary is presently entitled to 50% of the income of a trust, they will be assessed on 50% of the net income.

The *Greenhatch*[7] case clarified the effect of the *Bamford* decision on the streaming of trust amounts. It confirmed that, regardless of the character of the amount that a beneficiary's share of income was attributable to, that character is not used to determine, in a causative sense, the components of the share of net income.

Example

A trustee derived $50,000 rent and made a $50,000 capital gain (after discount) in a year of income. The deed equated the trust income with its net income (in this case, both were $100,000).

As it was able to do under the deed, the trustee made an individual presently entitled to the capital gain and a company entitled to the rental income. The trustee assumed that the tax provisions operate such that the individual includes the $50,000 capital gain in its assessable income and the company includes the $50,000 rent in its assessable income.

The effect of the *Greenhatch* decision is that both the company and the individual have $25,000 rent and $25,000 capital gain. As the company is not entitled to the CGT discount, it is taxed on $75,000 ($25,000 rent and $50,000 capital gain). The individual's share of the net income represents a $25,000 capital gain and $25,000 rent.

Present entitlement: is presently entitled beneficiary tax-exempt?

In certain situations, a tax-exempt beneficiary may be taken to *not* be presently entitled to income for tax purposes. Anti-avoidance rules were introduced at the same time as the rules to allow the streaming of capital gains and franked distributions. While the rules were aimed at discretionary trusts, they nonetheless apply to deceased estates and testamentary trusts. So, an LPR making an exempt beneficiary presently entitled to income must ensure that they satisfy these rules.

Section 100AA. For tax purposes, under s 100AA ITAA36, a tax-exempt beneficiary is treated as not being presently entitled to the income of a trust if the trustee failed to pay or notify the beneficiary of their entitlement within two months of the end of the relevant income year. If the "pay or notify" rule applies, the trustee is taxed on the beneficiary's share of the net income.

However, the Commissioner has the discretion not to apply the rule when the trustee fails to pay or notify on time. When exercising the discretion, the Commissioner must consider the following factors:

- the circumstances that led to the trustee failing to notify or pay the amount within two months of the year end;
- the extent to which the trustee has taken actions to try to correct the failure and how quickly those actions were taken;
- whether the trustee has applied to the Commissioner to exercise his discretion previously; and
- any other relevant matters.

A search of the ATO legal database shows that the Commissioner has exercised the discretion in the following circumstances:

- the trustee had died and a new trustee could not act until probate of the deceased trustee's estate had been granted;[8]
- there was an issue about the formal identification of a beneficiary which was resolved by a Supreme Court application;[9]
- there was a miscommunication between the trustee and the financial adviser about who was to pay the exempt entity;[10] and
- the trustee did not pay or notify the entity of its entire entitlement, but the shortfall was a minor amount and represented a small percentage of the exempt entity's present entitlement.[11]

A trustee of a testamentary trust can inadvertently trigger the "pay or notify" rule. For example, on the death of a life tenant, the trustee may overlook the obligation to notify tax-exempt remainder beneficiaries of their entitlements within the two-month period after the end of the financial year.

Section 100AB. Section 100AB ITAA36 is designed to overcome the exploitation of the proportionate approach whereby a charity can be made presently entitled to all of the income of a trust so that tax can be avoided on capital that is enjoyed by another entity. This is demonstrated in the following example (taken from the explanatory memorandum to the Tax Laws Amendment (2011 Measures No. 5) Bill 2011). Without s 100AB, the income that is capitalised in the example that actually benefits Emma would not be taxed.

Example

In the 2010–11 income year, the Bell Trust generated $100,000 of rental income and $70,000 of franked distributions (with $30,000 franking credits attached). The trust had no expenses. The taxable income of the trust is $200,000 (being the $100,000 rental income, the $70,000 franked distributions, and the $30,000 franking credits).

The trust deed does not define "income" for the purposes of the trust deed. However, there is a clause that allows the trustee to treat receipts as income or capital of the trust at its discretion. The trustee determines to exercise this power to treat $95,000 of the rental receipts as capital and so the income of the trust estate is $75,000. Casey Pty Ltd, Mark and Emma

Example (cont)

are within the class of discretionary objects. Casey Pty Ltd is an exempt entity.

The trustee specifically allocates all of the franked distributions to Mark and appoints all of the remaining income of the trust estate to Casey Pty Ltd ($5,000). The trustee notifies Casey Pty Ltd of its entitlement by 31 August 2011. The trustee appoints all of the capital in respect of that year to Emma ($95,000).

Casey Pty Ltd's adjusted Division 6 percentage is 100% (($75,000 − $70,000/$5,000) × 100) as it is presently entitled to all of the income of the trust estate after disregarding the $70,000 of franked distributions to which Mark is specifically entitled. However, Casey Pty Ltd's benchmark percentage is 5% (($5,000/$100,000) × 100).

The franked distributions to which Mark is specifically entitled and the attached franking credits (because they do not represent net accretions of value to the trust fund) are excluded from the adjusted net income for the purposes of calculating the benchmark percentage.

Casey Pty Ltd's adjusted Division 6 percentage exceeds the benchmark percentage by 95%. The trustee of the Bell Trust is therefore assessed and liable to pay tax on $95,000 (0.95 × $100,000) under s 99A ITAA36. Casey Pty Ltd's share of the Bell Trust's taxable income is confined to Casey Pty Ltd's entitlement of $5,000.

Section 100AB applies if there is a difference between a beneficiary's present entitlement to trust income (as a percentage) and their present entitlement to the trust estate reflected in the trust's adjusted net income (as a percentage). The provision operates by assessing the trustee, having regard to the amount by which the percentage entitlement to the income exceeds the entitlement to the adjusted net income.

The concept of present entitlement to the trust estate (that is reflected in the adjusted net income of the trust) is relevant only for s 100AB purposes. The present entitlement can be an entitlement to income and/or capital.

"Present entitlement to trust income" is a concept that has been considered by the courts on many occasions. The High Court decision in the *Union Fidelity* case[12] determined, among other things, that:

> "12. … When a beneficiary has been paid his share of the income of the estate in respect of a tax year he no longer satisfies the description of a beneficiary who is entitled to a share of the net income of the estate for that year."

As a consequence of that decision, the ITAA36 was amended to introduce s 95A(1) which provides that a beneficiary will continue to be presently entitled to trust income, notwithstanding that it has been paid to them or applied for their benefit.

However, s 95A(1) was not amended to provide that a beneficiary's entitlement to trust capital exists for a year, notwithstanding that it has been paid to them.

So, for example, if an entitlement to trust capital was created by an executor and paid to the beneficiary before the end of the income year, it may be that there is a mismatch between the relevant percentages. As such, the executor would need to seek an exercise of the discretion in s 100AB(5) in order to avoid an assessment by reason of s 100AB.

When exercising the discretion, the Commissioner must consider:

- the circumstances that led to the difference between the Division 6 percentage exceeding the benchmark percentage;
- the extent of the mismatch between the exempt entity's adjusted Division 6 percentage and the benchmark percentage;
- the extent to which the exempt entity actually received distributions from the trust estate in respect of the year of income; and
- the extent to which the exempt entity and other beneficiaries were entitled to benefit from amounts representing the net income of the trust.

Example

Daryl is the executor of his brother Monty's will. Monty left his entire estate to a gift deductible charity.

For various reasons, including the settlement of family maintenance claims, the administration of the estate was delayed.

The income of the estate for a particular year was $250,000. The LPR also made a discount capital gain of $200,000 from the sale of a property. The net income of the trust is $350,000.

The trustee, Daryl, determines that he does not require the $450,000 for the purposes of the estate administration and makes an interim distribution to the charity before 30 June. At year end, the charity is presently entitled to 100% of the income of the trust (by virtue of s 95A(1)); however, its present entitlement to the adjusted net income may be 55% [($250,000/$450,000) x 100].

Without the exercise of the discretion, the exempt entity's entitlement to income would be taken to be 55%. Therefore, Daryl would be assessed on 45% of the net income (45% x $350,000 = $157,000).

Clearly, the case is one in respect of which it was intended that the discretion should be exercised:

- the discrepancy arose as a result of the operation of the deceased's will and the general law of succession, and the fact that there is no deemed present entitlement rule in respect of an amount of capital paid to a beneficiary during the year;
- the exempt entity will benefit from amounts attributable to the capital gain as the residuary beneficiary of the estate;
- no other entity will benefit from an amount attributable to the capital gain; and
- a similar result could be achieved by making the entity specifically entitled to the capital gain.

Specific entitlement: background

Some people think that the streaming rules for capital gains and franked dividends are as ugly as Frankenstein's monster and tend not to use them. While the provisions can appear complex, they operate in a fairly predictable fashion. As will become obvious, anyone who doesn't at least consider the provisions does so at their own peril.

The specific entitlement rules for capital gains were introduced:

- to overcome the unfairness that arises under the proportionate approach whereby a person entitled to all of the trust income for a year (say, $100) was assessable on all of the net income of the trust (say, $100,000). That is, the income beneficiary can be assessed on a much larger amount from which they will never benefit; and
- to ensure that an amount of franked dividend or capital gain allocated to a beneficiary for trust purposes had the same character for tax purposes.

For a beneficiary to be specifically entitled to a capital gain, the following conditions must be met:

- the beneficiary must have received, or reasonably expect to receive, the net financial benefits "referable to the capital gain". To have such an expectation in the context of a deceased estate, the estate administration must have reached a point where the executors do not require the "gain" amounts (not necessarily the total capital proceeds) for the payment of liabilities; and
- the beneficiary's entitlement to the amount must be "recorded in its character" as an amount referable to the capital gain in the accounts or records of the trust *by 31 August* following the end of the income year in which the gain was made.[13]

"Net financial benefit" means an amount equal to the financial benefit referable to the capital gain after the application of trust capital losses (consistent with the application of those losses for the purposes of the method statement in s 102-5 ITAA97) but before the application of the CGT discount.

Specific entitlement: example

In one case, in respect of which the authors gave advice, the executors made a capital gain from the sale of an estate asset. The proceeds of sale formed part of the estate residue and were to be divided among 10 beneficiaries; many were friends of the deceased but one was a tax-exempt hospital.

As there was no estate income in this case, the executors were prima facie liable to pay tax on the net capital gain (the capital gain after the CGT discount). That is, none of the beneficiaries could be assessed as they were not presently entitled to income by 30 June of the income year in which the capital gain arose.

One approach might have been to stream one-tenth of the capital gain to each beneficiary. Under this approach, the hospital, being a tax-exempt entity, would not have had to pay tax on its share of the gain, but the other beneficiaries would have been assessable on their share. However, when one considers that a purpose of the streaming provisions was to enable tax-effective distributions, streaming all of the capital gain to a tax-exempt entity is consistent with that purpose.

Accordingly, the executors streamed the entire capital gain to the hospital (in partial satisfaction of its entitlement under the will). As the hospital was tax-exempt, it did not pay tax on the capital gain, nor was any tax payable by the executors or the other beneficiaries (those beneficiaries' estate entitlements were not attributable to the capital gain).

In this case, the entire "estate pie" was enlarged for the benefit of all of the beneficiaries. Because the executors were not taxed on the capital gain, the residue was not reduced by tax so each of the 10 beneficiaries received more. And because the capital gain was able to be streamed entirely to the hospital, each of the other residuary beneficiary's share of the residue was not taxable.

The executors in this case (like most executors) were conservative and obtained a favourable private ruling from the ATO.

If you were to contemplate making a tax-exempt entity specifically entitled to a capital gain, you should ensure that the LPR has an express or implied power to stream capital gains. In the authors' experience, the ATO has accepted that a power of appropriation in a will, or like that in s 46 of the *Trustee Act 1925* (NSW), is sufficient to enable the streaming of capital gains by an executor.

In order to avoid the expense of having to make private ruling applications in cases like this, it is hoped that the rewrite of IT 2622 deals with the streaming rules in contexts like this.

Residency of an estate and foreign resident beneficiaries

Residency of an estate

The residency of a deceased estate for tax purposes is determined in accordance with the rules that apply for other trusts. Broadly,[14] a trust will be a resident trust estate for an income year if:

- a trustee was a resident of Australia at any time during an income year; or
- the trust was centrally managed and controlled in Australia at any time during the year.

A trust that is not a resident trust is a non-resident trust.

The residency of an estate is relevant to determining:

- the amount of net income that may be assessed to the trustee (if the trustee rather than a beneficiary is assessable on a share of the net income);[15]
- the rates of tax that may be payable by the trustee; and
- the calculation of the net income of the trust (despite the definition in s 95(1) ITAA36).

In this article, only the last point is considered further.

Non-resident trust: calculation of net income

Despite the fact that s 95(1) specifies that the net (or taxable) income of a trust is required to be calculated on the assumption that the trustee is a resident, an issue arises as to how that provision interacts with s 855-10 ITAA97 which exempts a capital gain or loss that a trustee of a foreign trust makes from an asset that is not taxable Australian property (TAP).

In TD 2017/23, the ATO concludes that, if the assumption in s 95(1) were applied for the purposes of s 855-10, the latter provision would have no operation at all in relation to foreign trusts, despite its express reference to them. This cannot have been the intention of the legislature.

Pursuant to the general rule of statutory interpretation that a specific provision overrides a general provision where there is a conflict, the ATO concludes that s 855-10 prevails. This means that, in a non-resident deceased estate, capital gains from assets that are not TAP[16] are not required to be included in the net income of a foreign trust.[17]

It is fairly clear that this produces some unintended tax outcomes where a resident individual dies and appoints a foreign person as their executor.[18] This is best demonstrated by an example.

Example

The deceased has always lived in Australia and all of the deceased's assets are there. Their estate consists of a large share portfolio with significant inherent capital gains.

The deceased's will appoints his eldest child as executor. That child moved to the United States more than 30 years ago and is not an Australian tax resident.

The estate has been left in equal shares to the deceased's three children. The other children reside in Australia.

It is proposed that the estate assets will be sold and the proceeds distributed evenly among the children.

Most people would expect that, because the deceased was a resident, capital gains from the sale of the shares (reduced by the 50% CGT discount) would be included in the "taxable income" of the estate in the year that the shares are sold and assessed to the LPR or beneficiaries (depending on whether the beneficiaries are presently entitled to income, or made specifically entitled to the capital gains). Broadly, this is the approach that would apply if the executor was a resident.[19]

However, because the estate is not resident, the effect of TD 2017/23 is that gains from the sale of the shares would not form part of the estate net income for the year the shares are sold. Further, to the extent that the proceeds attributable to the capital gain are distributed to a foreign beneficiary, the distribution will not be assessable income in Australia.[20]

The Inspector-General of Taxation, in her report on the administration by the ATO of deceased estates, recommended that the ATO explore this issue with external stakeholders, with a view to making recommendations for law change.[21] BNR Partners has raised with the ATO and government a simple approach that might address this issue. That approach is to treat the estate as having the same residence as the deceased. There is a precedent in the United Kingdom. However, to date, the idea has not gained any traction.

What is more worrying is the treatment of distributions to resident beneficiaries. The ATO is likely to treat a distribution of an amount attributable to a beneficiary's "share of the estate capital gains" as an amount to which s 99B ITAA36 applies.

Section 99B(1) includes in a beneficiary's assessable income an amount, being property of a trust, that is paid to, or applied for the benefit of, the beneficiary[22] if they were a resident at any time during the income year.[23]

There are exceptions to the application of s 99B.[24] Perhaps the most important exception is for a distribution of trust corpus. However, that exception does not apply to so much of a corpus distribution that would have been assessable had it been derived by a resident taxpayer. Accordingly, TD 2017/24 takes the view that a distribution from corpus that is attributable to a capital gain does not fall within the corpus exception.

Further, TD 2017/24 takes the view that the amount made assessable by s 99B(1) does not have the character of a capital gain for Australian tax purposes, nor is there any linkage between s 99B(1) and Subdiv 115-C ITAA97. This means that an amount which is included in assessable income under s 99B cannot be reduced by a capital loss or the CGT discount.

Section 99B was originally introduced to tax, on distribution to a resident beneficiary, amounts of trust income that had been accumulated tax-free in a foreign trust. While it has been around for a long time, the ATO has not issued any advice about how the provision applies in particular contexts (for example, is a strict tracing of funds required?). The authors understand that the ATO is working on a draft public ruling, but it is not clear when this will be released. Private rulings which BNR Partners lodged more than a year ago on the application of s 99B have yet to be issued.

Taxation of foreign resident beneficiaries

With the rates of migration that we have experienced in the last decade, it is becoming much more common for tax issues to arise in multiple jurisdictions in respect of the estate of a deceased individual. The previous section of the article highlights how a choice of executor can affect the Australian tax outcomes. This section of the article considers the treatment of foreign beneficiaries of a resident trust estate. In particular, whether such a beneficiary's share of estate capital gains from non-TAP assets is tax-free in Australia.

Sections 855-10 and 855-40

You are no doubt familiar with the Full Federal Court decisions in *Greensill*[25] and *Martin*.[26] The court found that a foreign beneficiary's share of a trust capital gain from a non-TAP asset cannot be disregarded under s 855-10 ITAA97. This view is now reflected in TD 2022/13.

While the trusts in those cases were discretionary, the reasoning appears to apply equally to a foreign beneficiary's share of the non-TAP capital gains of a resident deceased estate.

Example

Alexia was an Australian resident for tax purposes. Her will, which appointed her sister Astrid (who resides in Australia) as her executor, provided that her assets were to be sold and the proceeds distributed among her three children (Benita, Chloe and Dudley). Dudley lived overseas. The estate assets included shares in numerous companies and properties in Australia and overseas.

Astrid had sold some of the shares and the administration had reached the stage where she knew that she would not need the proceeds to satisfy estate liabilities, so she made an interim distribution of the proceeds of sale to the three beneficiaries in equal shares (making them specifically entitled to the various gains for CGT purposes).

Dudley's share of the capital gains cannot be disregarded under s 855-10. Even though the gains were attributable to non-TAP assets, they were not gains from a CGT event that happened to Dudley.

An interesting question is whether the result in the example would be different if the administration of the estate had been completed and the beneficiary entitlements had crystallised before the distributions were made.

Section 855-40 ITAA97 exempts a foreign beneficiary's share of a trust capital gain from a non-TAP asset if the trust is a fixed trust. For the purposes of the ITAA97, a fixed trust is one in which entities have fixed entitlements to all of the trust income and capital. A fixed entitlement is one that is vested and indefeasible.[27]

BNR Partners has obtained private rulings in some cases where the ATO has agreed that, in the final year of administration, the relevant estate would be regarded as a fixed trust for the purposes of that section, that is, the beneficiaries under the will would have vested and indefeasible interests in the income and capital of the trust. Accordingly, non-resident beneficiaries' shares of non-TAP capital gains were exempt under s 855-40 ITAA97.[28]

In the absence of a public ruling on the topic, the authors recommend applying for a private ruling if you find yourself in a similar situation. Be aware that the fixed entitlement test is much harder to satisfy than, for example, the present entitlement to income or specific entitlement to capital gains tests. That is because the fixed entitlement test must be satisfied in respect of all interests in the trust. Without planning, you might find that a capital gain is taken to arise in a different year than the one in which the beneficiary interests become fixed.

Section 99D

While s 99D ITAA36 has not received must attention in the past, para 22 of TD 2022/12 indicates that, in some cases, where a trustee has paid tax in respect of a foreign-sourced capital gain, a non-resident beneficiary may be able to obtain a refund of the tax under s 99D.

In broad terms, s 99D applies where a trustee of a resident trust has been assessed under s 99 or 99A ITAA36 and paid tax on a foreign-sourced amount that is subsequently distributed to a foreign beneficiary. The beneficiary must apply for a refund within 60 days of the date on which the distribution was made to them (or such further period as the Commissioner allows).

The beneficiary must satisfy the Commissioner that the distributed amount:

- is attributable to a period when the beneficiary was a non-resident (query what this means in the context of the capital gain of a deceased estate – does the beneficiary have to be a non-resident throughout the period that the LPR owned the asset; presumably, they would not have to also be a non-resident when the deceased owned the asst?);
- was taken into account when calculating the net income of the trust; and
- is not an amount to which s 100A ITAA36 applies.[29]

Any entitlement under s 99D(1) ITAA36 is subject to the discretion of the Commissioner under s 99D(2) to refuse a refund where there was a purpose of enabling the beneficiary to obtain the refund of tax.

Using the example above (under the heading "Sections 855-10 and 855-40"), if Astrid paid tax on the capital gains from the Australian shares rather than making the beneficiaries specifically entitled to the gains, Dudley would probably not be able to obtain a refund of his share of the relevant gains from the Australian shares. These gains are not likely to be foreign sourced.[30] However, s 99D could potentially apply in respect of tax that Astrid paid on capital gains from the sale of the foreign properties owned by the deceased or foreign shares.

BNR Partners has made one application for a tax refund under s 99D. The ATO took a literal reading of the provision and concluded that no refund was available to the beneficiaries because the capital gains in respect of which tax was paid by the trustee did not form part of the income of the trust estate. This interpretation puts deceased estates in a much worse position than discretionary trusts because wills have generally not modified what will be income of the estate. Will drafters may want to think about whether it is possible and advisable to give an LPR a power to treat capital gains as income of an estate.

It does seem ironic that, on the ATO view, a non-resident beneficiary of a non-fixed trust is assessable on their share of a trust capital gain from a non-TAP asset, but is entitled to a refund of tax if the trustee is assessed on the gain and the proceeds attributable to the gain distributed to the beneficiary. But that result appears to be because the streaming amendments for capital gains in 2011 which removed consideration of the source concept for s 98 purposes did not apply to s 99D.

Main residence exemption

Main residence: full exemption

At its simplest, a full main residence exemption applies to a capital gain from a dwelling that was the main residence of the deceased when they died if:

- the dwelling was not being used to produce income when the deceased died; and
- settlement of the sale of the dwelling occurs within two years of the deceased's death.

Because an LPR, and a beneficiary to whom the dwelling passes, obtain a market value acquisition cost, the effect of the exemption is really in respect of the two-year period (or such period as extended by the Commissioner) after death.

Further, a full main residence exemption can apply to any pre-CGT dwelling of the deceased (whether or not it was ever the deceased's main residence) if sold by the LPR or beneficiary in the two years after death.

It has never been explained why "pre-CGT" dwellings qualify for the main residence exemption. Originally, with the two-year period of grace being just 12 months and house prices steadier, it probably wasn't much of an issue. But if someone today dies with several pre-CGT residential rental properties in their portfolio, some real tax advantages may accrue over a two-year period.

While the main residence provisions (not unlike those for streaming) look unattractive, they contain some hidden gems.

Cost base for deceased's main residence

To save compliance costs for the LPR or beneficiary, the law was amended in 1996 to provide a cost base uplift to market value for a deceased person's main residence. Prior to that, the LPR acquired the deceased's property for the deceased's cost base and had to work out any main residence exemption, having regard to the actual use that the deceased made of the property when alive.

You can see how difficult this would have been for the LPR. Often the deceased would not have kept any cost base records (on the assumption that they would qualify for a main residence exemption), and the LPR would have little way of establishing how the deceased had used the property.

The market value cost base applies automatically (there is no choice for this) and has no regard as to how the dwelling was previously used by the deceased. It is a point in time test. The dwelling could have been a rental property for most or almost all of the ownership period. There are also no adverse consequences that apply (as is the case with, say, the absence choice), such that no other dwelling may be treated as the deceased's main residence for the period prior to death.

Example

Agatha owns two post-CGT houses, one in country Victoria which she has always lived in, and one in the Melbourne CBD which she has always rented out.

Agatha becomes ill and decides to relocate to the Melbourne CBD property to be closer to medical treatment, leaving the country property vacant. Unfortunately, after eight months, she passes away in the CBD home.

The CBD property would get a market value cost base and could be sold within two years tax-free. The country property would get an almost total main residence exemption as well, based on actual use. In some cases, it may be possible to use the "six-month two dwelling rule" in s 118-140 to get two complete exemptions.

Partial exemption: counting the days

If an LPR (or beneficiary) does not qualify for a full main residence exemption, they may be entitled to a partial exemption. The example below considers where a full exemption is not available because there was a delay of more than two years in selling the property and the Commissioner would not grant an extension of that period.[31]

Example

George acquired his main residence at the beginning of 2010 and it was still his main residence when he died at the end of 2013 (three years). When he died, the property had a market value of $2m. For the next three years, the trustee rents the property out waiting for the value to increase. The trustee then sells the property for $5m.

The market value at the date of death gives proper recognition to the dwelling's status in George's hands as a main residence. Effectively, any gain or loss arising before death is disregarded. After that, the dwelling is simply used to produce income and held to maximise the sale price.

The dwelling was not sold within two years of the date of death and the Commissioner is unlikely to agree to extend the period in these circumstances.

If you didn't know better, you might assume that the capital gain of $3m was fully taxable.

However, the partial exemption in s 118-200 appears to confer a partial exemption. That is, there is nothing in the formula which "restarts" the period of "total days" and "non-main residence days" from the time of the market value uplift.[32] There was such a provision in the ITAA36, but it seems it was accidentally not rewritten.

If you apply the provision literally, the total days are six years (in days), and the non-main residence days are three years (in days). So only 50% of the $3m capital gain is taxable!

It appears that the ATO interprets s 118-200 literally in published guidance and in private rulings, such that a double dip (a cost base uplift and an exemption for the period that the dwelling was the deceased's main residence) is available.

Whatever the answer is, and of course the ATO may be correct, it is evident that a literal approach to the law must be leading to some degree of revenue leakage from a policy perspective.

Specific legacies and life and remainder interests

Specific legacies

Background

In a straightforward case, the CGT rules[33] that apply to a post-CGT[34] asset that a person has left in their will are simple. Effectively there is a tax roll-over. That is, there is no tax payable on death or when the asset passes to the deceased's LPR or a beneficiary in their estate. Rather, the LPR and later the beneficiary are taken to have acquired the asset for an amount equal to the deceased person's cost base at the time of death. There are different cost base rules for other assets, including those that the deceased acquired pre-CGT and the deceased's main residence.

The roll-over is only for assets that the deceased person owned when they died. So, if the LPR acquires an asset during the estate administration (for example, shares may be acquired under a dividend reinvestment plan that the deceased had entered into), a capital gain or loss will be recognised when the asset passes to a beneficiary.

There is no roll-over if an asset passes to a tax-exempt entity that is not a deductible gift recipient. Similarly, there is no roll-over if an asset that is not TAP passes to a foreign beneficiary. Rather, in these cases, a capital gain or loss from CGT event K3[35] is recognised in the deceased individual's final income tax return. The gain is worked out having regard to the market value of the asset on the day the individual died.

Specific legacies: double death

As always, the devil is in the detail. Who would expect, for example, that the roll-over would not apply in a case where an intended beneficiary dies before an asset that they were entitled to under the will of another person passes to them.

As noted above, the roll-over only applies in respect of an asset that the deceased person owned when they died. However, in many cases, you will find that, following the death of a person, a beneficiary of their estate (the first estate) will die before that estate is administered. A beneficiary who has an interest in an unadministered estate when they die did not "own" any of the assets that may ultimately pass from the first estate to the beneficiary's estate (the second estate). The result is that gains and losses are not able to be disregarded when estate 1 assets pass from the LPR of the second estate to a beneficiary of that estate.

Treasury had long ago identified this as an unintended policy outcome. The Treasury paper, *Minor amendments to the capital gains tax law*, issued in May 2011, outlined the following proposed amendment to the law:

"Issue 4. Death before administration	
[Current law]	[Proposed law]
Division 128 does not provide a roll-over when the intended beneficiary of a deceased estate dies before administration is completed and an asset owned by the first deceased person passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in the intended beneficiary's estate. This is because the asset was not one which the intended beneficiary owned when they died.	In cases where an individual (the first deceased) dies and the intended beneficiary also dies before an asset which the first deceased owned passes out to them, the asset will be treated as though it had passed to the intended beneficiary before they died. This ensures that a roll-over will apply when an asset passes from the intended beneficiary's LPR to a trustee of a testamentary trust or a beneficiary in their estate."

However, this proposal was abandoned as part of the then government's announced but unenacted measures review.[36] More recently, the issue was raised, and rejected, as a matter in respect of which the Commissioner's remedial power could be exercised, on the basis that the policy was clear.[37]

So, "what's the problem?", you say. While a law change would be nice, we've all been managing ok.

For one thing, it appears that different views have been taken about the cost base of the asset in the hands of the LPR/ beneficiary of the second estate in these cases. Traditionally, most people seem to have adopted the approach that assets owned by the first deceased passed to the LPR of the second estate for an amount determined in the table in s 128-15(4) ITAA97. That is, the roll-over applied at the level of the first estate, with the effect that the LPR's cost base is determined under the usual deceased estate rules.

However, there is an alternative view. On that view, as Div 128 does not apply to an asset of the first deceased in the hands of the LPR or beneficiary of the second estate, it is argued that the asset's cost base is not determined under Div 128 ITAA97. Rather, because the second LPR acquired the asset for no consideration, they are taken to have acquired it for market value under s 112-20 ITAA97. Under this approach, any gain inherent in the asset when the deceased person died falls out of the tax system.

If you are advising the LPR of a second estate about their potential liability from the sale of an asset that passed from the first estate, the authors would urge caution and suggest a private ruling be obtained. Remember that the LPR of estate 2 is liable for any tax that would be payable if a taxable capital gain arose from the transfer of the asset by the LPR of estate 2 to a beneficiary of that estate.

For another thing, it seems that the ATO occasionally forgets what its approach is. In January 2022, a private ruling[38] was issued which indicated that roll-over could apply in double death cases. This created much uncertainty in relevant legal and accounting circles: had the ATO changed its long-held view?[39]

Recently, the edited version of that private ruling has been annotated to indicate that it is misleading or incorrect and that the view it expresses does not represent the ATO's view of the relevant law. While the rulees can continue to rely on the private ruling that was issued to them, it is a useful reminder that private rulings only provide protection to those to whom they are issued. Anyone else who has applied the view to their own case should now reconsider their position and, if necessary, amend any relevant tax assessments.

Much consternation and expense could have been avoided if the law had been made clear as originally proposed, or the ATO had published a public ruling on the issue which presumably its staff would have located in coming to a view on the recent private ruling.

Life and remainder interests: some discrete issues

When we talk about life and remainder interests, we are generally referring to a situation where an asset is held on trust for the benefit of an individual for their life, with the remainder interests held for someone else (interests held via a trust are commonly referred to as "equitable life and remainder interests"). On the death of the life tenant, the remainder beneficiary generally becomes entitled to have the asset transferred to them.[40]

Trusts that create life and remainder interests often arise under a person's will. For example, a will may provide that a dwelling is to be held on trust for the benefit of the individual's second spouse for life, with the remainder to benefit the children of the individual's first marriage.

There is a difference at law between a life interest and a simple right to occupy. For example, a life interest carries an entitlement to income from the property and a right to occupy if that is specifically provided for. And each has different tax consequences. There is often a difference of views between the parties as to the nature of the interest that the deceased's will creates. This is a legal question that must be resolved before the tax consequences can be determined.

The ATO's views about the CGT consequences of life and remainder interests are set out in TR 2006/14. The ruling effectively ended a debate that had been raging since the CGT provisions were introduced in 1985 about how those provisions applied to life and remainder interests. TR 2006/14 is relatively comprehensive and considers a range of scenarios, including the creation of the trust, a disclaimer of a life interest, and the death of a life tenant. But there are things that it doesn't address and it would be useful for the ATO to revisit the ruling with a view to giving a view about them.[41]

Surrender of life interest

It often happens that the beneficiaries in a life/remainder trust will seek to bring the trust to an end after a number of years. TR 2006/14 addresses cases where, in doing so, the life tenant and remainder beneficiaries each acquire an interest in the trust assets.[42] However, it often happens that the life tenant will simply surrender their interest for no consideration.

Are there any CGT consequences for the life tenant from the surrender in these circumstances?[43]

CGT event E6[44] will not happen as there is no trust property being transferred to the life tenant in respect of the ending of the right to trust income. Accordingly, it is necessary to consider how CGT event C2 (the ending of an intangible asset) might apply. Before doing so, however, it is useful to consider how CGT event E6 might apply if the trustee paid the life tenant a nominal amount of consideration (say, $10).

CGT event E6 happens if the trustee of a trust disposes of a CGT asset of a trust to a beneficiary in satisfaction of the beneficiary's right to income of the trust. The trustee will make a capital gain or loss in respect of the asset. Also, the beneficiary will make a capital gain or loss in respect of their trust interest if the market value of the trust asset it receives is more than the cost of the base/reduced cost base of the life interest.

First, it needs to be determined whether the $10 is a relevant "CGT asset" that would trigger the operation of the provision. The ATO had for many years indicated on its "advice under development" website page that it intended to provide advice about whether Australian currency, or Australian currency denominated assets, were CGT assets for the purposes of CGT events E5 to E7. Recently, the ATO has removed those topics from the website on the basis that they were no longer a priority for them!

If the $10 is an asset, the trustee will make no gain or loss from it. The beneficiary will presumably make a capital loss on their interest equal to the difference between the $10 and the market value of the interest at the time it was acquired.[45] This loss could be considerable if, for example, the interest was acquired many years ago when the life tenant was relatively young. The main residence exemption would not apply to disregard the capital loss.[46]

Are the consequences the same if CGT event C2 is the relevant event?

CGT event C2 happens if your ownership of an intangible asset ends in one of a number of ways, including by surrender. You make a capital gain if the capital proceeds from the ending are more than the asset's cost base, or a capital loss if the proceeds are less than the asset's reduced cost base.

Unlike for CGT event E6, the market value substitution rule in s 116-30 ITAA97 will apply to determine the capital proceeds if there are no proceeds, or if the proceeds are more or less than the value of the asset if the parties did not deal at arm's length.

Also, unlike for CGT event E6, the main residence exemption applies to a capital gain or loss from CGT event C2. Although it is an issue for another day, one wonders how the main residence exemption applies where the trust assets consist of more than the property in which the life tenant has a relevant ownership interest for main residence purposes. Presumably, an apportionment would be appropriate.

Conclusion

As a practice that has specialised in the taxation of deceased estates and trusts for over 23 years, it is rare that a week goes by where BNR Partners does not encounter a little tax monster.

These "Frankensteins" often arise from the particular circumstances of each individual estate, be that from the affairs of the deceased, the assets they owned, or the geographical locations of the beneficiaries and executors. But many problems have, at their core, a failure by government to amend the law or of the ATO to provide clear guidance on how it considers the law to operate.

Anomalies in the tax law expose executors and administrators, as well as tax practitioners, to unnecessary risk and often come at a significant cost to revenue. While governments tend to be reluctant to make law changes that affect deceased estates, the Robodebt issue has highlighted that defective laws should be reviewed to protect those that are affected by them.

And while that may take some time to achieve, we should surely be able to look to the ATO to provide updated guidance on such matters as those highlighted in this article within a reasonable time frame.

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This article is an edited and updated version of "Deceased estates – taxation nirvana or Frankenstein's monster?" presented at The Tax Institute's Tax Summit held in Melbourne on 5 to 7 September 2023.

References

1 Div 6 of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

2 Subdiv 115-C and Subdiv 207-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

3 S 95(1) ITAA36.

4 *FCT v Bamford* [2010] HCA 10.

5 IT 2622 was introduced prior to the introduction of the self-assessment regime. The views in the ruling are not binding on the ATO in the same way as public rulings in respect of which the rules in Div 358 of the *Taxation Administration Act 1953* (Cth) apply.

6 *FCT v Whiting* [1943] HCA 45.

7 *Greenhatch v FCT* [2013] HCATrans 104; *FCT v Greenhatch* [2012] FCAFC 84.

8 PBR 1051760637680.

9 PBR 1051346488294.

10 PBR 1051630156354.

11 PBR 1051346488294.

12 *Union Fidelity Trustee Co of Australia Ltd v FCT* [1969] HCA 36.

13 S 115-228(1) ITAA97.

14 S 95(2) and (3) ITAA36. There is another definition that applies for CGT purposes, but it is not relevantly different in this instance.

15 Compare, for example, s 99(4) which applies to resident trusts, and s 99(5) which applies to non-resident trusts.

16 "Taxable Australian property" is defined in s 855-15 ITAA97. Mainly, it refers to interests in Australian land, including some indirect interests held via companies and trusts.

17 Significantly, shares in Australian listed companies will generally not be TAP.

18 If the deceased were a foreign resident, their assets were always outside the Australian tax net. If they appoint an Australian resident as their executor, the executor is taken to have a market value acquisition cost (based on the value at the date of death).

19 Some people might wonder if the full discount is available to the trustee or in respect of the non-resident beneficiary's share of the capital gains. These are valid questions, but topics for another day.

20 Section 99B (discussed below) does not apply if a beneficiary is a foreign resident for the entire income year in which a distribution is paid.

21 Inspector-General of Taxation, Australian Government, *Death and taxes: an investigation into ATO systems and processes for dealing with deceased estates*, July 2020, recommendation 6.

22 Section 99C ITAA36 sets out when an amount will be taken to have been applied for the benefit of a beneficiary.

23 The provision is drafted broadly and could apply to any trust, although it appears to be the ATO practice to apply it mainly to foreign trusts or trusts that were at one time foreign trusts.

24 S 99B(2) ITAA36.

25 *Peter Greensill Family Co Pty Ltd (trustee) v FCT* [2021] FCAFC 99.

26 *N & M Martin Holdings Pty Ltd v FCT* [2020] FCA 1186.

27 S 272-5(1), Sch 2F ITAA36. Subdivision 272-A, Sch 2 ITAA36 contains rules about determining whether beneficiaries have fixed entitlements.

28 For completeness, it is noted that, if the executor had transferred shares to Dudley, CGT event K3 would have happened, with possible gains and losses being recognised in the deceased's final income tax return.

29 Section 100A is about reimbursement agreements. For more information, see TR 2022/4.

30 ATO ID 2010/55.

31 Note that PCG 2019/5 outlines the circumstances where a taxpayer can self-assess an extension of the two-year period in s 118-195 ITAA97.

32 The rule for pre-CGT dwellings that are taken to be acquired for market value is different. It makes the appropriate adjustments to the non-main residence and total days periods.

33 Div 128 ITAA97.

34 One acquired on or after 20 September 1985.

35 S 104-215 ITAA97.

36 For more information, see the Hon. Arthur Sinodinos, the then Assistant Treasurer, "Integrity restored to Australia's tax system", media release, 14 December 2013.

37 QC 58416.

38 See edited version of PBR 1051943938848.

39 See, for example, T Donlan and A Manapakkam, "Tax on dying of a broken heart …two years on", (2023) 57(7) *Taxation in Australia* 419.

40 Life and remainder interests can also be legal interests, but these are not considered in this article.

41 Michael Flynn has written extensively on this topic. His papers would also be a useful starting point for the ATO.

42 See example 4 in TR 2006/14.

43 The ATO issued a private ruling in February 2023 (PBR 1052085239358) indicating that a capital gain from the surrender of a life interest was disregarded. It is unclear from the face of the edited version how this conclusion was reached. Possibly, it might have been on the basis that the main residence exemption applied to the gain from CGT event C2 happening to the interest (the main residence exemption does not apply to a capital gain from CGT event E6).

44 S 104-80 ITAA97.

45 The value of life interest is something that must be determined by actuarial calculation.

46 S 118-110(2) ITAA97. Note that, even though s 118-195 ITAA97 may apply in relation to the trustee's ownership interest in a dwelling, the life tenant has a different ownership interest which is to be considered under s 118-110.

The CGT main residence exemption: tips and traps

by Neil Brydges, CTA, Principal Lawyer, and Edward Hennebry, FTI, Senior Associate, Sladen Legal

The capital gains tax main residence exemption is (arguably) the most generous exemption for post-CGT assets in the income tax legislation. The eligibility requirements are not onerous, and it is available to young and old, rich and poor. However, actions, or inactions, can result in a loss of the exemption, in whole or in part. The article focuses on: the significance of "adjacent land" including for primary producers; keeping the exemption when demolishing or subdividing the family home; when one dwelling can be two CGT assets; planning for sea and tree changers with two dwellings; the impacts of death and inheritance; the impacts of relationship breakdowns; absences, especially for foreign residents; and the implications of the increasing use of main residences to derive income including through modern work practices and "side hustles".

Overview

Deceptively simple, but often misunderstood, more pages of the *Income Tax Assessment Act 1997* (Cth) are devoted to the capital gains tax main residence exemption (CGT MRE) in Subdiv 118-B than in any other Subdivision of Pt 3-1 (which includes the core provisions of the CGT rules). This article looks at some of the traps lurking in the detail of the CGT MRE that can cause the unwary a tax disaster.

The article discusses the CGT MRE, including:

- the significance of "adjacent land" (including for primary producers);
- keeping the exemption when demolishing or subdividing the family home;
- when one dwelling can be two CGT assets;
- planning for sea and tree changers with two dwellings;
- the impacts of death and inheritance;
- the impacts of relationship breakdowns;
- absences, especially for foreign residents; and
- the implications of the increasing use of main residences to derive income, including through modern work practices and "side hustles".

Fundamentals and core requirements

The CGT MRE can offer significant tax savings to individuals who structure their affairs prudently. However, the provisions in Subdiv 118-B are extremely prescriptive and, depending on how a dwelling is used through an ownership period, this may result in a loss of the full (or even partial) CGT MRE.

The core fundamentals of which to be aware are:

- the CGT MRE is generally only available to Australian tax resident individuals. This means that companies and trusts cannot take advantage of or access the CGT MRE unless it can be substantiated that those entities are mere legal owners of the dwelling, and the individual is absolutely entitled to the asset. So, if there is a difference between legal and beneficial ownership, keep good records and remember that a bare trust does not necessarily enliven absolute entitlement;[1]
- the CGT MRE only applies to the following CGT events:
  - CGT event A1: disposal of a CGT asset;
  - CGT event B1: use and enjoyment before title passes;
  - CGT event C1: loss or destruction of a CGT asset;
  - CGT event C2: cancellation, surrender and similar endings;
  - CGT event E1: creating a trust over a CGT asset;
  - CGT event E2: transferring a CGT asset to a trust;
  - CGT event F2: granting a long-term lease;
  - before 7:30 pm on 9 May 2017 (ACT legal time):
    - CGT event I1: individual or company stops being a resident; and
    - CGT event I2: trust stops being a resident trust;
  - CGT event K3: asset passing to tax-advantaged entity;
  - CGT event K4: CGT asset starts being trading stock;
  - CGT event K6: pre-CGT shares or trust interest (except one involving the forfeiting of a deposit); and
  - a CGT event that involves the forfeiting of a deposit as part of an uninterrupted sequence of transactions ending in one of the events listed above subsequently happening;
- the sale or transfer needs to be on capital account. It is not uncommon for "Mums and Dads" to decide to demolish their existing dwelling and build a new property, or properties, on that land. Depending on the facts and circumstances, those activities may venture beyond the mere realisation of a capital asset and constitute an isolated profit-making transaction or the sale of trading stock;

- to qualify for the CGT MRE, there must be a "dwelling". Section 118-115 ITAA97 defines dwelling as including:
- a unit of accommodation that:
  - is a building or is contained in a building; and
  - consists wholly or mainly of residential accommodation;
- a unit of accommodation that is a caravan, houseboat or other mobile home; and
- any land immediately under the unit of accommodation.

  However, except as provided in s 118-120 ITAA97 (see below), a dwelling does not include any land adjacent to a building;
- for the dwelling to be a main residence, it needs to be a residence. As outlined in *Koitaki Para Rubber Estates Ltd v FCT*,[2] "the place of residence of an individual is determined, not by the situation of some business or property he is carrying on or owns, but by reference to where he eats and sleeps and has his settled or usual abode".

  It is therefore necessary to show factors of residing in a dwelling, such as the location of possessions, the registered address under the electoral role, and the registered address for mailing purposes. Generally, a dwelling is your main residence if:
  - you and your family live in it;
  - your personal belongings are in it;
  - it is the address your mail is delivered to;
  - it is your address on the electoral roll; and
  - services such as gas and power are connected.

  TD 51 (now withdrawn) includes the following factors:
  - the length of time the taxpayer has lived in the dwelling;
  - the place of residence of the taxpayer's family;
  - whether the taxpayer has moved their personal belongings into the dwelling;
  - the address to which the taxpayer has their mail delivered;
  - the taxpayer's address on the electoral roll;
  - the connection of services such as telephone, gas and electricity; and
  - the taxpayer's intention in occupying the dwelling;
- understanding an individual's "ownership period" is crucial, particularly if they do not qualify for the full CGT MRE. Under s 118-125 ITAA97, coupled with s 118-130 ITAA97, the ownership period generally begins and ends at settlement, and not at the contract dates. This is also relevant for assessing the two-year period if a beneficiary of a deceased estate seeks to dispose of the deceased's main residence within two years of death.

  The use of the settlement date, rather than the contract date, is an exception to the general approach for a disposal or an acquisition under a contract;[3]
- the CGT MRE regime allows taxpayers to make a range of choices when more than one dwelling is owned (for example, which property is chosen as a main residence, which property is chosen as a main residence under the absence rules in s 118-145 ITAA97, which property is chosen as a main residence under the building/construction rule in s 118-150 ITAA97);
- there is no approved form or written election needed to make these choices. Rather, consistent with s 103-25(2) ITAA97, the way a taxpayer prepares their income tax returns is sufficient evidence of the making of the choice. However, as income tax returns include minimum details, apart from showing the claiming of the CGT MRE, taxpayers should keep documentary evidence of any choices to support their returns; and
- while the CGT MRE allows the taxpayer to make choices, the CGT MRE itself is self-executing. Section 118-110 ITAA97, the core provision, says that a capital gain or loss you make from a CGT event that happens in relation to a CGT asset that is a dwelling or your ownership interest in it "is disregarded" if you are an individual and the dwelling was your main residence throughout your ownership period. That is, if the requirements are satisfied, the capital gain or loss "is disregarded" – taxpayers do not have a choice. For example, if they incurred a capital loss.

  Similarly with deceased estates, s 118-195 ITAA97 says a capital gain or loss "is disregarded".

Adjacent land

Under s 118-120, a main residence includes "adjacent land" of up to two hectares less the area of the land immediately under the dwelling. Land adjacent to a dwelling is adjacent land to the extent that the land was used primarily for private or domestic purposes in association with the dwelling. Examples of land use primarily for private or domestic purposes include gardening, regular upkeep, the location of a swimming pool, and the storing of trailers.

Generally, the CGT MRE does not apply to a CGT event that happens in relation to adjacent land if that CGT event does not also happen in relation to the dwelling.[4]

TD 92/171 considers that the CGT MRE extends to additional land acquired after the time of acquisition of the residence, as long as the requirements in ss 118-120 and 118-165 ITAA97 are satisfied, that is:

- the additional land (including the area of land on which the dwelling is built) is adjacent to that on which the dwelling is situated;
- the total area of land is not greater than two hectares;
- the additional land is used primarily for private or domestic purposes in association with the dwelling; and
- the CGT event that happens in relation to the additional land also happens in relation to the dwelling (or the ownership interest in it).

TD 92/171 includes the following example:

> "Tom and Mary purchase a home in 1987 and occupy it as their main residence. The home has never been used for income producing purposes. In 1989, they purchase the vacant block of land that adjoins the land on which their dwelling is situated and construct a private swimming pool. The total of the area of adjacent land and the area of the land on which the home is situated is less than 2 hectares. In 2001, they enter into a contract to sell the home with the adjoining block. A full main residence exemption is available."

The concept of "adjacent land" has particular significance to primary producers because their land typically:

- serves a dual purpose as being the location of their dwelling, as well as where they conduct farming activities; and
- exceeds two hectares.

Accordingly, to calculate the potential capital gains tax exposure on disposal of the land, a primary producer may need to assess which portion of the land qualifies as "adjacent land", as well as whether any other CGT concessions apply. For example, the CGT discount and/or the CGT small business concessions.

Adjacent land does not need to be contiguous to the dwelling, but proximity is important. As highlighted in TD 1999/68, the further the distance between the land and the land on which a dwelling is situated, the less likely it is that the relevant land is "adjacent land" for the purposes of the legislation. Example 2 of TD 1999/68 provides:

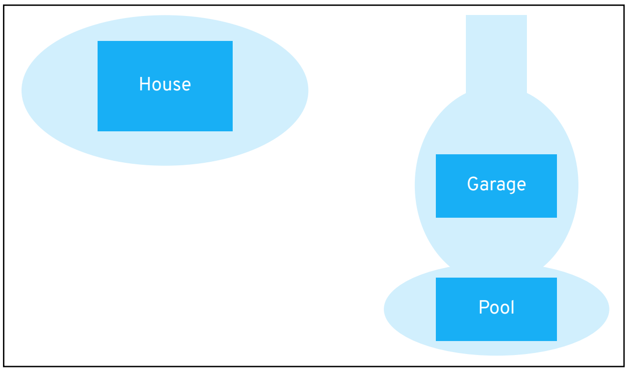
> "9. Bob and Lyn own a house in a country town. Lyn owns a horse which she rides in local horse competitions. There is no room for the horse in the backyard of the house, so Bob and Lyn bought a block of land some two street blocks away on which to run the horse. The total area of the land on which the house is situated and the horse yard is less than 2 hectares. The horse yard, which is used by Lyn primarily for private or domestic purposes in association with her house, is considered to be adjacent land for the purposes of section 118-120."

For land which is greater than two hectares, TD 1999/67 allows taxpayers to choose which area of land qualifies as adjacent land (in addition to the land over which the dwelling is situated). However, when choosing the land, the land must be used primarily for private or domestic purposes. With primary producers, if the land containing the dwelling is fenced off to (say) 1,000 square metres and the farm is beyond that fence, the MRE would likely only extend to the 1,000 square metres, not two hectares.

In TD 1999/67, the ATO says that, if the selected area of land cannot be separately valued, apportionment of the capital proceeds and cost base should be undertaken on an area basis. Example 2 of TD 1999/67 provides:

> "10. Alistair owns a 10 hectare property – see the diagram below. He has selected the shaded area as the part of the land on which he wishes to claim the main residence exemption. This area does not exceed 2 hectares and is used primarily for private or domestic purposes in association with Alistair's dwelling. He sells the property for $500,000. He obtains an opinion from an expert valuer that the value of the 2 hectares of land and the house is $300,000. The cost base attributable to this part of the property (taking into account improvements since purchase) is $180,000 and the remainder is $120,000. The capital gain on the total property is $200,000. Alistair disregards $120,000 of the capital gain because it is attributable to his main residence.

ROAD



ROAD"

Does vacant land qualify as "adjacent land"? Arguably, yes, if the vacant land is used "primarily for private or domestic purposes in association with the dwelling". If a taxpayer had evidence that the vacant land was used as a place for (say) exercise, personal contemplation, walking a dog, paddocking a pony etc in association with the dwelling, it seems reasonable that the vacant land could be "adjacent land".

However, if the vacant land was not being used for any purpose, it is unlikely that the vacant land would meet the statutory test. In a different context, the Commissioner considers that vacant land "not being used for any purpose" does not fall within the definition of an asset used "solely for personal use and enjoyment" under s 152-20 ITAA97 (which concerns the maximum net asset value test in the small business CGT concessions) because the vacant land is not being used solely for the personal use and enjoyment of the individual.[5]

When one dwelling can be two CGT assets

Two buildings on the land

As highlighted above, the CGT MRE applies to a "dwelling", not to "dwellings". What is the circumstance if a taxpayer has more than one unit of accommodation?

Section 118-115 defines "dwelling" as including (among other things) a unit of accommodation that is a building, or is contained in a building, or consists wholly or mainly of residential accommodation. Subsections 118-120(5) and (6) extend this to "adjacent structures":

- s 118-120(5): the CGT MRE "applies to an adjacent structure of a flat or home unit (if the same CGT event happens to that structure or your ownership interest in it) as if it were a dwelling"; and

- s 118-120(6): "[a] garage, storeroom or other structure associated with a flat or home unit is an adjacent structure of the flat or home unit to the extent that the structure was used primarily for private or domestic purposes in association with the flat or home unit".

In TD 1999/69, the ATO says that whether two or more units of accommodation are used together as one place of residence or abode for the purposes of the definition of "dwelling" is a question of fact that depends on the particular circumstances of each case. Examples might include a caravan or granny flat.

In TD 1999/69, the ATO states that the following factors are relevant when considering whether units of accommodation are used together as one place of residence or abode:

- whether the occupants sleep, eat and live in them;
- the distance between and the proximity of the units of accommodation;
- whether the units are connected;
- whether the units are capable of being sold separately;
- the extent to which the daily activities of the occupants in the units are integrated;
- how the units are shared by the occupants; and
- how costs of the units are shared by the occupants.

Example 3 of TD 1999/69 provides:

> "9. William owns a large farming property. He employs his brother Henry to help him. As the house on the farm is not large enough to accommodate both William and Henry's families, Henry and his family sleep in William's caravan at the rear of the property. Both families live and eat in the house and use and enjoy it for their domestic purposes. They all spend most of their daily lives on the farm and in the house. The caravan is connected to electricity from the house.
>
> 10. The caravan and the house are considered to be one dwelling because the activities of the families in them are so integrated that they use them together as one place of residence."

Building separate to the land

Taxpayers should be conscious of the circumstances of a post-CGT dwelling constructed on pre-CGT land.

Section 108-55(2) ITAA97 provides that a building constructed on pre-CGT land is a separate CGT asset from the land if the taxpayer entered into a contract for the construction of the building on or after 20 September 1985 or, if there is no contract, the construction started on or after that day. This is different to the common law rule about fixtures attaching to the land.

The term "building or structure" is undefined but, based on a plain and ordinary meaning, would include a dwelling. In addition, for the purposes of the CGT rules, a building or structure is taken to be acquired at the time that construction first commenced (not when the land was acquired).

This means that, when there is a disposal of pre-CGT land that contains a post-CGT dwelling, any portion of the dwelling which does not qualify for a full CGT MRE (for instance, because the dwelling is used for income-producing purposes) may be subject to CGT despite being situated on pre-CGT land.

TD 2017/13 confirms that the CGT MRE can apply to any gain that is attributable to the building. However, a full CGT MRE may not be available if the building was the main residence for only part of the period when the taxpayer had an ownership interest in it. TD 2017/13 includes the following example:

> "2. Erica owns pre-CGT land on which she started to build a dwelling on 1 January 2011. The dwelling was completed on 1 January 2016 and Erica moves in immediately. She lives in the dwelling until the settlement of the sale of the property on 1 April 2016.
>
> 3. As the dwelling was Erica's main residence from 1 January 2016 to 1 April 2016, she will qualify for the main residence exemption for that period. She can also choose under subsection 118-150(2) to extend the main residence exemption for the four year period prior to 1 January 2016 as she has met the conditions; the dwelling became her main residence on completion and she resided in it for at least three months.
>
> 4. As the property was Erica's main residence for this three month period, and she makes a choice to apply section 118-150, she will qualify for the main residence exemption for the period from 1 January 2012 to 1 April 2016 (four years and three months). No other dwelling can be treated as Erica's main residence during this period."

Section 118-150, referred to in TD 2017/13, is discussed in more detail later in this article.

Owning two or more dwellings

Taxpayers are generally only able to treat one "dwelling" at a time as their main residence for the purposes of the CGT MRE. This extends to spouses, that is, spouses can only claim a full CGT MRE on a single dwelling, unless they are "living permanently separately and apart" from one another.[6] Section 118-170 ITAA97, which deals with this situation, provides:

> "(1) If, during a period, a dwelling is your main residence and another dwelling is the main residence of your spouse (except a spouse living permanently separately and apart from you), you and your spouse must either:
>
> (a) choose one of the dwellings as the main residence of both of you for the period; or
>
> (b) nominate the different dwellings as your main residences for the period.
>
> (2) If you nominate the different dwellings as your main residences for the period, you split the exemption in accordance with subsections (3) and (4).

(3) If your interest in the dwelling you chose was not, during the period, more than half of the total interests in the dwelling, the dwelling is taken to have been your main residence during the period. Otherwise, the dwelling is taken to have been your main residence for half of the period.

(4) If your spouse's interest in the dwelling your spouse chose was not, during the period, more than half of the total interests in the dwelling, the dwelling is taken to have been your spouse's main residence during the period. Otherwise, the dwelling is taken to have been your spouse's main residence for half of the period."

Section 118-170 includes the following example:

> "Example: You and your spouse (who are Australian residents) own a town house as tenants in common in equal shares. You and your spouse also own a beach house as tenants in common, with your interest being 30% and your spouse's 70%. From 1 July 1999, you live mainly in the town house and your spouse lives mainly in the beach house. On 1 July 2000 you and your spouse dispose of both dwellings.
>
> For the period 1 July 1999–30 June 2000 you nominate the town house as your main residence and your spouse nominates the beach house. The town house is taken to be your main residence during the period. The beach house is taken to be your spouse's main residence during half the period."

TD 92/174 illustrates how spouses need to carefully consider which dwelling they are to treat as their main residence (note that the example considers the absence choice under s 118-145 which is discussed later in this article). Specifically:

> "2. A husband and wife own a pre-CGT house which they both occupy. Due to a change in employment, the husband moves to another town and they acquire another (post-CGT) house on 1 July 2000. The husband occupies this house for 2 years during the course of his employment contract. On 1 July 2002, he returns to the pre-CGT house which he then continues to occupy with his wife. The post-CGT house is sold within six years of the husband ceasing to occupy it.
>
> 3. To obtain a full main residence exemption on disposal of the post-CGT house, the husband must make a choice under section 118-145 to treat that house as his main residence for the period 1 July 2002 until disposal. The husband and wife can then choose to treat the post-CGT house as their main residence under paragraph 118-170(1)(a) for the entire period that they owned it.
>
> If the husband does not make the choice under section 118-145, neither would be entitled to an exemption for the period after the husband ceased to occupy the post-CGT house."

However, a key exception to the above is in s 118-140 ITAA97 which concerns taxpayers who are moving from one main residence to another. This section affords taxpayers a period of up to six months to treat two properties as dwellings for the purposes of the CGT MRE. This may be relevant when settlement of the contract for the disposal of the existing dwelling occurs later than the settlement of the contract for the acquisition of the new dwelling. However, this rule can only apply if:

- the taxpayer's existing main residence was their main residence for a *continuous* period of at least three months in the 12 months ending when their ownership interest in it ends (that is, settlement); and
- the taxpayer's existing main residence was not used for the purpose of producing assessable income in any part of that 12-month period when it was not their main residence.

This rule automatically applies, taxpayers cannot opt out.

Example 1 in TD 1999/43 highlights how the rule in s 118-140 interacts with the absence choice under s 118-145 (discussed later in this article):

> "5. Anne acquired a dwelling on 1 January 1986 where she lived until she went overseas on 1 January 1997. Anne did not rent the home during her absence.
>
> 6. She acquired another dwelling on 1 February 1998 and moved into that dwelling on her return from overseas on 1 March 1998. Anne disposed of the first dwelling on 1 August 1998.
>
> 7. In accordance with section 118-145, Anne chose to continue to treat the first dwelling as her main residence for the period 1 January 1997 until she disposed of it on 1 August 1998.
>
> 8. In addition, under section 118-140, Anne may treat the second dwelling as her main residence from when she acquired it on 1 February 1998. Under section 118-140, Anne is able to treat both dwellings as her main residence for up to six months, ending when she ceased to have an ownership interest in the first dwelling."

Using the dwelling to derive income

Basic position

Taxpayers who use their dwelling to produce assessable income will generally lose their ability to claim a full exemption from CGT under the main residence rules (subject, perhaps, to the absence rule under s 118-145 discussed below).

Section 118-185 ITAA97 provides that, if a dwelling was not a person's main residence for the whole time they owned it, the formula below should be used as the starting point to work out the amount of capital gains or losses subject to the MRE:

$$\text{Capital gain or loss amount} \times \frac{\text{Non-main residence days}}{\text{Days in ownership period}}$$

The capital gain or loss amount is the capital gain or loss the taxpayer would have made from the CGT event apart from the application of the MRE.

Non-main residence days is the number of days in the taxpayer's ownership period when the dwelling was not their main residence.

Section 118-185 does not apply if the person is an excluded foreign resident or a foreign resident who does not satisfy the life events test (discussed below).

The capital gain or loss after s 118-185, even if there is no adjustment, may be further adjusted if the dwelling was used to produce assessable income (see below). It should be remembered that not all items of income from a dwelling will be assessable income, such as board or lodgings under a domestic family relationship.[7]

Example

Tom bought a dwelling on 1 May 2020 for $1,000,000. He rented it out from the date of purchase to 30 April 2021. He then moved into the dwelling and used it as his main residence until he sold it on 30 April 2022 for $1,500,000.

Tom is not entitled to the full CGT MRE because he did not treat the dwelling as his main residence for the entire period of his ownership. He rented out the dwelling for the first year. So, the capital gain is calculated as follows:

> The gross capital gain amount = $500,000
>
> Non-main residence days = 365 days (1 May 2020 to 30 April 2021)
>
> Days in ownership period = 730 days (1 May 2020 to 30 April 2022)
>
> Capital gain subject to tax = $500,000 (365/730) = $250,000

Since Tom had owned the dwelling for more than 12 months, the 50% CGT discount applies. Therefore, the amount of capital gain that is subject to tax is $125,000.

Using the dwelling to derive assessable income

Section 118-190 ITAA97 provides that taxpayers can only obtain a partial CGT MRE when they sell a dwelling if they used the dwelling both as their main residence and for the purpose of producing assessable income.

Taxpayers who, while residing in their dwelling:

- carry on a business in their dwelling;
- lease a room in their dwelling; or
- allow guests to stay in their dwelling via platforms such as Airbnb,

should be conscious of this rule.

A taxpayer can only receive the partial exemption if, had they incurred interest on money borrowed to acquire the dwelling, they could have deducted some or all of that interest.[8] This is a hypothetical test which assumes that the taxpayer had borrowed money to acquire the dwelling and incurred interest on the money borrowed.

Furthermore, given the circumstances triggered by COVID-19, taxpayers should consider IT 2673 and whether they may have started treating their main residence as a "place of business":

> "9. An appropriate part of any capital gain or capital loss on the disposal of a dwelling would come within the capital gains provisions in the income tax law where part of the dwelling is used for income producing purposes. Examples include where part of a dwelling is dedicated for use in deriving rental income from tenants and where a doctor's dwelling contains a surgery that is used solely as a place of business and is clearly identifiable as a place of business.
>
> 10. Many other income producing activities may be conducted, in whole or in part, from a dwelling. To take some examples, each of the following activities may be undertaken for reward, namely, children may be cared for by a daycare giver, music or swimming lessons may be given, tutoring or other tuition may be given, and car or television repair services may be provided. In other cases, professional people and self-employed persons might undertake income producing activities from a study or other room of a principal residence merely because it is inconvenient for the work to be done at their normal place of work. The dwelling in each of these instances would only be regarded as being used for the purpose of gaining or producing assessable income where that part of the dwelling used for these activities has the character of a place of business.
>
> 11. Whether a dwelling, or part of it, has the character of a place of business is a question of fact that turns on the particular circumstances of each case but the broad test to be applied is whether a particular part of the dwelling:
>
> (a) is set aside exclusively as a place of business;
>
> (b) is clearly identifiable as a place of business; and
>
> (c) is not readily suitable or adaptable for use for private or domestic purposes in association with the dwelling generally."

In the context of COVID-19 and post-COVID-19 work-from-home arrangements, the views of the ATO in TR 93/30 are useful. The ATO considers what is a place of business or a private study:

> "5. The following factors, none of which is necessarily conclusive on its own, may indicate whether or not an area set aside has the character of a 'place of business':
>
> - the area is clearly identifiable as a place of business;
> - the area is not readily suitable or adaptable for use for private or domestic purposes in association with the home generally;
> - the area is used exclusively or almost exclusively for carrying on a business; or
> - the area is used regularly for visits of clients or customers.
>
> …

11. Paragraph 5 lists some of the factors which may indicate that a part of a home has the character of a place of business. The existence of any of these factors or a combination of them will not necessarily be conclusive in ascertaining the character of an area used as a home office. Rather the decision in each case will depend on whether, on a balanced consideration of:
    - the essential character of the area;
    - the nature of the taxpayer's business; and
    - any other relevant factors,

    the area constitutes a 'place of business' in the ordinary and common sense meaning of that term.
12. The absence of an alternative place for conducting income producing activities has also influenced a court or tribunal to accept a part of a taxpayer's residence as a place of business. Examples include:
    - a self employed script writer using one room of a flat for writing purposes and for meetings with television station staff …;
    - an employee architect conducting a small private practice from home …;
    - a country sales manager for an oil company whose employer did not provide him with a place to work …

    In each of these cases the taxpayer was able to show that, as a matter of fact, there was no alternative place of business, it was necessary to work from home, and that the room in question was used exclusively or almost exclusively for income producing purposes.
13. In circumstances such as those referred to in paragraph 12, a place of business will exist only if:
    - it is a requirement inherent in the nature of the taxpayer's activities that the taxpayer needs a place of business;
    - the taxpayer's circumstances are such that there is no alternative place of business and it was necessary to work from home; and
    - the area of the home is used exclusively or almost exclusively for income producing purposes.

…

14. The circumstances where part of a home is considered to have the character of a place of business can be contrasted with the more common case where a taxpayer maintains an office or study at home as a matter of convenience (i.e., so that he or she can carry out work at home which would otherwise be done at his or her regular place of business or employment). Examples of this include:
    - a barrister who reads client briefs at home;
    - a teacher who prepares lessons or marks assignments at home; and
    - an insurance agent who maintains client files and occasionally interviews a client in his or her home office.

    In these circumstances the area of the home and the expenses incurred (subject to the exceptions listed below) retain their private or domestic character …
15. The expenses that may be associated with a home office or study can be divided into two broad categories. These are:
    - Occupancy expenses relating to ownership or use of a home. These include rent, mortgage interest, municipal and water rates, land taxes and house insurance premiums.
    - Running expenses relating to the use of facilities within the home. These include electricity charges for heating/cooling, lighting, cleaning costs, depreciation, leasing charges and the cost of repairs on items of furniture and furnishings in the office."

Lastly, amounts received for board/lodgings in the context of a domestic family relationship may not be assessable income, as highlighted in IT 2167.

To calculate the CGT exposure on dwellings used to derive assessable income, TD 1999/66 provides that, under most circumstances, a floor area basis is appropriate, taking into account the length of time the area has been used for income-producing purposes. That is:

$$\text{Capital gain} \times \text{Percentage of floor area not used as main residence} \times \text{Percentage of period of ownership that that part of the home was not used as a main residence} = \text{Taxable portion}$$

TD 1999/66 includes several examples:

"Example 1

7. John, a carpenter, has lived in his home for 10 years and he owns it. He has used the garage as a workshop for his carpentry business for the whole 10 years. Based on the area of the dwelling occupied by the garage, John estimates the workshop is 20% of the area of the whole dwelling. This is the basis on which John would have claimed an interest deduction if he had a mortgage on the property. John sells the home and makes a capital gain of $25,000 from that CGT event.

8. Apart from section 118-190, as the dwelling was John's main residence he would have been able to disregard the whole capital gain of $25,000. However, applying subsection 118-190(2), John has a capital gain of $5000 (20% of $25,000) to be included in his assessable income.

Example 2

9. Peter owns a home that he lived in since October 1994. In October 1995, after taking a redundancy package, he extended the rear of the home and built a studio for his photography business. He has conducted business from these premises since October 1996. Peter borrowed $50,000 to build the studio. On the basis that

the interest on the $50,000 relates solely to the studio, Peter has claimed 100% deduction. In October 1999, Peter sells the property.

10. Because Peter first used his dwelling to produce income after 20 August 1996, he is taken by subsection 118-192(2) to have acquired it in October 1996 for its market value. Having regard to the market value acquisition cost Peter made a capital gain of $10,000 on the disposal of the property in October 1999.

11. As the dwelling was Peter's main residence for the whole period from October 1996 (when he is taken to have acquired the dwelling) to October 1999, apart from subsection 118-190(2) he would have been able to disregard the $10,000 capital gain, so that he would have made a capital gain of nil.

12. Subsection 118-190(2) requires Peter to increase the capital gain that he would have made by an amount that is reasonable having regard to the amount of interest he would have been able to deduct had he borrowed to acquire the whole house, including the studio, and incurred interest. The interest Peter actually incurred on the money he borrowed to build the studio is irrelevant. Under the hypothetical test, assuming that the studio is 10% of the floor space of the house, the proportion of the hypothetical interest deduction is 10%. Peter would increase the capital gain from nil to 10% of the capital gain made on the disposal of the house (10% of $10,000, being $1,000). No adjustment is made to take account of the use of the property prior to October 1996 because Peter is not regarded as having owned it before that time.

Example 3

13. Assume the same facts as in example 2 except that Peter commenced to use the premises for business in April 1996 and made a capital gain of $15,000 on the sale of the property (based on the actual acquisition cost).

14. In determining his capital gain Peter would take into account the fact that only 10% of the dwelling was used for income producing purposes and the fact that the income producing activity was carried out for only 42 of the 60 months in the period of ownership of the house. His capital gain would be $1,050 (42/60 x $1,500)."

Note that the rules only apply to "your" assessable income. So, if a taxpayer allows someone else to use the taxpayer's main residence for their work, the taxpayer can still access a full exemption.[9]

Special rule in s 118-192 for first use to produce income

Section 118-192 ITAA97 includes a special rule for dwellings first used after 20 August 1996 to produce income. The special rule states that the taxpayer is taken to have acquired the dwelling or their ownership interest when the dwelling was first used to produce income for its market value.

This rule only applies if:

- the dwelling was used for the purpose of producing assessable income during the taxpayer's ownership period;
- that use occurred for the first time after 7:30 pm on 20 August 1996; and
- the taxpayer would have been entitled to a full MRE before the first time it was used for the purpose of producing assessable income during their ownership period.

Example 2 in TD 1999/66 above shows the application of the special rule when calculating the taxable capital gain. In that example, Peter first used his dwelling to produce income after 20 August 1996. Therefore, he is taken by s 118-192(2) to have acquired it in October 1996 for its market value. Having regard to the market value acquisition cost, Peter made a capital gain of $10,000 on the disposal of the property in October 1999.

Application of the absence rule under s 118-145

Under s 118-145, a taxpayer may choose to continue to treat a dwelling that ceased to be their main residence as their main residence. If the taxpayer:

- uses the dwelling for the purpose of producing assessable income, the maximum period that they can treat it as their main residence while they use it for that purpose is six years. The taxpayer is entitled to another maximum period of six years each time the dwelling again becomes and ceases to be their main residence; or
- does not use the dwelling for the purpose of producing assessable income, they can treat it as their main residence under s 118-145 indefinitely.

For the absence rule to apply, the dwelling must first be used as the taxpayer's main residence before the absence (effectively, the taxpayer must have *ceased* to live in the dwelling).

The absence rule in s 118-145 does not apply if the dwelling was the main residence because of s 118-147 ITAA97 (main residence that was compulsorily acquired or destroyed) and ceases to be the main residence because of s 118-147(3) and (4).[10]

If the taxpayer chooses to apply the absence rule in s 118-145, no other dwelling can be treated as their main residence at the same time, except if s 118-140 (changing main residences) applies.[11]

Example 1

Fred moved into a dwelling on 1 May 2020. He used the house as his main residence for three years and then rented it out for three years until 1 May 2026.

Fred has not treated any other dwelling as his main residence during his absence. Under s 118-145, Fred can choose to continue to treat the dwelling as his main residence during the absence because the absence is less than six years.

Fred can make this choice when preparing his income tax return for the income year in which the CGT event happens.

Example 2

On 1 May 2010, Tom moved into a dwelling and used it as his main residence.

On 30 April 2012, Tom rented out one-quarter of the dwelling to be used as a clothing alteration shop.

On 30 April 2014, Tom moved out and rented out the whole dwelling to be used as a clothing alteration shop.

On 30 April 2019, the lease ended. Tom moved back into the dwelling and used it for himself as his main residence.

On 30 April 2020, Tom sold the dwelling.

Diagram 1 shows the timeline and the application of the absence rule.

From 1 May 2010 to 30 April 2012, the full MRE applies since Tom used the whole dwelling as his main residence.

From 1 May 2012 to 30 April 2014, Tom is entitled to a partial exemption under s 118-185 since he rented out one-quarter of the dwelling for the purpose of producing assessable income. The absence rule under s 118-145 does not apply as Tom did not move out of the dwelling. The dwelling did not cease to be Tom's main residence for that period.

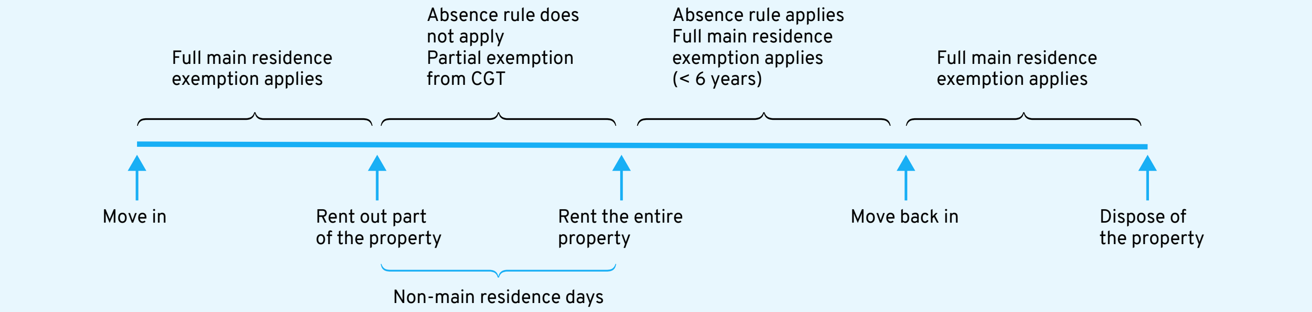
The part of the capital gain that is taxable can be calculated as follows:

$$\text{Capital gain or loss amount} \times \frac{\text{Non-main residence days}}{\text{Days in ownership period}}$$

From 1 May 2014 to 30 April 2019, the absence rule applies as the dwelling ceased to be Tom's main residence. Since the dwelling was used to produce assessable income, the maximum period that Tom can choose to treat it as his main residence is six years. In this case, the full rental period is less than six years, so Tom can treat the dwelling as his main residence for the whole period.

From 1 May 2019 to 30 April 2020, the full MRE applies since Tom moved back and used the whole dwelling as his main residence.

Diagram 1. Timeline and application of the absence rule



Query Tom's cost base of the property when he calculates the capital gain — is it reset to market value under s 118-192 at the date that he rents out part of the dwelling, or when he rents out the entirety of the dwelling? It seems that the former is correct.[12]

The interactions between the absence rule under s 118-145 and the "first use to produce assessable income" rule under s 118-192 are highlighted in ATO ID 2003/1112 and ATO ID 2003/1113 (which have since been withdrawn as the views were transposed into other ATO CGT guidance products).

Demolition issues

Under Subdiv 118-B, to avail oneself of the MRE, there must be a dwelling. Demolition of a dwelling is regarded as a CGT event and a deemed disposal of the dwelling. Often a taxpayer will not receive any capital proceeds for the demolition, so there is no capital gain for the CGT MRE to apply to (the market value substitution rule does not apply to CGT event C1). The CGT MRE would disregard a capital loss.

However, if the taxpayer then sells the vacant land, or subdivides and sell the new lots, they must account for any capital gain or capital loss they make on the sale. As there is no dwelling on the land, the taxpayer is not entitled to claim a partial exemption for the period when there was a dwelling occupied as their main residence they sell. The MRE will be available if the sale occurs whilst a dwelling that is the taxpayer's main residence remains on the land they sell.

If a taxpayer decides to rebuild after demolishing the dwelling, s 118-150 provides that the MRE can still be claimed if:

- the taxpayer makes an election to treat the vacant land as their main residence from the time the demolished dwelling was last occupied by them; and
- there is no more than four years between the time of last occupation of the demolished dwelling and the time the new dwelling becomes the taxpayer's main residence.

Section 118-150 requires the taxpayer to live in the newly constructed dwelling for at least three months.

TD 92/147 includes guidance on determining whether a dwelling becomes a taxpayer's main residence as soon as practical after erection or completion. The following factors are relevant:

- the date the certificate of occupancy (if applicable) is used;
- the date final building inspection approval is given;
- the date the dwelling becomes structurally complete; and
- the connection of services, for example, electricity, gas etc.

TD 92/147 includes examples that take the above factors into account:[13]

> "Example 1: Kim constructs a post-CGT dwelling intended to become Kim's main residence. A Certificate of Occupancy issues on 1 March and Kim arranges for furniture and other belongings to be moved in the following day. However, due to flooding, the removalists are unable to carry out their obligations on that date. Kim moves into the dwelling on the earliest possible date after the flooding has subsided. In these circumstances, Kim is taken to have moved into the dwelling as soon as practicable after the construction of the dwelling is finished. In these circumstances, Kim is taken to have moved into the dwelling as soon as practicable after its erection or completion.
>
> Example 2: The construction of Tom's dwelling is due to finish on 1 June. On 1 May, Tom decides to travel overseas for a period of 6 months. He leaves on 15 May. Although the construction of the dwelling is finished on 1 June, Tom does not move into the dwelling until his return to Australia in November. In these circumstances, a choice that section 118-150 apply to the dwelling cannot be made as the dwelling has not become Tom's main residence as soon as practicable after the construction of the dwelling is finished.
>
> Example 3: The construction of Mary's dwelling is due to finish on 1 March. On 11 February, Mary is directed by her employer to go overseas on an assignment for 4 months, leaving on 25 February. The construction of Mary's dwelling is finished on 1 March. Mary moves into the dwelling on her return to Australia in mid June. As she is required by her employer to go overseas, Mary is taken to have moved into the dwelling as soon as practicable after the construction of the dwelling is finished."

In the absence of s 118-150, the MRE does not apply to vacant land until the new dwelling is constructed and used as the taxpayer's main residence.

Marriage breakdown issues

Law

Sections 118-178 and 118-180 ITAA97 enable the CGT MRE to be available to individuals who acquired an interest in a dwelling following a marriage or relationship breakdown. However, for these provisions to be enlivened, it is necessary that the individual acquired their interest in the dwelling because of the CGT roll-over under Subdiv 126-A ITAA97.

Section 118-178 will apply if a taxpayer:

- acquired an ownership interest in a dwelling from another person ("the former partner") as a result of a CGT event ("the earlier event");
- the former partner acquired the ownership interest on or after 20 September 1985;
- there was a roll-over under Subdiv 126-A for the earlier event; and
- a CGT event ("the later event") happens in relation to the ownership interest.

If s 118-178 applies, the CGT MRE applies to the later event in the way that it would if:

- the taxpayer's ownership interest had commenced when their former partner's ownership interest commenced ("the acquisition time"); and
- from the acquisition time until the time the former partner's ownership interest ended:
  - the taxpayer had used the dwelling in the same way that the former partner used it; and
  - the dwelling had been the taxpayer's main residence for the same number of days as it was their former partner's main residence.

The effect of the above is shown in the following examples in s 118-178:

> "Example 1: Peter (the transferor spouse) is the 100% owner of a dwelling that he uses only as a main residence before transferring it to Susan (the transferee spouse). Susan uses the dwelling only as a rental property.
>
> Susan will be eligible for a partial main residence exemption having regard to how both Peter and Susan used the dwelling if, at the time the dwelling is sold, Susan is an Australian resident.
>
> Example 2: Caroline (the transferor spouse) is the 100% owner of a dwelling that she uses only as a rental property before transferring it to David (the transferee spouse). David uses the dwelling only as a main residence.
>
> David will be eligible for only a partial main residence exemption having regard to how both Caroline and David used the dwelling if, at the time the dwelling is sold, David is an Australian resident."

Section 118-180 is like s 118-178 but applies in situations when a company or trust transfers the dwelling to the individual. An individual who acquires a dwelling in these circumstances will only be able to utilise a partial CGT MRE when they choose to dispose of the dwelling. This is because the days when the company or trust owned the dwelling are ineligible main residence days.

Practical tips

1. The requirements of the Subdiv 126-A relationship roll-over should be carefully reviewed. ATO guidance products (such as TR 2014/3 and TD 1999/53) and the Full Federal Court case of *Ellison v Sandini Pty Ltd*[14] show that the legislative parameters will be interpreted and administered strictly.

Furthermore, the time at which the Subdiv 126-A relationship roll-over occurs should be reviewed. Before 1998, the Subdiv 126-A relationship roll-over was found under former s 160ZZM of the *Income Tax Assessment Act 1936* (Cth) and was more restrictive than under Subdiv 126-A.

2. In the process of the marital/relationship split, the transferee spouse should obtain from the transferor spouse a written statement confirming how the dwelling has been used by the transferor spouse (that is, as a main residence, use of the six-year absence rule, if the transferor spouse was a foreign resident etc), as this will assist in substantiating eligibility for the CGT MRE in the event of ATO scrutiny.

3. Note that a transfer of a property pursuant to the Subdiv 126-A relationship roll-over qualifies as one of the "life events" under the "life events test". This means that spouses who are foreign residents for less than six years who transfer a property to their former spouse to which a Subdiv 126-A roll-over applies may still qualify for the full CGT MRE.

Example

John and Mary are a married couple. They purchased their family home as joint tenants in Melbourne in 1995. In 2015, John and Mary moved to France for the purposes of Mary's employment. From this moment, they started to self-assess as foreign residents of Australia for tax purposes. They decided to rent out the matrimonial home.

In 2020, John and Mary decide to separate. Mary stays in France and John returns to Australia. Mary transfers her interest in the property to John under a Subdiv 126-A roll-over. John starts to self-assess as a tax resident of Australia. John does not move back into the property and continues to rent it. In 2022, John sells the property.

Can John access the full CGT MRE?

CGT MRE and deceased estates

Full exemption

A capital gain or loss from a CGT event that happens in relation to a dwelling, or the ownership interest in it, is disregarded if the taxpayer is an individual and the interest passed to the taxpayer as a beneficiary of a deceased estate, or the taxpayer owned the dwelling as the trustee of a deceased estate and, under s 118-195, the following conditions are satisfied:

- either:
  - the deceased acquired the ownership interest on or after 20 September 1985 and the dwelling was the deceased's main residence just before death and was not then being used for income-producing purposes; or
  - the deceased acquired the ownership interest before 20 September 1985; and
- either:
  - the ownership interest ends within two years of the deceased's death, or within such longer period allowed by the Commissioner; or
  - the dwelling was, from the deceased's death until the taxpayer's ownership interest ends, the main residence of one or more of the following persons:
    - the spouse of the deceased immediately before the death;
    - an individual who had a right to occupy the dwelling under the deceased's will; or
    - if the CGT event was brought about by the individual to whom the ownership interest passed as a beneficiary – that individual.

For this purpose, under s 118-197 ITAA97, a taxpayer who acquires a dwelling as a surviving joint tenant is treated as acquiring the dwelling as a beneficiary of a deceased estate.

The CGT MRE is not available where, at the time of death, the deceased was an excluded foreign resident (see below).

The CGT MRE for beneficiaries and trustees of deceased estates applies only if the interest passed to an individual taxpayer as a beneficiary in a deceased estate, or the taxpayer owned it as a trustee of a deceased estate. An "individual" is defined in s 995-1 ITAA97 to mean a natural person. A CGT asset "passes" to a beneficiary in a deceased estate in the way described in s 128-20 ITAA97.

The dwelling must have been disposed of within two years of the deceased's death or used as a main residence as described in one of the ways listed in the table in s 118-195. If none of the items are applicable, a full CGT MRE is not available under s 118-195. A partial CGT MRE may be available under s 118-200 ITAA97 (see below).

The CGT MRE will only apply where the ownership interest disposed of by the taxpayer is the same as the ownership interest that the deceased held at the time of death.[15]

A full CGT MRE was not available where an individual was granted a right of occupancy under the will for only part of the period from the time of the deceased's death until the dwelling was sold.[16]

Use for income-producing purposes

If the dwelling was used for income-producing purposes, the taxpayer may make a capital gain or loss.[17] However, the use of a dwelling to produce assessable income can be disregarded in the circumstances covered by ss 118-145 and 118-190 (see above).

Section 118-190 applies if the dwelling is the main residence of the taxpayer or of someone else.
Section 118-190(4) provides that, in those circumstances, any income-producing use before the death of the deceased is ignored if:

- the interest was acquired by the trustee or beneficiary after 7:30 pm on 20 August 1996 (s 118-195 of the *Income Tax (Transitional Provisions) Act 1997* (Cth));
- the dwelling was the main residence of the deceased just before death; and
- the dwelling was not being used for income-producing purposes just before death, or any such use just before death was ignored under s 118-190(3) (that is, under the absence rule in s 118-145).

Section 118-192 (see above) contains a special rule which applies when the taxpayer loses the entitlement to a full CGT MRE because the dwelling was used for income-producing purposes for the first time. The taxpayer is taken to have acquired the dwelling or the taxpayer's ownership interest in the dwelling immediately before the first time it was used for income-producing purposes for its market value at that time.

If the taxpayer's ownership interest in the dwelling passed to the taxpayer as a beneficiary of a deceased estate, or if the taxpayer owned it as a trustee of such estate, and the CGT event did not happen within two years of the death of the deceased, the CGT MRE applies as if:

- the taxpayer had acquired the interest as an individual and not as a beneficiary or a trustee of a deceased estate. This has the effect that ss 128-15 and 118-210 ITAA97 (dealing with the valuation of acquisitions by beneficiaries and with the calculation of the cost base) do not apply. It also enables s 118-185 to apply; and
- when applying the s 118-185 formula, the non-main residence days were the number of days in the ownership period when the dwelling was not the main residence of the spouse of the deceased, an individual who had a right to occupy the dwelling under the deceased's will, or a beneficiary.

If the CGT event happens within two years of the death of the deceased, any income-producing use by the beneficiary or trustee is disregarded because the CGT MRE under s 118-195 does not require the dwelling to be the beneficiary's main residence during the two years.

However, s 118-192 does not apply to an entity:[18]

- that acquired an ownership interest in a dwelling as trustee of a deceased estate on or before 7:30 pm on 20 August 1996; or
- to whom an ownership interest in a dwelling passed as a beneficiary in a deceased estate on or before that time.

Therefore, in relation to deceased estates, s 118-192 only applies to ownership interests acquired by trustees or beneficiaries after 20 August 1996.

The CGT MRE can still apply where the beneficiary, or trustee of the deceased estate, uses the property for income-producing purposes after the death of the deceased.[19]

CGT MRE only applies to specified CGT events

The CGT MRE for beneficiaries and trustees of deceased estates only applies in relation to capital gains and losses arising from specified CGT events. Therefore, if a capital gain or loss arises from a CGT event which is not specified in s 118-195, the CGT MRE will not apply. The specified CGT events to which the CGT MRE applies are:

- CGT event A1: disposal of a CGT asset;
- CGT event B1: use and enjoyment before title passes;
- CGT event C1: loss or destruction of a CGT asset;
- CGT event C2: cancellation, surrender and similar endings;
- CGT event E1: creating a trust over a CGT asset;
- CGT event E2: transferring a CGT asset to a trust;
- CGT event F2: granting a long-term lease;
- before 7:30 pm on 9 May 2017 (ACT legal time):
  - CGT event I1: individual or company stops being a resident;
  - CGT event I2: trust stops being a resident trust;
- CGT event K3: asset passing to tax-advantaged entity;
- CGT event K4: CGT asset starts being trading stock;
- CGT event K6: pre-CGT shares or trust interest (except one involving the forfeiting of a deposit); and
- a CGT event that involves the forfeiting of a deposit as part of an uninterrupted sequence of transactions ending in one of the events listed above subsequently happening.

Section 118-230 ITAA97 expands the list in s 118-195 to include CGT events E5 (beneficiary becoming entitled to trust asset) and E7 (disposal to beneficiary to end capital interest) that happen from 1 July 2006 in relation to a dwelling held at some time in a special disability trust.

Partial exemption

Where the taxpayer is an individual and the interest passed to the taxpayer as a beneficiary of a deceased estate, or the taxpayer owned the dwelling as the trustee of a deceased estate and the conditions for a full CGT MRE are not satisfied, either a partial exemption or no exemption will be available.[20] The amount of the capital gain or loss is apportioned by working out the number of non-main residence days compared to the total ownership days that are relevant for CGT MRE purposes.[21]

Under s 118-205 ITAA97, the apportionment formula is adjusted where a dwelling is inherited from someone who had previously acquired the dwelling by inheritance. Where the property was acquired by the deceased on or after 20 September 1985, the non-main residence days will also include days where the property was the main residence of an excluded foreign resident.[22]

Under s 118-210, special rules also apply where, under a deceased person's will, the trustee of the deceased estate acquires an ownership interest in a dwelling for occupation by an individual. Such an acquisition may be in pursuance of the will or under its authority, but does not have to be by force of the will nor in strict conformity with it. However, if a trustee acquires an ownership interest in a dwelling during the administration of an intestacy, the trustee does not acquire the interest under the deceased's will because there is no will.[23]

Extension of two-year period

PCG 2019/5 includes details of the factors to be considered when exercising the Commissioner's discretion to extend the two-year period and includes a safe harbour to treat the discretion as being exercised.

Some of the factors that the Commissioner may consider when deciding whether to exercise the discretion are set out in PCG 2019/5. The non-exhaustive list is below.

Factors favouring a longer period

The factors that favour a longer period include:

- the ownership of the dwelling, or the will, is challenged;
- a life or other equitable interest given in the will delays the disposal of the dwelling;
- the complexity of the deceased estate delays the completion of administration of the estate;
- settlement of the contract of sale of the dwelling is delayed or falls through for reasons outside of the taxpayer's control; and
- restrictions on real estate activities imposed by a government authority in response to the COVID-19 pandemic.

Factors weighing against a longer period

The factors that weigh against a longer period include:

- waiting for the property market to pick up before selling the dwelling;
- waiting for refurbishment of the dwelling to improve the sale price;
- inconvenience on the part of the taxpayer to organise the sale of the dwelling; and
- unexplained periods of inactivity by the executor in attending to the administration of the estate.

Other factors not relevant for the safe harbour

Other factors that are not relevant for the safe harbour include:

- the sensitivity of the taxpayer's personal circumstances and/or of other surviving relatives of the deceased;
- the degree of difficulty in locating all beneficiaries required to prove the will;
- any period the dwelling was used to produce assessable income; and
- the length of time the taxpayer held the ownership interest in the dwelling.

PCG 2019/5 includes a safe harbour to allow taxpayers up to 12 months, in addition to the two-year period, to dispose of the dwelling if they satisfy all of the following conditions, as if the discretion to extend the two-year period had been exercised:

- in the first two years, more than 12 months was spent addressing one or more of the factors under "Factors favouring a longer period" above;
- the dwelling was listed for sale as soon as possible after those circumstances were resolved (and the sale was actively managed to completion);
- the sale completed (settled) within six months of the dwelling being listed for sale;
- if any of the factors listed under "Factors weighing against a longer period" above were applicable, they were immaterial to the delay in disposing of the taxpayer's interest; and
- the longer period for which the taxpayer would otherwise need the discretion to be exercised is no more than 12 months.

Special disability trusts

Under s 118-222 ITAA97, the CGT MRE is available after the death of the principal beneficiary of a special disability trust where the intended recipient of the residence disposed of the dwelling within two years of the death and the dwelling was not used to produce assessable income. A partial CGT MRE may be available to the trustee in the event that the property was used to produce assessable income prior to the principal beneficiary's death.

CGT MRE changes for foreign residents

Background

The government's Housing Affordability Package was announced on 9 May 2017 as part of the Federal Budget 2017–18.[24]

The policy to deny the CGT MRE to taxpayers who, at the time of the CGT event (that is, when they enter into a contract to sell a dwelling that has been their main residence), are a foreign resident or non-resident for tax purposes (hereafter referred to as simply "foreign resident") was announced in the following brief terms:

> "The Government will extend Australia's foreign resident capital gains tax (CGT) regime by … denying foreign and temporary[25] tax residents access to the CGT main residence exemption from 7:30pm (AEST) on 9 May 2017, however existing properties held prior to this date will be grandfathered until 30 June 2019 …"

After a chequered legislative history following the Budget announcement in 2017, the *Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Act 2019* (the MRE Act) was enacted on 12 December 2019 and applies from 9 May 2017 (subject to a transitional rule).

This article does not consider the Australian individual tax residency rules. TR 2023/1 gives the ATO's views on the individual residency tests.

Amendments from 9 May 2017

Foreign resident individuals

By amending s 118-110, the core provision, the MRE Act removed the entitlement to the CGT MRE for foreign resident individuals as follows:

1. Individuals who are an "excluded foreign resident"[26] (that is, foreign resident) at the time the CGT event happens to a dwelling in which they have an ownership interest are not entitled to the CGT MRE for any part of the exemption that arises from their use of the dwelling.

   The CGT MRE is denied where the dwelling:

   a. is held by an individual who is an excluded foreign resident or is a foreign resident who does not satisfy the life events test (see below);

   b. was, or was taken to be, the individual's main residence for the whole[27] or part[28] of the ownership period; and

   c. the interest did not pass to the individual as a beneficiary in, or as trustee of, the estate of a deceased person.

2. The CGT MRE is also denied if the individual is a foreign resident at the time the CGT event happens to part of their individual ownership interest because of a compulsory acquisition.[29]

For capital gains from CGT event A1, the time of disposal is when the contract for sale of the property is entered into.[30]

Example 1.2. Main residence exemption denied (from the EM)

Vicki acquired a dwelling in Australia on 10 September 2010, moving into it and establishing it as her main residence as soon as it was first practicable to do so.

On 1 July 2018 Vicki vacated the dwelling and moved to New York. Vicki rented the dwelling out while she tried to sell it. On 15 October 2020 Vicki finally signs a contract to sell the dwelling with settlement occurring on 13 November 2020. Vicki was a foreign resident for taxation purposes on 15 October 2020.

The time of CGT event A1 for the sale of the dwelling is the time the contract for sale was signed, that is 15 October 2020. As Vicki was a foreign resident at that time, she is not entitled to the main residence exemption in respect of her ownership interest in the dwelling.

Note: This outcome is not affected by:

- Vicki previously using the dwelling as her main residence; and
- the absence rule in section 118-145 that could otherwise have applied to treat the dwelling as Vicki's main residence from 1 July 2018 to 15 October 2020 (assuming all of the requirements were satisfied).

Exemption for certain life events

Under s 118-110(5), a foreign resident will be able to continue to access the CGT MRE for CGT events concerning certain life events if:

- they have been a foreign resident for no more than six years at the time of the CGT event; and
- they satisfy the "life events test", which requires that, during the person's period of foreign residency, one of the following specified circumstances occurred:
  - the person or their spouse has had a terminal medical condition that existed at any time during that period of foreign residency;
  - the person's child has had a terminal medical condition that existed at any time during that period of foreign residency, and that child was under 18 years of age at, at least, one such time;
  - the person's spouse, or child who was under 18 years of age at death, died during that period of foreign residency; or
  - the CGT event happens because of separation or divorce.

> "By amending s 118-110 … the MRE Act removed the entitlement to the CGT MRE for foreign resident individuals …"

Terminal medical condition. A person will satisfy this element of the life events test if, during all or part of the period of a person's foreign residency, either they, their spouse or their child had a "terminal medical condition".[31]

For a child of the foreign resident, it is necessary that, during at least part of the period of foreign residency where the child was suffering from a terminal medical condition, the child was under 18 years of age.

Death. A person will satisfy this element of the life events test if, during a person's period of foreign residency, their spouse, or their child who was under 18 years of age at the time of their death, dies.

Divorce or separation. A person will satisfy this element of the life events test if the CGT event occurs because of a matter referred to in a paragraph of s 126-5(1) ITAA97 (which provides a CGT roll-over for certain assets transferred between spouses because of a marriage or relationship breakdown) involving the person or their spouse (or former spouse).

If the CGT event has not occurred because of one of the matters in s 126-5(1), the person is not able to access the CGT MRE even if the matter has occurred during their period of foreign residency.

Example 1.8. Main residence exemption – life events test (from the EM)

Joan acquired a dwelling on 7 February 2015, moving into it with her spouse John and establishing it as their main residence as soon as it was first practicable to do so. Joan and John are residents of Australia at the time of the purchase of the property. In 2020, they retire to live in the Bahamas and acquire a new residence there. They become foreign residents at this time. They rent out their former Australian residence after they leave Australia, and it is not maintained as their main residence in the rental period. In 2021, John dies and Joan decides to sell their former residence. As Joan has been a foreign resident for less than six years at the time of entering into the CGT event for the sale and her spouse has passed away during the period of her foreign residency, she is entitled to a partial main residence exemption for the sale of the residence based on the period that it was her main residence.

In the above example, Joan satisfies the life events test. Accordingly, only a partial exemption is available to Joan because she (and John) acquired a new residence overseas. Had Joan not acquired a new residence overseas but instead rented a residence overseas, because she satisfies the life events test, she would have been entitled to a full exemption under s 118-145 which allows her to continue to treat the former residence as her main residence for up to six years after it ceases to be her main residence.

Foreign resident disposes of dwelling acquired from deceased person

If the deceased was an Australian resident. Under s 118-195(1A)(b), where a foreign resident disposes of a dwelling acquired from a deceased person who was a resident of Australia, the CGT MRE will continue to be available for the period attributable to the period:

- during the deceased person's lifetime when they used the dwelling as their main residence;
- that occurs within two years of the deceased's death (or within the further time allowed by the Commissioner); and
- following the deceased's death, where the dwelling was the main residence of an an individual who:
  - was the spouse of the deceased immediately before their death; and/or
  - had a right to occupy the dwelling under the deceased's will.

However, any additional component of the CGT MRE that the foreign resident beneficiary accrued (that is, from occupying the dwelling) is denied.

Refer to example 1.6 of the EM, where a foreign resident beneficiary inherits a main residence from a deceased person who was an Australian resident at the time of their death.

If the deceased was an excluded foreign resident at the date of death. Under s 118-195(1)(c) and (1A)(a), the part of the CGT MRE accrued by the deceased in respect of the dwelling is not available to the beneficiary.

Beneficiaries continue to be entitled to the CGT MRE for any part of the exemption that they accrue (if they are not a foreign resident at the time the CGT event occurs). To ensure that no part of the CGT MRE of the deceased is included, the following apply when calculating a capital gain or loss:

- the first element of the dwelling's cost base and reduced cost base for the beneficiary is the cost base of the deceased, immediately before the deceased's death;
- a surviving joint tenant of a dwelling is not able to treat the dwelling as the deceased's main residence where that dwelling was being built, repaired or renovated if the deceased was a foreign resident at the time of their death; and
- apportionment occurs on a day's basis based on "non-main residence days" to "total days", with the number of days the deceased person held the ownership interest in the dwelling treated as "non-main residence days".[32]

The CGT MRE will not apply if the deceased was an excluded foreign resident at the time of their death and:[33]

- the beneficiary who inherits the ownership interest was a foreign resident at the time when the CGT event happens; or
- the trustee of the deceased estate acquired a dwelling after the deceased person's death for an individual to occupy under the terms of the will, and the dwelling was later disposed of by the trustee.

Australian residency ends. The MRE Act also amended the CGT MRE so that it does not apply if CGT event I1 or I2[34] occurs to an ownership interest in a dwelling.[35]

Marriage or relationship breakdown

The authors discuss below an issue relating to the impact of the changes to the CGT MRE for foreign residents on taxpayers who have a marriage or relationship breakdown and there is a later sale of a dwelling that was their main residence, in circumstances where a property is transferred under the family law settlement and the transferor subsequently becomes a foreign resident.

CGT roll-over on marriage or relationship breakdown under current law. The Subdiv 126-A roll-over is discussed earlier in this article.

Under s 118-178, an individual who acquires an ownership interest in a dwelling that was the subject of a Subdiv 126-A roll-over must consider, in addition to their own use of the dwelling, how their former spouse used the dwelling. If either of the individuals used the property other than as their main residence (that is, for a taxable purpose), there may only be a partial CGT MRE available on sale. If the dwelling was used solely as the main residence by the individual and their former spouse from when the former spouse acquired the dwelling, a full CGT MRE is available.

Impact of changes. The MRE Act is silent on the interaction between ss 118-110(3) and 118-178, so it is unclear how the measures impact a resident individual selling the dwelling whose former spouse is a foreign resident at the time of the CGT event. It is possible that the individual selling the property could be adversely affected by the measures despite the fact that they are a resident at the time of the CGT event.

Assume that:

- the resident spouse sells a dwelling in Australia which was transferred from their former spouse under a family law settlement;
- the property is eligible for a CGT roll-over under s 126-5;
- the resident spouse continues to treat the dwelling as their main residence until they sell it; and
- the former spouse is a foreign resident at the time the CGT event happens to the resident.

There are two interpretations:

1. the CGT event does not happen to the foreign resident former spouse, so there is no impact on their main residence days — accordingly, the resident spouse can consider the main residence days of their foreign resident former spouse and would be eligible for a full CGT MRE on the sale of the property; or
2. notwithstanding that the CGT event does not happen to the foreign resident former spouse, they are a foreign resident *at the time* the CGT event happens to the resident, so the main residence days of the foreign resident former spouse are zeroed out as if they had never lived there — in this case, when the resident spouse sells the property, they will be eligible for only a partial exemption.

This second outcome is an extraordinary one, given that:

- para 1.22 of the EM states:

  > "Individuals who are Australian residents for taxation purposes at the time a CGT event occurs to a dwelling are not affected by this measure."

- the resident may not even know whether their former spouse is a foreign resident at the time of the CGT event;[36]
- existing family law settlements would not have taken these measures and this outcome into account; and
- it would be difficult to negotiate a future family law settlement and quantify the tax impact so that an equitable settlement could be reached, to consider the contingency that the former spouse may, one day and following the family law settlement, be a foreign resident at the time the resident spouse sells the property.

Application and transitional provisions

The amendments to the CGT MRE generally apply to CGT events happening on or after 7:30pm on *9 May 2017*. However, under transitional rules, the amendments do not apply in relation to a capital gain or loss from a CGT event that happened on or before *30 June 2020*,[37] if an individual held an ownership interest in the dwelling to which the CGT event related at all times from immediately before 7:30pm on 9 May 2017 until immediately before the CGT event happened.[38]

Similar transitional rules apply to deceased estates and special disability trusts.

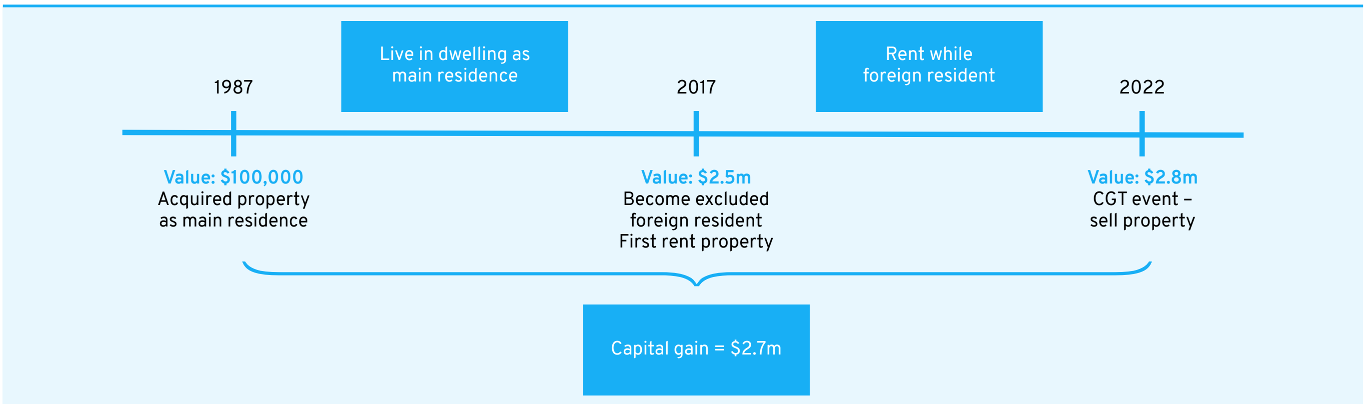
Case study: effect of foreign resident changes to the CGT MRE

Facts

An Australian resident taxpayer, Mike, has always been a resident for tax purposes. He bought a dwelling in Australia on 1 July 1987 for $100,000 and used it as his home; it has never been rented out, and the dwelling has always been his main residence. On 30 June 2017, having decided to accept a job overseas, Mike relocated offshore for an indefinite period and became a foreign resident. At that time, Mike's home was worth $2.5m.

Mike decides to stay overseas. Five years later, on 30 June 2022, he sells the dwelling that, prior to moving overseas, had been his home for 30 years. Because Mike is a foreign resident at the time of the CGT event, and Mike did not satisfy the life events test, he is not entitled to the CGT MRE — at all. So, he will have a taxable capital gain of $2.7m (see Diagram 2).

Diagram 2. Case study timeline



Tax implications

Mike *cannot*:

- claim a partial CGT MRE for the number of days he lived in the dwelling;
- continue to treat the dwelling as his main residence after he vacates it (under the absence rule in s 118-145) – which would otherwise allow him to continue to treat the dwelling as his main residence indefinitely if the property is not used for an income-producing purpose or for up to six years if he rents it out; or
- if he had decided to rent the property in 2017 when he left Australia – reset/uplift the cost base of the dwelling to its market value on the date he first began to rent it (where that use occurs for the first time after *20 August 1996*) under s 118-192.

This is because all of these concessions are contained in the CGT MRE rules and rely on the taxpayer being entitled to claim a partial CGT MRE – and Mike is not entitled to any CGT MRE.

Third element ownership costs. Had Mike instead acquired the dwelling after *20 August 1991*, he would be entitled to include ownership costs, such as rates, repairs, maintenance, insurance and interest expenses, in the cost base of the property. But Mike never kept records of these costs because he did not think it was necessary; everyone knows that the sale of a dwelling that is your main residence is not subject to CGT. Mike could not have foreseen all those years ago that the government would propose to retrospectively deny him the CGT MRE, causing the sale of his home to be taxable in the future based on his circumstances.

If Mike is unable to substantiate his third element ownership costs, he would not be able to include an estimate of these amounts in the cost base of the property, thereby increasing his taxable capital gain.

Contrast this with a taxpayer who acquires a dwelling after these changes are enacted with the knowledge that, under the rules, there is a possibility that they will not be entitled to the CGT MRE – they would be able to prospectively retain all relevant cost base records from the date of acquisition to minimise their eventual taxable capital gain.

CGT event I1 not applicable. CGT event I1 (s 104-160 ITAA97) happens when an individual stops being an Australian resident, causing a deemed disposal of their CGT assets at their market value, and allows the taxpayer to choose to defer the tax on these assets. However, CGT event I1 does not happen when Mike stops being an Australian resident, because CGT event I1 applies only to CGT assets that are not *taxable Australian property*[39] – in this case, Mike's dwelling continues to be *taxable Australian property* and therefore still is within the Australian CGT regime.

What about the CGT discount? Mike will have a taxable capital gain of $2.7m, without access to any CGT MRE. Is he entitled to any CGT discount as a foreign resident? Foreign residents have not been entitled to the CGT discount since 8 May 2012.

Under s 115-115:

- as Mike became a foreign resident after 8 May 2012, he is entitled to a reduced discount based on the number of days he was a resident. (The law requires the calculation to be performed based on the number of days but, for illustrative purposes and simplicity, years have been used here instead.) So, given that Mike was a resident for 30 years out of 35 years of ownership, he will be entitled to a CGT discount of 42.85% instead of the full 50% discount; but
- had Mike become a foreign resident before 8 May 2012, he would be entitled to apportion the CGT discount by applying it only to that part of the capital gain which had accrued to 8 May 2012 by figuring out the market value of the property on 8 May 2012. On the facts as given, Mike did not become a foreign resident until 2017, so this market value rule is not available to him.

Variations to facts

What if Mike moves back to Australia? If Mike moves back to Australia after 30 June 2020 and re-establishes himself as a resident, then sells the dwelling, he would not be a foreign resident *at the time of the CGT event* and he would be entitled to the CGT MRE. So, he could access a partial CGT MRE, the absence rule in s 118-145, and the cost base market value deeming rule in s 118-192 as applicable.

However, para 1.23 of the EM explains that the general anti-avoidance rules in Pt IVA may be applied to arrangements that have "been entered into by a person for the sole or dominant purpose of enabling that person or another person to obtain the [CGT MRE]".

What if Mike dies while he is overseas? If Mike dies while he is overseas, his interest in the dwelling will pass to the beneficiaries (referred to in this article as "the beneficiary") of his deceased estate in accordance with the wishes set out in his will. Table 1 summarises whether the CGT MRE is available to a beneficiary of a deceased estate who inherits a dwelling.

Assume that Mike dies on 10 June 2024, and Mike's beneficiary sells the property on 15 October 2024.

Mike is an excluded foreign resident at the time of his death. As Mike is an excluded foreign resident at the time of his death, any part of the CGT MRE that Mike has accrued is not available to the beneficiary. This means that, despite Mike residing in the property for 30 years as a resident and because he was an excluded foreign resident when he died, his beneficiary may not be able to claim any CGT MRE – it will depend on their residency status at the time of the CGT event.

If *the beneficiary is a resident* at the time of the CGT event (that is, when they sell the property), they will be entitled to the CGT MRE that accrues, but not that of Mike.

If *the beneficiary is a foreign resident* at the time of the CGT event, they will not be entitled to any CGT MRE; not for the period that Mike resided in the dwelling, nor for the period following his death. This is irrespective of the beneficiary's use of the dwelling or the beneficiary's residency status throughout the ownership period. This means that, if the deceased was an excluded foreign resident at the time of death, and the beneficiary is a foreign resident at the time of the CGT event, no CGT MRE is available to the beneficiary.

If Mike had died before 30 June 2023, he would not have been an excluded foreign resident at the time of his death, and there would have been a life event (his death). Therefore, the CGT MRE would have been available up to the time of Mike's death.

Mike was a resident at the time of his death. Had Mike been a resident at the time of death (that is, he had re-established his residency before he died and was not a foreign resident at the time of death), the CGT MRE accrued by Mike will continue to be available to his beneficiary to the extent of:

- the period during Mike's lifetime that he used the dwelling as his main residence;
- the period that occurs within two years of Mike's death (or within such longer period allowed by the Commissioner); and
- the period following Mike's death where the dwelling was the main residence of Mike's spouse (assuming he had one) immediately before his death and/or an individual who had a right to occupy the dwelling under Mike's will, regardless of the residency status of that spouse or individual.

However, the beneficiary — to whom the ownership interest in the dwelling passed under the will (but falling short of having a right to occupy the dwelling under the will) — is denied any component of the CGT MRE that is attributable to the period following death when they lived in the dwelling as their main residence if they are a foreign resident at the time of the CGT event.

So, to summarise, if Mike's beneficiary is:

- *a resident* at the time of the CGT event (that is, on 15 October 2023) — they continue to be entitled to the CGT MRE for any part of the exemption that they accrue (the cost base for the beneficiary will be Mike's cost base immediately before his death); or
- *a foreign resident* at the time of the CGT event — they will be denied any part of the CGT MRE that they accrued.

Foreign resident inherits dwelling from deceased foreign resident

Varying the facts from earlier, Mike acquired the dwelling on 1 July 1987, moving into it and establishing it as his main residence as soon as it was first practical to do so. He continued to reside in the property until he became a foreign resident on 30 June 2017. He still owned the dwelling when he died on 10 June 2024.

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

Table 1. Is the CGT MRE available to a beneficiary of a deceased estate who inherits the dwelling?

At the time of the CGT event, the beneficiary is a ...	At time of death, the deceased is a resident	At the time of death, the deceased is an excluded foreign resident
Resident	✔ CGT MRE available.*	✘ In relation to the deceased's period of ownership. ✔ In relation to the period following the date of death.
Foreign resident	✔ CGT MRE available* but only in relation to: • the period before the date of death during which the dwelling was the deceased's main residence;* and • the period within two years of the date of death;^ and • the period after the date of death where the dwelling was the main residence of the deceased's spouse and/or an individual who had a right to occupy the dwelling under the deceased's will. ✘ CGT MRE not available in relation to the period following the above.	✘ CGT MRE not available

* Subject to normal CGT MRE rules.
^ Or within such longer period allowed by the Commissioner.

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

Sarah is not entitled to any CGT MRE for the ownership interest that she has in the dwelling at the time she sells it. Specifically, she is not entitled to any CGT MRE for the following periods:

- 1 July 1987 to 30 June 2017 (when Mike used the dwelling as his main residence): because Mike was an excluded foreign resident at the time of his death, any part of the CGT MRE that Mike accrued is not available to Sarah;
- 1 July 2017 to 10 June 2024 (when the property was leased out by Mike while he was overseas): Mike cannot access the absence rule in s 118-145; and
- 10 June 2024 to 15 October 2024 (when the property was leased out by Sarah): Sarah is not entitled to the CGT MRE because she is a foreign resident on 15 October 2024, the day on which she signs the contract to sell her ownership interest (the day on which CGT event A1 occurs).

Foreign resident inherits dwelling from deceased Australian resident

Varying the facts from earlier, Mike acquired the dwelling on 1 July 1987, moving into it and establishing it as his main residence as soon as it was first practical to do so.[40] He continued to live in the property, and it was his main residence until his death on 10 June 2022. Mike was at no time a foreign resident.

Sarah, Mike's daughter, inherited the dwelling following Mike's death. On inheriting the dwelling, Sarah rented it out. It was not her main residence at any time. On 12 November 2023, Sarah signs a contract to sell the dwelling and settlement occurs on 12 December 2023.

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

Sarah is entitled to a partial CGT MRE for the ownership interest that she has in the dwelling at the time she sells it, being the exemption that accrued while Mike used the dwelling as his main residence (1 July 1987 until 10 June 2022). She is not entitled to any CGT MRE that she accrued in respect of the dwelling (10 June 2022 until 15 October 2023). This is because she was a foreign resident on 15 October 2023, the day on which she signs the contract to sell her ownership interest (the day on which CGT event A1 occurs).

It should be noted that Sarah will need to apply s 118-200 to work out the amount of the capital gain or loss that she realises from the sale of the ownership interest in the dwelling.

If Sarah had instead sold the dwelling on or before 10 June 2024, she would have been entitled to a full CGT MRE. This is because the whole of the CGT MRE would have, or would be taken to have, accrued from Mike's use of the residence. This includes the two-year period following Mike's death.

What if Mike returns to Australia to die?

Assume that, in February 2022, Mike is diagnosed with a terminal medical condition. He decides to return to Australia for medical treatment and to be close to his family and friends. Mike returns to Australia but is immediately confined to a hospital bed, where he spends the next four months until his death.

While in hospital, Mike, as part of attending to his estate planning and financial affairs, may arrange to sell the property before he dies in June 2024. Alternatively, he may still own the dwelling at the time of his death.

If Mike is a resident at the time of the CGT event or his death, he is entitled to the CGT MRE, including the absence rule under s 118-145. But, if he is an excluded foreign resident at the time of the CGT event or his death, he is not entitled to any CGT MRE.

Assume that, immediately on Mike's return to Australia, he is transferred to a hospital and dies without ever moving back into his home. Has Mike become a resident again, or is he still a foreign resident at the time of the CGT event or his death? This is a question of fact, but it may be problematic to establish that Mike has re-established his residency simply by virtue of his presence in Australia while he seeks medical treatment.

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This article is an edited and updated version of "The main residence exemption: tips, traps, trips and tricks" presented at The Tax Institute's Tax Summit held in Melbourne on 5 to 7 September 2023.

References

1 Paras 33 to 40 of TR 2004/D25.

2 [1941] HCA 13.

3 Ss 104-10 and 109-5 ITAA97. An exception to the general approach of settlement date, not contract date, for the CGE MRE is for foreign residents (discussed later in this article).

4 S 118-165 ITAA97. There is an exemption under s 118-245 ITAA97 for adjacent land compulsorily acquired.

5 ATO ID 2009/34.

6 S 118-170 ITAA97.

7 IT 2167.

8 S 118-190(1)(c) ITAA97.

9 TD 1999/71.

10 S 118-145(3A) ITAA97.

11 S 118-145(4) ITAA97.

12 PBR 1012989015101.

13 TD 92/147.

14 [2018] FCAFC 44.

15 *Estate of JR Cawthen and FCT* [2008] AATA 1168.

16 ATO ID 2004/882 and ATO ID 2006/34

17 S 118-190 ITAA97.

18 S 118-195 of the *Income Tax (Transitional Provisions) Act 1997*.

19 TD 1999/70.

20 S 118-200(1) ITAA97.

21 S 118-200(2) ITAA97.

22 S 118-205(4) ITAA97.

23 TD 1999/74.

24 This section of the article draws on N Brydges and R Jacobson, "Latest legislative developments in property", paper presented at The Tax Institute's 2021 Yarra Valley Tax Retreat on 3 June 2021. Any errors in updating are by the present authors alone.

25 The government announced on 18 December 2017, as part of the Mid-Year Economic and Fiscal Outlook 2017–18, that, following consultation, the government amended the proposal so that "temporary tax residents" who are Australian residents would be unaffected. This ensures that only Australian tax residents, including temporary residents, can access the CGT MRE. So, only foreign residents are affected by this measure.

26 An "excluded foreign resident" is a foreign resident who has been a foreign resident for a continuous period of more than six years (s 118-110(4) ITAA97).

27 S 118-110(3) ITAA97.

28 S 118-185(3) ITAA97. Refer to example 1.4 of the explanatory memorandum to the Bill that became the MRE Act (the EM) which illustrates denial of the partial CGT MRE.

29 S 118-245(3) ITAA97. Refer also to example 1.5 of the EM.

30 This is different to most aspects of the "main residence exemption" in Subdiv 118-B ITAA97 that uses the "ownership period" as defined in s 118-30 that looks to the settlement date.

31 A "terminal medical condition" has the meaning given by reg 303-10.01 of the *Income Tax Assessment Regulations 1997* (Cth). This requires, among other things, that two medical practitioners, jointly or separately, have certified that the illness, or injury, the affected person suffers from is likely to result in their death within 24 months of the certification.

32 S 118-200(2), (3) and (4), s 118-205(4), and item 3 of the table in s 128-15(4) ITAA97. See also example 1.7 of the EM, where a resident beneficiary inherits a dwelling from a foreign resident deceased person.

33 S 118-210(6) ITAA97.

34 CGT events I1 and I2 may occur if an individual or trust stops being a resident of Australia for taxation purposes. The amendments ensure consistent application of the CGT MRE, whether a foreign resident has an ownership interest in a dwelling that is real property or a mobile home.

35 Ss 118-110(2)(a), 118-195(2)(a), and 118-210(5)(a) ITAA97.

36 Even if the individual was aware that their former spouse was working overseas when they sold their home, they may not be privy to the residency status of their former spouse at that time.

37 This was originally proposed to be 30 June 2019 but was extended to 30 June 2020.

38 S 118-110 of the *Income Tax (Transitional Provisions) Act 1997* (Cth).

39 S 855-15 ITAA97.

40 The following is adapted from example 1.6 of the EM.

Changes to the thin capitalisation rules

by Ed Ng, Partner, and Richard Goodwin, CTA, Associate Partner, EY Australia

The changes to the thin capitalisation rules from an asset-based approach to an earnings-based method will require careful consideration for all taxpayers within the scope of the new rules. While these changes have previously been foreshadowed by the government, there is "devil in the detail". Non-corporate and non-consolidated group structures will need to review application of the fixed ratio test to their circumstances. Entities seeking to rely on the third party debt test will need to review the terms of the debt and security arrangements in relation to their external borrowings. The surprise inclusion of new debt creation rules, on which there was no earlier consultation and which are very broad in scope, will potentially apply to many financing arrangements (including existing financial arrangements). The new measures apply for income years commencing on or after 1 July 2023 and, therefore, taxpayers need to commence a review of their existing financing arrangements now.

Introduction

On 22 June 2023, the government introduced into parliament the Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Bill 2023 (the Bill) which will amend the thin capitalisation provisions in Div 820 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The amendments will apply for income years commencing on or after 1 July 2023.

The Bill will replace the current asset-based thin capitalisation measures with three new tests:

- a default fixed ratio test based on 30% of tax earnings before interest, taxes, depreciation and amortisation (EBITDA) (replaces the safe harbour test for all general class investors);
- a group ratio test (replaces the worldwide gearing test for all general class investors); and
- a third party debt test for general class investors and financial entities that are not authorised deposit-taking institutions (ADIs).

The changes to the thin capitalisation rules to adopt an earnings-based approach follows the recommended approach of the OECD as set out in its action 4 report.[1] The changes were proposed by the government ahead of the 2022 Federal election and were subject to consultation after the election, before the government confirmed in the Federal Budget in October 2022 that it would proceed with these measures. In March 2023, exposure draft legislation was released (the Treasury Laws Amendment (Measures for Future Bills) Bill 2023: Thin capitalisation interest limitation (the exposure draft Bill)).

The measures included in the Bill are a significant change to the current thin capitalisation rules and need to be carefully considered by taxpayers. While the Bill has taken into consideration the many submissions that were made in response to the exposure draft Bill, there remain issues with the operation of the new rules that will impact taxpayers in certain industries.

The Bill also includes new debt creation rules that were not previously foreshadowed. These measures, which will deny deductions for interest on borrowings to either acquire assets from an associate or to fund dividends or other distributions to an associate, are very broad and would appear to apply to a wide range of transactions.

At the time of writing, the Bill had been passed unamended by the House of Representatives and is before the Senate, pending the amendments that have been foreshadowed by Treasury in the report by the Senate Economics Legislation Committee (SELC) which was issued on 22 September 2023. On 18 October 2023, Treasury released, for consultation, an exposure draft of the proposed amendments to the Bill. The amendments deal with a number of the issues that are raised in this article, including:

- application of the third party debt test to ensure that it can apply to trusts and partnerships;
- amendments to the security and asset recourse limitations in the third party debt test to ensure that it operates appropriately;
- modifications to the fixed ratio test and in particular the calculation of tax EBITDA for certain trusts;
- modifications are also made to the fixed ratio test to require adjustments for prior year tax losses and notional R&D deductions; and
- limiting the scope of the debt creation rules by introducing certain exemptions similar to those contained in the "old" debt creation rules in former Div 16G of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). The exposure draft amendments will ensure that borrowing from a third party to fund the acquisition of an asset from an associate is not subject to the debt creation rules. The draft amendments also include a one-year "grace period" for financial arrangements entered into before 22 June 2023, such that the debt creation rules only apply to

these arrangements for income years commencing on or after 1 July 2024.

The consultation period on the exposure draft amendments closed on 30 October 2023. The amended Bill will be considered by the Senate, which is due to sit from 6 November to 17 November 2023, and finally from 27 November to 7 December 2023.[2] It is anticipated that the amendments to the Bill would be considered during these periods (most likely the latter period). Any amendments made by the Senate must then be agreed to by the House of Representatives, which sits from 13 November to 16 November 2023, and finally from 27 November to 7 December 2023.[3]

The exposure draft amendments confirm that there will be no deferral of the start date of the Bill, that is, the measures in the Bill will apply for income years commencing on or after 1 July 2023 (other than the one-year grace period under the debt creation rules for financial arrangements entered into before 22 June 2023). Nor, given the potential complexity, is there likely to be any grandfathering of existing financing arrangements.

As such, passage of the Bill through parliament will mean that the new thin capitalisation rules and the debt creation measures have retrospective application (in some cases).

Thin capitalisation

The amendments to the thin capitalisation provisions in Div 820 ITAA97 will introduce three new tests to replace the existing tests for "general class investors":

- a default fixed ratio test based on 30% of tax EBITDA;
- a group ratio test; and
- a third party debt test.

The amendments will apply for income years commencing on or after 1 July 2023.

The thin capitalisation rules continue to apply only where debt deductions of the taxpayer and its associate entities exceed $2m in an income year.

The definition of "debt deduction" in s 820-40(1) ITAA97 is widened by removing the requirement that the cost needs to be incurred "in relation to a debt interest issued by the entity". The intent of this change is to include as debt deductions amounts that are economically equivalent to interest in line with OECD best practice guidance. This expanded definition of "debt deduction" may therefore include costs such as guarantee fees, arranger fees and other costs related to financing arrangements that were not previously treated as a debt deduction. Section 820-40(3)(a) will also be repealed to ensure that interest rate swaps are included within the definition of "debt deduction".

The existing exemption in s 820-37 ITAA97 for outward investing entities where the assets of the Australian entity and its associates represent at least 90% of its total assets continues to apply. Therefore, Australian outbound groups with limited overseas operations should remain exempt from the thin capitalisation rules.

General class investors

The new thin capitalisation rules will apply to "general class investors". This term is defined (somewhat confusingly) in s 820-46(2) ITAA97 and provides that an entity will be a general class investor for an income year where:

- it is not, for all of that year, a financial entity or an ADI that is either an outward investing entity or an inward investing entity; and
- assuming that the entity was a financial entity, it would be either an outward investing financial entity or an inward investing financial entity that is not an ADI for the income year.

This means that the following entities will be general class investors:

- an Australian entity that carries on business in a foreign country at or through a permanent establishment or through an entity that it controls;
- an Australian entity that is controlled by foreign residents; and
- a foreign entity having investments in Australia.

This new definition will encompass entities of any of the following types under the current thin capitalisation provisions:

- outward investors (general);
- inward investors (general); and
- inward investment vehicles (general).

The definition of "financial entity" in s 995-1(1) ITAA97 is amended to include two additional conditions in para (a) for entities that are a registered corporation under the *Financial Sector (Collection of Data) Act 2001* (Cth). These conditions will require that the entity is carrying on a business of providing finance (but not predominantly to associates) and that it derives all or substantially all of its profits from that business. This is a change from the exposure draft law which had proposed to repeal para (a) entirely.

Financial entities that satisfy the requirements of the amended definition will remain subject to the existing thin capitalisation rules (other than the arm's length debt test which will be replaced by the third party debt test for both general class investors and financial entities).

Fixed ratio test

The fixed ratio test is the default test that "general class investor" entities will apply, unless an election to use either the group ratio test[4] or the third party debt test[5] is made.

The fixed ratio test allows an entity to claim net debt deductions of up to 30% of its tax EBITDA (referred to as the entity's "fixed ratio earnings limit").[6]

"Net debt deductions" are calculated as follows:[7]

1. first, work out the sum of the entity's debt deductions for the income year;

- next, work out the sum of each amount included in the entity's assessable income for that year, that is:

  - interest, an amount in the nature of interest, any other amount that is calculated by reference to the time value of money;
  - any amount directly incurred by another entity in obtaining or maintaining the financial benefits received, or to be received, by the other entity under a scheme giving rise to a debt interest; or
  - any other expense that is incurred by another entity and that is specified in the *Income Tax Assessment (1997 Act) Regulations 2021* (Cth) made for the purposes of s 820-50(3)(b)(iii) ITAA97; and
- next, subtract the sum of assessable income from the sum of debt deductions.

If the entity's net debt deductions are less than its fixed ratio earnings limit (ie 30% of tax EBITDA), no debt deductions are disallowed (subject to application of the transfer pricing provisions discussed below). The excess debt capacity cannot be carried forward.

If the entity's net debt deductions exceed its fixed ratio earnings limit, the excess amount is disallowed as a deduction in the current income year.[8] This is not a permanent denial of deductions (as is the case under the existing thin capitalisation provisions). As discussed below, the excess deductions (the fixed ratio test (FRT) disallowed amount) may be carried forward and deducted in later income years (subject to satisfying certain conditions).

Tax EBITDA

The concept of "tax EBITDA" is the key element of this new earnings-based approach and will be relevant to both the fixed ratio test and the group ratio test (discussed below).

An entity's tax EBITDA is calculated as follows:[9]

- first, work out the entity's taxable income or tax loss for the income year (disregarding the operation of Div 820 ITAA97 and treating a tax loss as a negative amount);
- next, add the entity's net debt deductions for the income year;
- next, add the sum of the entity's deductions (if any) under Div 40 ITAA97 (capital allowance decline in value deductions) and Div 43 ITAA97 (capital works deductions) for the income year (other than deductions for the entire amount of an expense incurred by the taxpayer); and
- next, make adjustments to the result of the last bullet point in accordance with the *Income Tax Assessment (1997 Act) Regulations 2021* (if any) made for the purposes of s 820-50(1)(d).

If the result of the calculation is less than zero, it will be deemed to be zero. In this case, the entity will not be able to deduct any of its debt deductions for the income year.

There have been a number of changes to the calculation of tax EBITDA from the exposure draft Bill.

The add-back for depreciation and capital allowances has been expanded to include all amounts deductible under Div 40 and Div 43 (except amounts that are immediately deductible, such as mining and exploration expenditure that is deductible under Subdiv 40-H). The change from the exposure draft is welcome and ensures that balancing adjustments under Subdiv 40-D and deductions allowed under other parts of Div 40, including low-value and software development pools (Subdiv 40-E) and project pools and business-related costs (Subdiv 40-I), are included in the depreciation add-back.

The Bill does not contain an add-back for prior year tax losses that are deducted from the taxpayer's assessable income in the current year under Div 36 ITAA97. This had been included in the tax EBITDA calculation in the exposure draft Bill (thereby resulting in an increase in the current year tax EBITDA).

The most significant change to the calculation of tax EBITDA from the exposure draft Bill is the exclusion from taxable income/(loss) (first step of the calculation) of the following amounts:

- dividends (and franking credits to the extent that the dividend is franked);[10]
- for a beneficiary of a trust: its share of the net income of the trust where the beneficiary is an associate entity of the trust (in this respect, a beneficiary will be considered an associate entity of the trust where it holds at least a 10% thin capitalisation control interest (TC control interest));[11] and
- for a partner in a partnership: its share of the net income/loss of the partnership where the partner is an associate entity of the partnership (in this respect, a partner will be considered an associate entity of the partnership where it holds at least a 10% TC control interest).[12]

The exclusion of these amounts would appear to be a clear policy decision.[13] It is aimed at preventing double-counting of tax EBITDA capacity by ensuring that amounts of income are only included in the tax EBITDA of the lower tier entity and not in the tax EBITDA of the investors in that entity (even though the income may ultimately be subject to tax at the investor level). Unlike the current thin capitalisation rules,[14] there is no ability for the excess debt capacity of the lower tier entity to be shared with the investor entities when determining their thin capitalisation capacity. In this respect, p 93 of the explanatory memorandum to the Bill notes that:

> "Feedback was considered on the inclusion of an ability to share excess interest capacity within trust groups, but ultimately decided against including this for simplicity and integrity reasons."

This will have significant implications for non-corporate and non-consolidated group structures, which are commonplace in the property development, infrastructure and engineering sectors. It is often the case that each investor in a joint venture project would be responsible for securing its own debt funding which is then provided to the joint venture entity by way of an equity contribution. Such structuring is for commercial and financial reasons (and is not driven by tax factors), including:

- an investor may have an interest in a portfolio of assets and is borrowing in relation to the overall portfolio rather than an individual project; and
- each investor may have a different risk profile and/or be able to secure debt funding on different terms.

Given these commercial considerations, it may not be possible for the debt to be "pushed down" to the joint venture level. Further, the new debt creation rules (discussed below) may preclude such restructuring of the debt. Impacted stakeholders have made submissions to Treasury and the SELC that there should be amendments to the Bill to allow for the excess tax EBITDA capacity of the lower tier entity to be included in the tax EBITDA at the investor level (ie akin to the "associate entity excess amount" in the current thin capitalisation provisions).

The following example highlights the issue.

Assume the following facts (and see Diagram 1):

- JV is a tax law partnership engaged in property development;
- Aus Co is a general class investor and has received equity and debt funding from its foreign parent (Foreign Co) to fund its equity contribution to JV;
- both Aus Co and Aus Co1 have provided funds to JV as equity contributions. JV does not have any debt funding;
- the net income of JV (pursuant to s 90 ITAA36) is $100m;
- Aus Co has paid $10m of interest to Foreign Co; and
- Aus Co's taxable income (before application of the thin capitalisation rules) and tax EBITDA is calculated as set out in Table 1.

Aus Co's fixed ratio earnings limit (30% of tax EBITDA) will be nil and therefore it will not be able to claim a deduction for the interest paid to Foreign Co. This is despite there being excess debt capacity at the joint venture (project) level and the income of the JV being taxable in the hands of Aus Co. Consequently, Aus Co's taxable income (after applying the thin capitalisation rules) will be $50m. The ability to carry forward excess debt deductions is of no benefit in this example as there will be no tax EBITDA in later income years.

Table 1. Aus Co taxable income and tax EBITDA

Taxable income (before thin capitalisation rules)	**$m**
Net income from JV	50
Debt deductions	(10)
Taxable income	40
Tax EBITDA	
Taxable income (before thin capitalisation rules)	40
Exclude share of net income of JV	(50)
Add-back net debt deductions	10
Tax EBITDA	Nil

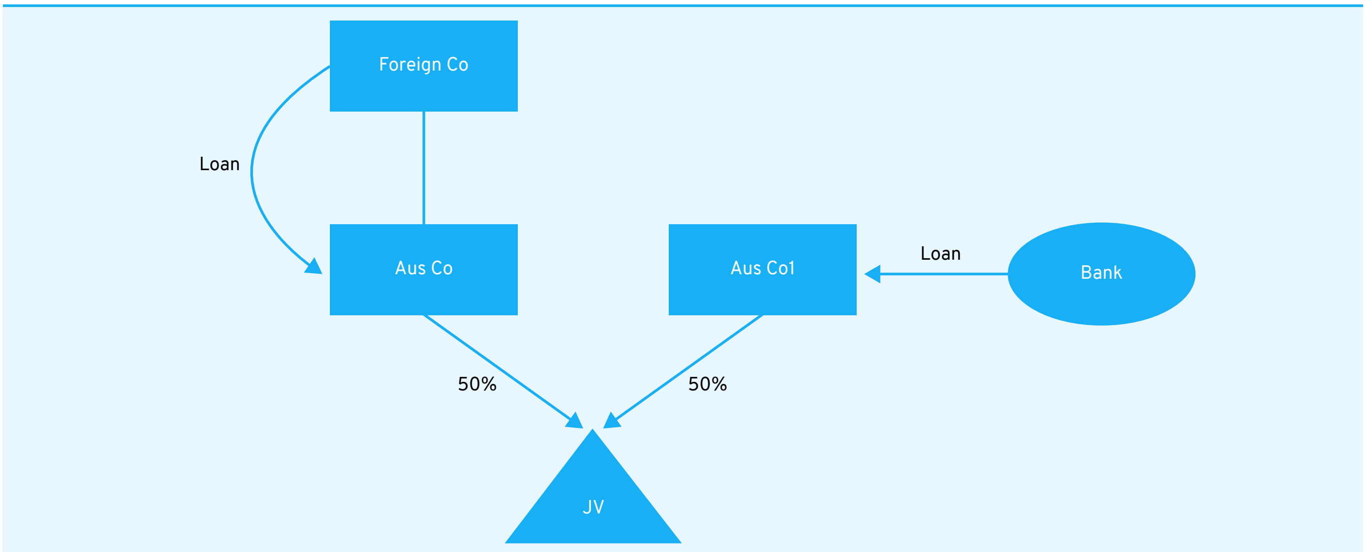
FRT disallowed amount

A deduction may be allowed in the current income year where an entity had debt deductions disallowed in an earlier income year under the fixed ratio test (the FRT disallowed amount) if the entity's net debt deductions are less than its fixed ratio earnings limit (ie 30% of its tax EBITDA) for the current income year.[15] FRT disallowed amounts over the previous 15 years can be claimed under this rule.

This deduction is only available under the fixed ratio test and may address year-on-year volatility concerns for businesses which are limited in their ability to claim debt deductions depending on their economic situation.

The fixed ratio test must also be used in all intervening income years between the year the FRT disallowed amount arose and the year in which it is utilised. Where an entity chooses to use either the group ratio test or the third party debt test in an intervening income year, the FRT disallowed amount is deemed to be zero and therefore cannot be applied in a later income year.[16]

Diagram 1. Fixed ratio test for non-corporate structures



The FRT disallowed amount is treated in a similar manner to a tax loss. In order for a company to claim a deduction for an FRT disallowed amount in a later income year, the company needs to satisfy either a modified continuity of ownership test (COT) or a modified business continuity test (BCT).[17] The addition of the BCT as an alternative test where the COT is failed is a positive development from submissions made in response to the exposure draft Bill.

For trusts, utilisation of the FRT disallowed amount in later income years will be subject to the trust loss provisions in Sch 2F ITAA36. Trusts will not be able to rely on an alternative BCT.[18]

Tax consolidated group or MEC group. Where an entity joins a tax consolidated group or multiple entry consolidated (MEC) group, any FRT disallowed amounts may be transferred to the head company subject to satisfying a transfer test.

The FRT disallowed amount is transferred to the head company at the joining time if the joining entity could have deducted the FRT disallowed amounts in respect of the "trial year".[19] As with the loss transfer tests in the tax consolidation provisions, the trial year is generally the period starting 12 months before the joining time and ending just after the joining time. Likewise, when applying the transfer test, it is to be assumed that the entity had not joined the tax consolidated group (but was a wholly-owned subsidiary of the head company) and it had sufficient fixed ratio earnings capacity to enable it to use the FRT disallowed amount.

The transfer test therefore requires that the joining entity must be able to satisfy either the modified COT or the modified BCT for the trial year. The addition of the BCT as a transfer test is a welcome change from the exposure draft Bill and should mean that FRT disallowed amounts are able to be transferred to the head company in most acquisition scenarios.

The head company may choose to cancel the transfer of an FRT disallowed amount that would otherwise be transferred to the joined group.[20] Such choice cannot be revoked. This is also a change from the exposure draft Bill.

If the FRT disallowed amounts are transferred to the joined group, the head company is deemed to have the amount for the same income year as the joining entity.[21] That is, the 15-year carry forward period is not reset on joining a tax consolidated group or an MEC group. However, for the purposes of applying the modified COT or modified BCT going forward, the head company is deemed to have acquired the FRT disallowed amounts at the joining time.[22] Therefore, the head company must satisfy the modified COT or modified BCT on a go-forward basis to be able to use the transferred FRT disallowed amount. Further, the FRT disallowed amounts that are transferred are not subject to an available fraction limitation.

If a head company has multiple FRT disallowed amounts for a particular income year (eg as a result of multiple entities joining the group), the head company is taken to have only one FRT disallowed amount for that year, which is the aggregate of the FRT disallowed amounts transferred to it.[23]

Where the FRT disallowed amounts are transferred to the head company, the allocable cost amount of the joining entity will be reduced by the tax effect of the amount transferred (new step 6A of the allocable cost amount calculation).[24]

When an entity leaves a tax consolidated group or an MEC group, any FRT disallowed amounts remain with the head company.[25]

Group ratio test

The group ratio test allows an entity in a highly leveraged group to claim debt deductions in excess of the amount permitted under the fixed ratio test, based on the ratio of net third party interest expense to EBITDA of the entity's worldwide group (referred to as the "group ratio").

The entity must make a choice to apply this test.[26] The choice must be made in the approved form and made before the date on which the entity lodges its income tax return for the income year or the due date for lodgment of that tax return (whichever is earlier) or a later date allowed by the Commissioner.[27] The choice is revocable on application to the Commissioner and on the Commissioner granting the revocation if it is fair and reasonable to do so.[28] This may occur where there has been a change in the entity's circumstances and, at the time the entity made the original choice, it was reasonable to believe that the entity's group ratio earnings limit was greater than the entity's fixed ratio earnings limit. Where the choice is revoked, it is taken never to have been made.

To apply the group ratio test, the entity must be a "group ratio (GR) group member". This requires that the entity be part of a group (a GR group) that prepares audited consolidated financial statements and the entity is fully consolidated on a line-by-line basis in those financial statements.[29]

Where the group ratio test applies, the amount of debt deductions that are disallowed is the amount by which the entity's net debt deductions for the income year exceed the entity's "group ratio earnings limit" for the income year.[30]

The group ratio earnings limit for an entity is equal to its "group ratio" multiplied by its tax EBITDA.[31]

Unlike the fixed ratio test, there is no ability to carry forward excess debt deductions under this test. Any excess debt capacity is also not carried forward.

The entity's group ratio is its "GR group net third party interest expense" divided by the "GR group EBITDA" of the GR group. If the GR group EBITDA is zero or less than zero, the group ratio is zero.[32]

The group ratio test relies on information in the audited consolidated financial statements of the GR group parent. However, certain adjustments need to be made to the amounts disclosed in those financial statements, which may make application of this test difficult (if not impossible for large multinational groups).

First, when calculating the "GR group net third party interest expense", an amount in the nature of interest and any other amount that is economically equivalent to interest are to be treated as interest.[33]

Further, payments of interest or amounts economically equivalent to interest between GR group members and their associate entities outside the group are to be disregarded. When applying this provision, there is a modification to the definition of "associate entity" such that a TC control interest of 20% or more is only required (as opposed to the usual associate interest of 50% or more).[34] This may significantly broaden the scope of entities that are treated as associate entities for this purpose.

Second, when calculating the "GR group EBITDA", any group entity that has a negative EBITDA is to be disregarded.[35] This partly reflects recommendations in the OECD action 4 report which recognised that the presence of loss-making entities within a group could potentially increase the capacity of profitable entities in the group to deduct interest expenses. As such, the report recognised that some limit may need to be placed on a group ratio test, while also noting that obtaining information on loss-making entities could be difficult. At para 151, the report stated:

> "This risk could be dealt with in part by a general principle that places an upper limit on the interest capacity of any entity applying the group ratio rule, equal to the net third party interest expense of the entire group. This upper limit should not mean that an entity's net interest deductions are lower than they would have been under the group ratio rule if group EBITDA had not been reduced by losses. This approach does not remove the risk that the total net interest deductions of all group entities could exceed the group's actual net third party interest expense. However, it should prevent an individual entity receiving a very high level of interest capacity that could be used for base erosion and profit shifting purposes."

The approach adopted in the Bill for excluding entities with negative EBITDA is complex and may mean that adoption of this test is not viable for large multinational groups. It may be the case that the group ratio test is applied in limited circumstances (eg portfolio companies of private equity or investment funds).

Entities that apply the group ratio test are required to prepare and keep records documenting how the group ratio was calculated. These records must be prepared by the due date for lodging the entity's income tax return for the income year or the date of lodgment (whichever is earlier).[36]

Third party debt test

As with the group ratio test, entities are able to elect to utilise the third party debt test for a year, but any disallowed interest cannot be carried forward for use in later years.

The entity must make a choice to apply this test. The choice must be made in the approved form and made before the date on which the entity lodges its income tax return for the income year or the due date for lodgment of that tax return (whichever is earlier) or a later date allowed by the Commissioner.[37] The choice is revocable on application to the Commissioner and on the Commissioner granting the revocation if it is fair and reasonable to do so.[38] This may occur where there has been a change in the entity's circumstances and, at the time the entity made the original choice, it was reasonable to believe that the entity's third party earnings limit was greater than the entity's fixed ratio earnings limit. Where the choice is revoked, it is taken never to have been made.

The Bill introduces the concept of an "obligor group". An entity is a member of an obligor group in relation to a debt interest if the creditor (lender) in respect of that debt has recourse to payment of that debt to the assets of the entity. Where the member entity that issued the relevant debt interest has made a choice to use the third party debt test, all members of the obligor group are taken to have made that choice if the member is an associate entity (TC control interest of 20% or more, and treat ss 820-860(3) and 820-870(1)(b)(i) to (ii) ITAA97 as applying when determining whether such member is an associate of the issuer of the debt interest).[39]

> "The measures … are a significant change to the current thin capitalisation rules and need to be carefully considered …"

The third party debt test allows all debt deductions which are attributable to third party debt and satisfy certain conditions. For this purpose, a debt deduction that satisfies the following conditions is taken to be attributable to the third party debt:

- it is directly associated with hedging or managing the interest rate risk in respect of the debt interest; and
- it is not referrable to an amount paid, directly or indirectly, to an associate entity of the borrower entity.

This ensures that the costs of interest rate swaps between unrelated parties can also be deducted under the third party debt test.

The conditions include:[40]

- the entity (borrower) issued the debt interest to an entity (lender) that is not an associate entity;
- the debt interest is not held at any time in the income year by an associate entity;
- the holder of the debt interest has recourse for payment of the debt only to Australian assets:
  - of the entity; and
  - that are not rights under or in relation to a guarantee, security or other form of credit support;

- the entity uses all, or substantially all, of the proceeds of issuing the debt interest to fund its commercial activities in connection with Australia that do not include:
  - any business carried on by the entity at or through its overseas permanent establishments; and
  - the holding by the entity of any associate entity debt, controlled foreign entity debt or controlled foreign entity equity; and
- the entity is an Australian resident.

As recourse is limited to the borrower's assets, or those of entities in the same tax consolidated group, the use of related party guarantees where one or more guarantors are outside of the tax consolidated group, or Australia, is precluded. The Bill does, however, allow recourse to credit support rights in certain situations, such as where the right relates wholly to the creation or development of a CGT asset that is, or is reasonably expected to be, real property situated in Australia.[41]

Real property includes the lease of land, if the land is situated in Australia. The recourse to credit support rights do not extend to a foreign entity that is an associate entity of the holder of the right (eg an overseas parent entity). The intention of this special exception is to allow the third party debt test to be relied on by Australian residents in respect of certain greenfield developments of real property (ie land and buildings) situated in Australia. Notably, this special exception is intended to only apply during the development phase of the real property, and not to operating the subsequent business when the development is completed/ operating.

This recourse requirement would also appear to exclude common security arrangements, seen particularly in property and infrastructure projects, where a lender has recourse to the membership interests in the borrower (which is required for ease of enforcement of the security, rather than credit enhancement), as well as the assets of the borrower. Submissions have been made to Treasury and the SELC on this issue, and it seems that amendments will be made to correct this deficiency in the Bill.

As currently drafted, the requirement that the borrower be an "Australian resident" would preclude trusts and partnerships from being able to use the third party debt test (the definition of "Australian resident" refers back to s 6(1) ITAA36). Again, submissions have been made on this issue and it is likely that this definitional issue will be amended to allow trusts and partnerships to access the third party debt test.

The borrowed funds must also be used to fund the borrower's Australian operations, but cannot be used to fund its overseas permanent establishments or any associate entity debt, controlled foreign entity debt or controlled foreign entity equity, irrespective of whether assessable income is generated.[42] This precludes the on-lending of funds to foreign companies and the acquisition of foreign equity stakes, irrespective of whether income is attributed to Australia under Australia's controlled foreign corporation (CFC) rules or otherwise assessable in Australia. Where income is assessable in Australia or attributed to Australia under the CFC rules, this will lead to double taxation as the income generated is assessed in Australia, while the associated debt deductions incurred in funding the relevant on-loan or equity stake are denied.

Conduit financer arrangements. The Bill includes rules that allow conduit financing to satisfy the third party debt test conditions in certain circumstances, allowing one entity in a group to raise third party financing and on-lend to other entities in the group.

Conduit financer arrangement rules operate to allow associate entity debt to qualify in some circumstances where the conduit financer's debt interest (to an "ultimate lender") satisfies all of the third party debt conditions (with some modifications) and:[43]

- the conduit financer funds on-loans to its associates only with amounts borrowed from the ultimate lender;
- any intermediate conduit financers may fund on-loans with funds borrowed by the preceding conduit financer only;
- the on-lending is on the same terms, to the extent that those terms relate to a cost incurred in relation to the relevant debt interest, as the debt interest issued to the ultimate lender, disregarding the following:
  - the terms (if any) of the ultimate debt interest that have the effect of allowing the recovery of reasonable administrative costs that relate directly to the ultimate debt interest;
  - the terms (if any) of a relevant debt interest issued to the conduit financer that have the effect of allowing the recovery of reasonable administrative costs of the conduit financer that relate directly to the relevant debt interest; and
  - the terms (if any) of a relevant debt interest, to the extent that those terms have the effect of allowing the recovery of costs of the conduit financer that:
    - are a debt deduction for the income year of the conduit financer; and
    - are a debt deduction that is treated as being attributable to the ultimate debt interest under s 820-427A(2) ITAA97 because it is directly associated with hedging or managing the interest rate risk in respect of the ultimate debt interest; and
- the conduit financer that borrows from the ultimate lender and the borrowers are Australian residents.

For this purpose, the threshold for an associate entity is a TC control interest of 20% or more.[44]

Transfer pricing overlay: modifications to s 815-140

A notable change in the Bill is that s 815-140 ITAA97 will be amended to apply Subdiv 815-B ITAA97 to the quantum of debt under consideration to general class investors or outward investing financial entities (non-ADI).

Previously, there was an exclusion in s 815-140 that meant Subdiv 815-B would not operate to substitute a level of gearing that an independent taxpayer dealing at arm's length would have had, and instead Div 820 ITAA97 applied to restrict the quantum of debt on which debt deductions were allowable. With this amendment, the quantum of debt, which gives rise to debt deductions subject to one of the three proposed tests, will also be subject to a transfer pricing analysis in terms of gearing that an independent taxpayer would have had, consistent with the arm's length principle. Effectively, it will obligate taxpayers with debt arrangements that are within the scope of Subdiv 815-B to analyse their capital structure to ensure that their debt levels can be supported by a debt analysis which demonstrates an "arm's length" amount of debt, in addition to supporting an arm's length interest rate.

The analysis which will be required to support the debt quantum will, in many ways, be analogous to the economic assessment of an arm's length capital structure which was required under the current arm's length debt test. This would typically involve an analysis of borrowing capacity, with reference to relevant financial ratios that an independent lender would consider, as well as the debt/equity and risk profile that would be expected to be accepted by shareholders in the market.

In this context, taxpayers need to be mindful that this analysis will be expected to consider a range of financial ratios relative to comparable industry peers, such as interest cover, debt service cover, debt to EBITDA, and debt to equity. The analysis may also extend to the overall structure of debt finance as part of the arm's length conditions. This analysis is potentially complex and may be onerous for taxpayers seeking to document their self-assessment position for transfer pricing purposes in relatively conservative gearing scenarios.

As a consequence, the fixed ratio test and group ratio test operate as a cap on the amount of the debt deduction after applying transfer pricing principles and not as a safe harbour. In other words, this means that there is no ability for general class investors or outward investing financial entities (non-ADI) to calibrate the amount of debt such that their debt deductions would be, for example, at exactly 30% of their tax EBITDA until they first satisfy the transfer pricing rules.

Diagrams 2 and 3 illustrate what the amended s 815-140 could mean in practice.

Diagram 2 shows the operation of the current law (safe harbour debt amount takes precedence over arm's length capital structure). The actual conditions are an interest rate of 5% (assume, for example, that this is equivalent to a BBB credit rating), and an actual debt amount from an international related party of $100, meaning a total debt deduction of $5. Assume that the transfer pricing rules under Subdiv 815-B determine that the arm's length capital structure should be a debt amount of $50, equivalent to a credit rating of A, which then suggests that an arm's length interest rate should be 4%. Currently, the law specifies that s 815-140 modifies the application of the transfer pricing

Diagram 2. Interaction of current transfer pricing and thin capitalisation law

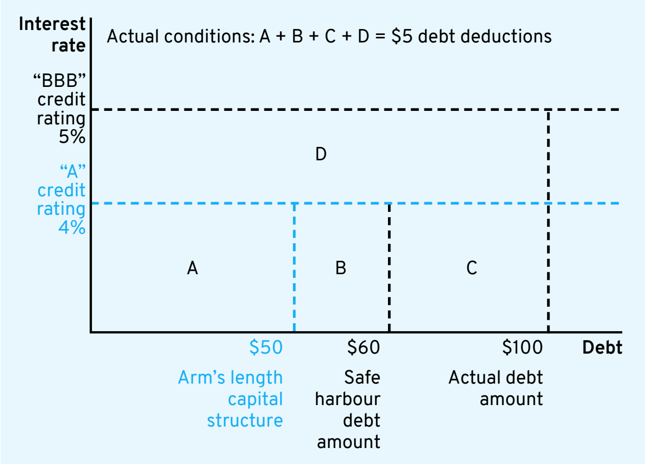
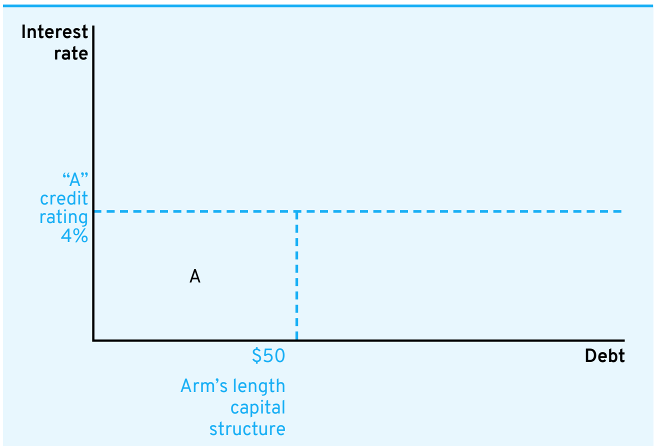


Diagram 3. Impact of amendment to s 815-140



rules such that Div 820 should determine the maximum allowable debt amount that the arm's length interest rate should be applied against. In this case, the safe harbour debt amount is assumed to be $60. Therefore, the allowable debt deductions would be determined by multiplying an arm's length interest rate of 4% to the safe harbour debt amount of $60 (ie the areas A + B), equivalent to $2.40.

Diagram 3 shows the amended s 815-140 in operation, ie the arm's length capital structure places a limit on the debt ($50 in this example) on which any debt deductions may be claimed. Applying an arm's length interest rate of 4%, the allowable debt deduction is now only $2 (ie the area A).

As mentioned, as a consequence of the Bill, the fixed ratio test and the group ratio test operate as a cap on the amount of the debt deduction after applying transfer pricing principles. If, for example, the taxpayer relies on the fixed ratio test and the tax EBITDA of the taxpayer is $5, the fixed ratio earnings limit (ie 30% of tax EBITDA) will be $1.50 and, accordingly, $0.50 of debt deductions will be disallowed in the current income year. However, the FRT disallowed amount may be carried forward and deducted in later income years, subject to satisfying certain conditions.

If, for example, the taxpayer relies on the fixed ratio test and the tax EBITDA of the taxpayer is $10, the fixed ratio earnings limit (ie 30% of tax EBITDA) will be $3 and, accordingly, no debt deduction will be disallowed in the current income year. The excess debt capacity of $1 (being the difference between the fixed ratio earnings limit of $3 and the debt deduction supported under the transfer pricing rules of $2) cannot be carried forward.

Debt creation deduction limitation

The Bill did not include the proposed changes to s 25-90 ITAA97 that were included in the exposure draft Bill. The explanatory memorandum to the Bill noted that the proposed amendments would be deferred (following concerns raised by stakeholders), to be considered through a separate process.

However, unexpectedly and without any earlier consultation, the Bill included broad-ranging "debt deduction creation rules" in new Subdiv 820-EAA ITAA97. These rules will also apply for income years commencing on or after 1 July 2023. In part, these debt creation rules will do what the proposed changes to s 25-90 were intending to do, but will also extend much further.

Paragraphs 2.144 to 2.146 of the explanatory memorandum states the policy intent for these new measures:

> "Excessive debt deductions pose a significant risk to Australia's domestic tax base.
>
> The strengthened thin capitalisation rules will play an important role in limiting excessive debt deductions. However, they do not address the risk of excessive debt deductions for debt created in connection with an acquisition from an associate entity or distributions or payments to an associate entity. Such debt deductions may only ever indirectly, and at most, be partially limited by the thin capitalisation rules.
>
> New Subdivision 820-EAA seeks to directly address this risk by disallowing debt deductions to the extent that they are *incurred in relation to debt creation schemes that lack genuine commercial justification*." (emphasis added)

The operative provisions, however, do not include any reference to a lack of commercial justification for their application and, as currently drafted, will potentially apply to many transactions that have a commercial purpose or where there is no increase in the overall level of debt in Australia. Indeed, these rules are currently impacting existing third party transactions and causing uncertainty for taxpayers in relation to determining the tax implications of a proposed investment and hence the pricing of such a transaction.

In broad terms, the debt creation rules will apply to disallow debt deductions where an entity borrows in the following situations:

- asset acquisition: an entity borrows (either from a related party or a third party) to acquire a CGT asset, or a legal or equitable obligation, from an associate;[45] and
- payment or distribution: an entity borrows from an associate to fund one or more payments or distributions (eg dividend and/or return of capital) to that associate or another associate.[46]

As currently drafted, the debt creation rules could apply to the following transactions:

- borrowing from an Australian resident lender (related party or third party) to acquire a CGT asset from an associate: there does not seem to be any mischief with such an arrangement as the interest paid by the borrower will be subject to tax in Australia in the hands of the lender;
- transactions that occurred before 1 July 2023 (before the debt creation rules were introduced) but where interest continues to be paid after 1 July 2023: the retrospectivity of the provision in these circumstances is a harsh outcome. It is submitted that the debt creation rules should only apply to transactions entered into for income years commencing on or after 1 July 2023;
- borrowing to fund the subscription for new shares in a foreign subsidiary: in this respect, the debt creation rules will achieve the intended purpose of the proposed amendments to s 25-90, which is contrary to the statements in the explanatory memorandum that the amendments to s 25-90 are to be deferred and considered through a separate process;[47]
- refinancing existing related party debt: this does not result in any increase in the overall debt in Australia;
- post-acquisition restructuring: it is common that, following a global acquisition, there is a commercial desire to combine the Australian entities of the target group with those of the acquirer group. Such restructuring may no longer be able to be debt-funded; and
- the acquisition of trading stock and depreciating assets from a related party.

While the government asserts that these arrangements lack commercial justification and thus relevant debt deductions are to be denied, this measure also denies debt deductions arising from genuine commercial activities (as discussed above) and irrespective of whether:

- there is a dominant or principal purpose of increasing debt deductions;
- the borrowing in question is from a related party or third party lender;
- the creditor is in Australia or overseas;
- the borrower entity could satisfy the amended s 815-140 in terms of the "arm's length capital structure" with the borrowing in question; and
- the interest deductions would otherwise be deductible under the amended thin capitalisation provisions discussed in this article.

The asset acquisition aspect of this measure appears to be the government's attempt at addressing scenarios similar to that in *Mylan Australia Holding Pty Ltd v FCT*,[48] given the similar fact pattern.

The former debt creation rules[49] included exceptions for a number of the above transactions (eg the acquisition of trading stock, the acquisition of newly issued shares, and where the Commissioner was satisfied that there was no overall increase in the indebtedness of the Australian group). Submissions have been made to Treasury and the SELC in regard to (among others) the breadth of the new debt creation rules. It appears that consideration is being given to amending the Bill to provide similar exclusions from the new debt creation rules as were contained in former Div 16G ITAA36.

The only anti-avoidance rule within the debt creation measures is a specific anti-avoidance provision designed to address schemes seeking to avoid application of the debt creation rules.[50] The anti-avoidance rule applies a principal purpose test rather than a dominant purpose test and may readily impact any attempts to avoid application of the rules.

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Note

Due to publishing deadlines, detailed consideration of the exposure draft amendments released on 18 October 2023 has not been able to be included in this article other than as noted in the introduction.

Acknowledgment

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Disclaimer

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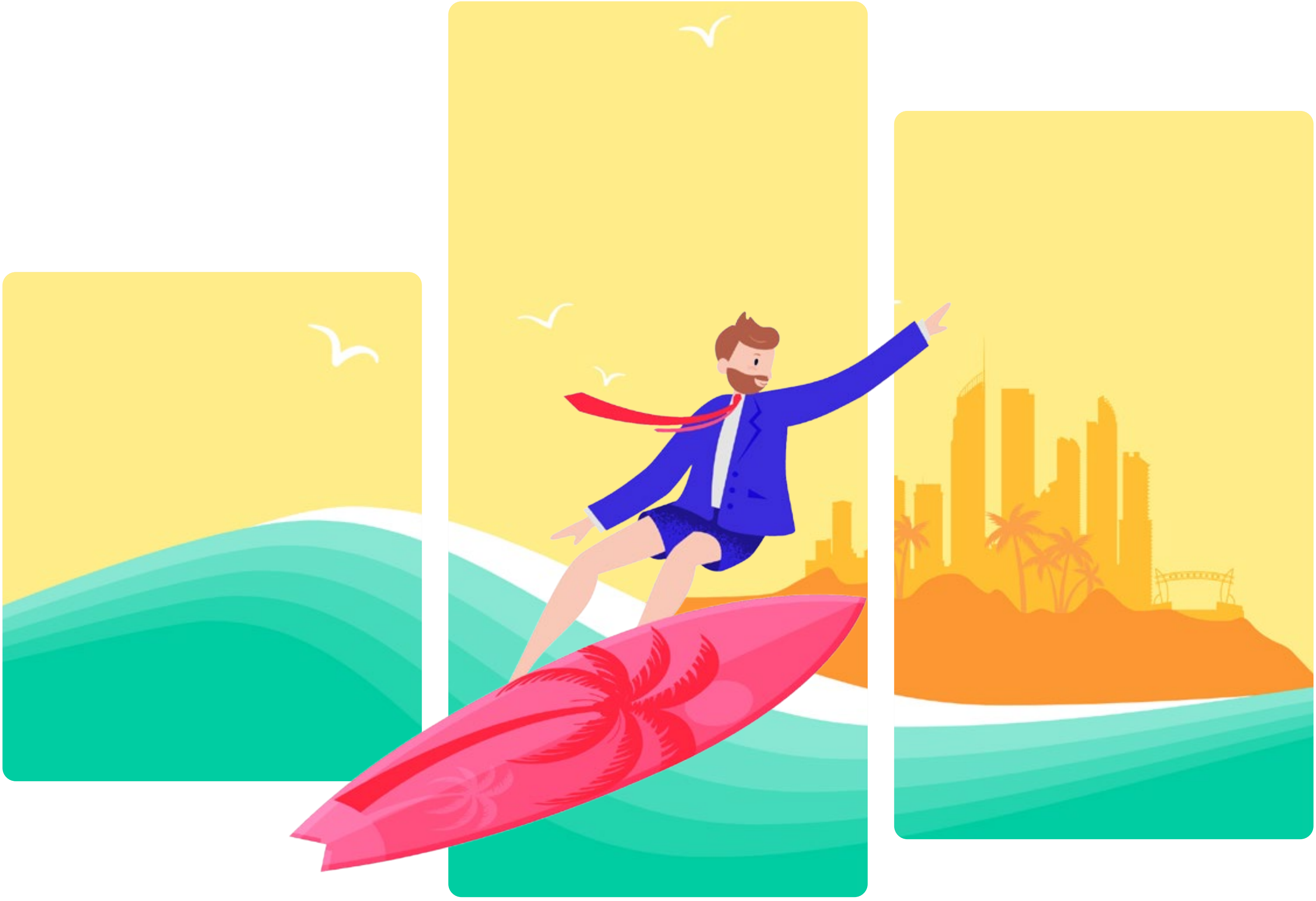

Superannuation

by Daniel Butler, CTA, DBA Lawyers

New 15% tax on $3m+ member super balances

Deferring the taxation of unrealised gains until they are realised is very likely to "grow the pie" for both members and the Revenue in the longer term.

Overview

The Treasury Laws Amendment (Better Targeted Superannuation Concessions) Bill 2023 (the draft Bill), together with accompanying explanatory materials, were released by Treasury for public consultation on 3 October 2023. This follows the release by Treasury of a consultation paper, *Better targeted superannuation concessions*[1] (the consultation paper) on 31 March 2023.

The draft Bill proposes to insert new Div 296 in the *Income Tax Assessment Act 1997* (Cth) (ITAA97), which will contain the core provisions relating to the new tax. An exposure draft of the Superannuation (Better Targeted Superannuation Concessions) Imposition Bill 2023 (the Imposition Bill) was also released, which sets out the proposed provisions that are necessarily required to be contained in a separate Bill for constitutional reasons to impose the new tax.

Broadly, from 1 July 2025, new Div 296 tax will apply where a member's total superannuation balance (TSB) exceeds $3m and there has been an increase in their TSB at the end of the relevant income year (as adjusted for withdrawals and contributions) compared to their TSB just before the start of that year. This movement in the adjusted TSB is termed "superannuation earnings". The proportion of the superannuation earnings that corresponds with the percentage of an individual's TSB that exceeds $3m is termed "taxable superannuation earnings" (TSE). The TSE will be assessed to the individual and subject to tax at the rate of 15%.

This article provides an analysis of several key aspects of the new tax that is proposed to commence on 1 July 2025 and apply from the 2025–26 income year (assessments would commence to be issued after 1 July 2026). For ease of expression, the term "TSB" is referred to throughout this article rather than "adjusted TSB (as adjusted for withdrawals and contributions)".

Key issues with the draft Bill

While broadly supportive of the principle that tax concessions for superannuation should be subject to certain limits, numerous professional bodies have concerns with the following aspects of the new measure:

- the imposition of a tax on unrealised gains: especially as the new tax will adversely impact those with illiquid assets, such as real estate that may have no ready funds to pay the tax. Self-managed superannuation funds could easily report actual taxable income on a "per member" basis, which would overcome this concern;
- negative superannuation earnings are quarantined: they can only be used to offset future earnings and do not give rise to a refund. If unrealised gains are to be subject to tax, tax symmetry and fairness suggest that a refund should be provided for negative superannuation earnings;
- the $3m threshold is not indexed: while the new measure is initially expected to impact around 80,000 members in the 2025–26 income year, with increasing investment values and contributions to superannuation over time, it will cover many more; and
- a member will have no ability to withdraw their superannuation balance when it exceeds $3m and they have not yet satisfied a condition of release. The goalposts will change substantially with this new tax and impact taxpayers who are unable to withdraw their superannuation (where their TSB exceeds $3m) — these people will have no choice but to pay the new tax.

A number of professional and industry bodies continue to advocate for changes to address one or more of the above concerns.

How the new tax will work

The operation of Div 296 is broadly consistent with the overview provided in the consultation paper. A simplified summary from the exposure draft explanatory materials follows on how the mechanics of the new tax will work:

- An individual has TSE for an income year if their TSB at the end of that year is greater than the "large superannuation balance threshold" (the threshold) (defined to be $3m) and the amount of their superannuation earnings for the year is greater than nil.
- The total amount of TSE for an income year is worked out by first determining the percentage of the TSB at the end of the year that exceeds the threshold according to the following formula:

$$\frac{\begin{matrix}\text{Your total} \\ \text{superannuation balance} \\ \text{at the end of the year}\end{matrix} - \begin{matrix}\text{The large} \\ \text{superannuation} \\ \text{balance threshold}\end{matrix}}{\begin{matrix}\text{Your total superannuation balance} \\ \text{at the end of the year}\end{matrix}} \times 100$$

- The percentage provided by the formula is then multiplied by the amount of superannuation earnings for the year to provide the amount of TSE. This is achieved by applying the following formula:

$$\text{The percentage worked out under subsections (2) and (3)} \times \text{The amount of your superannuation earnings for the year}$$

- The amount of an individual's basic superannuation earnings for an income year is determined by subtracting their previous balance (their TSB immediately before the start of the income year) from their current adjusted balance (their adjusted TSB at the end of that year), as follows:

  Current adjusted balance – Previous balance

- An individual's adjusted TSB is worked out using the following formula:

$$\text{Your total superannuation balance at the end of the year} + \text{Your withdrawals total for the year} - \text{Your contributions total for the year}$$

- The adjusted TSB reflects a modified closing superannuation balance after considering the effect of a range of withdrawals and a range of contributions that would otherwise overstate or understate earnings. This area is complex, given the nature and number of withdrawals and contributions that may result in an adjusted TSB.
- The draft Bill includes that a member will be liable to pay tax on TSE under the proposed s 296-15 ITAA97. Proposed s 5 of the Imposition Bill imposes a 15% tax rate on those earnings. The proposed Div 296 tax will operate as a separate assessment process to a member's income tax assessment, similar to how Div 293 tax operates, and therefore does not form part of the member's taxable income.

Thus, broadly, earnings are calculated with reference to the difference in the TSB at the start and end of the income year, with adjustments for withdrawals and contributions.

For example, Sarah's TSB on 30 June 2026 is $6m. The proportion of her TSB that exceeds $3m is 50% ([$6m – $3m] ÷ $6m). In this case, 50% of her TSE will attract the additional tax.

A flat tax rate of 15% is then applied to the proportion of earnings attributable to an individual's balance over $3m.

For example, Sarah's calculated earnings are $650,000; however, only 50% of these earnings are attributed to her TSB that exceeds $3m and attract the additional 15% tax.

Sarah's tax liability is $48,750 (15% × $650,000 × 50%).

Key changes in the draft Bill (compared to consultation paper)

Compared to the consultation paper, there are a number of key changes in the draft Bill, including:

- the definition of "total superannuation balance" will undergo substantive changes and require considerably more analysis to determine. The changes to the TSB remove the link to the transfer balance account (TBA), and defined benefit pensions will need to be valued on an annual basis, broadly reflective of their withdrawal value. Currently, such pensions reflect their original TBA value;
- a person is not liable to pay Div 296 tax in the following circumstances:
  - they are a child recipient of a superannuation income stream at the end of the income year;
  - they have (in any year) had a structured settlement contribution made in respect to them as a payment for personal injury, regardless of the amount; or
  - they die before the last day of the income year;
- foreign superannuation fund interests have been expressly excluded from an individual's TSB;
- the draft Bill confirms that a member's share of an outstanding borrowing, in relation to a limited recourse borrowing arrangement that is added to a member's TSB under s 307-230(1)(d) ITAA97, will not be included in their TSB for Div 296 purposes only. This was also noted in the consultation paper;
- negative superannuation earnings are quarantined and can only be used to offset future positive superannuation earnings; and
- a reduced rate of Div 296 general interest charge will apply to any outstanding liabilities relating to Div 296 which remain unpaid by the due date. The reduced rate will be the base interest rate plus 3% (rather than the usual 7%).

The draft Bill makes numerous other consequential and miscellaneous amendments to the ITAA97, the *Taxation Administration Act 1953* (Cth) and other Commonwealth laws to give effect to this measure.

Members are taxed and can elect to obtain a release authority

The new tax will be levied on the member and not on the fund itself. Members will have 84 days to pay their Div 296 tax liability. However, a member will be given the opportunity to withdraw moneys to pay Div 296 tax under a "release authority" arrangement that is similar to what is in place for Div 293 tax. They will have 60 days to elect to release a certain amount from one or more of their superannuation funds for the purposes of paying that tax.

Division 293 tax (an extra 15% tax) is imposed on a member in respect of their concessional contributions where their adjusted taxable income exceeds $250,000 in a financial year (this is a simplification of the Div 293 tax regime which is more complex than this broad summary can explain).

University of Adelaide's report

After reviewing data on more than 720,000 SMSF members each year over the financial years ending in 2021 and 2022, the University of Adelaide's International Centre for Financial Services report[2] concluded that:

> "• Taxation on unrealised capital gains is rare among OECD countries, and rarer still in OECD pension systems. Australia's tax system clearly delineates between income

and capital gain taxes (CGT), and the CGT regime, which has been in place now for almost 40 years, is based primarily on realised gains evidenced by completed transactions. Given both the benchmarking to other OECD nations and Australia's own economic history, we interpret the structure of the current proposal – to reduce superannuation tax concessions for individuals with TSBs in excess of $3 million – as a somewhat radical departure from existing taxation policy, with potentially far broader consequences than just those outlined by Treasury in their consultation paper.

- Deferring the taxation of unrealised gains until they are realised is very likely to 'grow the pie' for both superannuants, and for those taxing superannuants, in the longer term.
- Selling illiquid assets is typically associated with substantial transaction costs, and the Government's proposal to cover the new liability with funds external to superannuation is unlikely to be possible for all affected members.
- We estimate an approximate 4-fold increase in the rate of liquidity problems, from 3.1% to 13.5%, once we account for members meeting the added tax expense in a prior period. This implies an additional cumulative liquidity risk factor for affected members.
- There might be as many as 49,000-50,000 SMSF members in Australia that will be impacted by the change in tax concessions for super, year-on-year, based on our balanced panel."

Conclusion

While the ATO will perform the calculations and issue the assessments from its systems and data, advisers will need to understand how the systems and processes work so they can accurately advise their clients on the expected financial impact and Div 296 tax liability. Undoubtedly, there will be errors, issues and teething problems in implementing and refining the systems before the tax is bedded down.

Naturally, the short consultation period (just over two weeks) provides limited opportunity to properly consider and respond to such a substantive new and complex tax that impacts one of Australia's most important retirement regimes and structures: superannuation funds.

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Successful Succession

by Archana Manapakkam, ATI,
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Death and the small business CGT concessions

The structure within which an individual holds their business assets will affect the way the small business CGT concession regime applies following their death.

Introduction

The small business CGT concessions (SBCs) are contained in Div 152 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). Broadly, these rules allow a taxpayer that meets certain "basic conditions" to access the SBCs to reduce or disregard a capital gain that would otherwise arise from a CGT event in relation to a CGT asset that they own. These SBCs are the 15-year exemption, the small business 50% reduction, the retirement exemption, and the small business roll-over. For some of these SBCs, additional conditions (beyond the basic conditions) apply to access the concessions.

The impact of death on operation of the SBCs differs depending on whether the relevant CGT asset was owned by the deceased personally or by their company or discretionary trust. This is examined below.

Asset owned by individual

Special rules in s 152-80

Where the CGT asset forms part of the estate of a deceased individual (or the deceased individual owned the asset as a joint tenant just before they died), s 152-80 ITAA97 contains special rules that effectively allow a legal personal representative (LPR), a beneficiary, a trustee of a testamentary trust, or a remaining joint tenant(s) to "stand in the shoes" of the deceased and access the SBCs where a CGT event happens in relation to that asset if:

- the deceased would have been entitled to reduce or disregard a capital gain under Div 152 had the CGT event happened just before the deceased's death; and
- the CGT event happens in relation to the CGT asset within two years of the deceased's death.

When determining whether the deceased would have been entitled to reduce a capital gain under Div 152 had the CGT event happened just before their death, the following modifications apply:

- in relation to the 15-year exemption: ordinarily, as the rule applies to individuals, either: (1) the individual must be 55 years or over at the time of the CGT event *and the CGT event happens in connection with their retirement*; or (2) the individual must be permanently incapacitated at the time of the CGT event. Where s 152-80 applies, the requirement for the CGT event to happen in connection with retirement (where the (deceased) individual was 55 years or over at the time of the hypothetical CGT event) is dispensed with; and
- in relation to the retirement exemption: if the deceased was under 55 years of age at the time of the hypothetical CGT event, there is no requirement to contribute any funds in superannuation.[1]

No aggregation of ownership periods for purpose of 15-year exemption

When determining whether the deceased would have been entitled to the 15-year exemption, it is important to bear in mind that it is not possible to aggregate the deceased's period of ownership with the period of ownership of the LPR, beneficiary, trustee or remaining joint tenant(s) (as the case may be). This is because the deceased needed to have been entitled to the exemption if the CGT event had happened just before their death and, if they did not own the asset for at least 15 years as at that date, they would not have been entitled to the 15-year exemption.

CGT event does not happen within two years of deceased's death

Where the CGT event does not happen within two years of the deceased's death, the Commissioner has a discretion under s 152-80(3) to extend the time limit so that the LPR, beneficiary, trustee or remaining joint tenant(s) can still access the SBCs by standing in the shoes of the deceased. This discretion is unfettered, and the rules of administrative law will apply to the exercise of the power (eg the Commissioner will be required to take into account relevant considerations, not take into account relevant considerations etc).

If an exercise of the Commissioner's discretion is required, the taxpayer will need to make an application for a private ruling to the Commissioner requesting the Commissioner to exercise their discretion under s 152-80(3).

Taxpayer may be able to access SBCs in own right if s 152-80 not satisfied

If the requirements in s 152-80 are not satisfied, for example:

- the deceased would not have been able to access the SBCs had the CGT event happened just before their death, for example:
  - the asset was a pre-CGT asset in the deceased's hands; or
  - the deceased was not a small business entity and did not satisfy the maximum net asset value test; or
- the CGT event does not happen within two years of the deceased's death and the Commissioner has not exercised his discretion under s 152-80(3) to extend the limit,

the LPR, beneficiary, trustee or remaining joint tenant(s) will not be able to access the SBCs by standing in the shoes of the deceased under s 152-80.

Despite the above, the LPR, beneficiary, trustee or remaining joint tenant(s) may still be able to access the SBCs in their own right to reduce or disregard the capital gain. Further, if the requirements are not satisfied because the asset was a pre-CGT asset in the deceased's hands, the LPR, beneficiary, trustee or remaining joint tenant(s) would receive a market value cost base in the asset/interest as at the deceased's death, which would effectively shelter any capital gain that has accrued on the asset until the date of death from CGT. However, any gains accruing on the asset after the deceased's date of death would be exposed to CGT.

Asset owned by company

Where the deceased owned shares in a company that are then acquired by the LPR, beneficiary, trustee or remaining joint tenant(s), s 152-80 will only apply where the CGT event happens in relation to the shares in the company (eg the shares are sold), provided the other requirements in s 152-80 are satisfied. However, if the CGT event happens in relation to the assets of the company (eg the company sells a business that it carries on), s 152-80 has no scope for operation as those assets never formed part of the assets of the deceased.

If the CGT event happens in relation to the assets of the company, this causes difficulties in the context of the 15-year exemption for the following reasons:

- it will generally be more difficult for the company to satisfy the requirements to access the 15-year exemption on the sale of the assets in s 152-110 ITAA97, in particular, the requirements in s 152-110(1)(d); and
- even if the company is able to access the 15-year exemption on the disposal of the assets, it may not be possible to extract the exempt amount tax-free from the company.

This is expanded on below.

Ability of company to access 15-year exemption

Section 152-110(1)(d) provides that the company must have a "significant individual" (ie an individual who has a "small business participation percentage" in the company of at least 20%)[2] just before CGT event and either:

- the significant individual is 55 years or over at the time of the CGT event and the CGT event happened in connection with their retirement; or
- the significant individual is permanently incapacitated at that time.

In the context of death, the significant individual cannot be the deceased for obvious reasons.

In addition, the LPR or trustee cannot be a significant individual. This means that, if the company sells its assets while all of the shares in a company are held by the LPR or trustee, the company can only access the 15-year exemption if the LPR or trustee makes income and capital distributions from the deceased estate or trust estate to beneficiaries in such a manner that one or more of those beneficiaries satisfies the requirement in s 152-110(1)(d). In many circumstances, this may simply not be possible, for example, due to:

- the characteristics of the beneficiaries (they may all be working adults under 55 years of age and not permanently incapacitated);
- the terms of the will/testamentary trust (eg there may be four beneficiaries who are to receive all distributions equally such that none of them will meet the 20% threshold to be a significant individual); and/or
- the stage of administration of the estate.

If the company waits until the shares pass to a beneficiary, the company will only be able to access the 15-year exemption if the beneficiary satisfies the requirements in s 152-110(1)(d). Again, this may not be possible due to the characteristics of the beneficiary or their percentage shareholding in the company.

Given the above, it can be appreciated that determining whether the 15-year exemption can be accessed at the company level after the death of a sole shareholder is a complex exercise and the outcome may well be that the company is not entitled to the exemption.

Ability to extract exempt amount tax-free from company

A capital gain made by a company that is disregarded under the 15-year exemption (or would be disregarded if the asset was not a pre-CGT asset) (the "exempt amount") can only be extracted tax-free from a company under s 152-125 ITAA97 if:

- the exempt amount it is paid to an individual who is a "CGT concession stakeholder" (ie a significant individual or their spouse if that spouse holds a small business participation percentage of more than 0% in the company)[3] just before the CGT event; and
- the payment is made within two years of the CGT event (although a later time can apply if a look-through earnout right is involved).

For the same reasons set out above, the CGT concession stakeholder cannot be the deceased, the LPR or the trustee of a testamentary trust.

Given the requirements in s 152-125, even if the 15-year exemption can be accessed at the company level following the death of a sole shareholder, it is entirely possible that the exempt amount (or a portion of it) would not be able to be extracted tax-free from the company, in which case that amount may be trapped in the company. This will be the case if, for example, there is a significant individual who meets the requirements in s 152-110(1)(d), but the exempt amount is to be shared equally with that individual and others who do not meet the requirements in s 152-110(1)(d).

Assets owned by discretionary trust

Section 152-80 will never have any scope for operation if the relevant assets are owned by a discretionary trust. This is because the assets of the trust would not form part of the deceased's estate. Further, and in contrast with shares in a company, the deceased would never have held an "interest" in that discretionary trust which is capable of forming part of the assets of the deceased's estate.

In terms of the 15-year exemption, as with a company, a trust that disposes of a CGT asset will be able to access the 15-year exemption if it meets the requirements in s 152-110. This includes the requirement in s 152-110(1)(d) discussed above in the context of assets owned by a company. This may again be difficult to satisfy as the deceased cannot be the significant individual. Depending on the characteristics of the discretionary objects of the trust (and who controls the trust following the deceased's death), it may or may not be possible for the trust to make distributions in such a manner that the requirements in s 152-110(1)(d) are satisfied.

As a trust is a flow-through vehicle, unlike with a company, there will be no issue of an exempt amount being trapped in the relevant entity.

Given the above, where a CGT event happens in relation to assets owned by a discretionary trust that was controlled by the deceased, there will be difficulties involved in the context of the 15-year exemption, but generally not to the same extent as with a company.

Key takeaways

The operation of the SBC rules in the context of death is littered with traps and anomalies. These traps and anomalies vary with the nature of the entity that holds the relevant CGT assets, as discussed above. In the context of individuals, these include the fact that s 152-80 will not apply where the asset was a pre-CGT asset of the deceased just before their death and the two-year time limit contained in s 152-80.

In the context of companies, there will be difficulties with accessing the 15-year exemption at the company level and the exempt amount being potentially trapped in the company, although there is the possibility of disposal at the shareholder (rather than asset) level to bypass these issues. In the context of discretionary trusts, there will also be difficulties with accessing the 15-year exemption.

It is important for an adviser to be aware of the differences in the operation of the SBC rules for assets held by a deceased personally or through company or trust structures. An adviser who is well-versed in the differences can not only assist with avoiding missteps after death, but can also identify potential issues prior to death and help a client to take steps so that these issues do not eventuate.

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Cumulative Index

The following cumulative index is for volume 58, issues (1) to (5). Listed below are the pages for each issue:

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Giving back to the profession

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

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