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Taxation in Australia

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In our sights at the start of a new financial year
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Invitation to write

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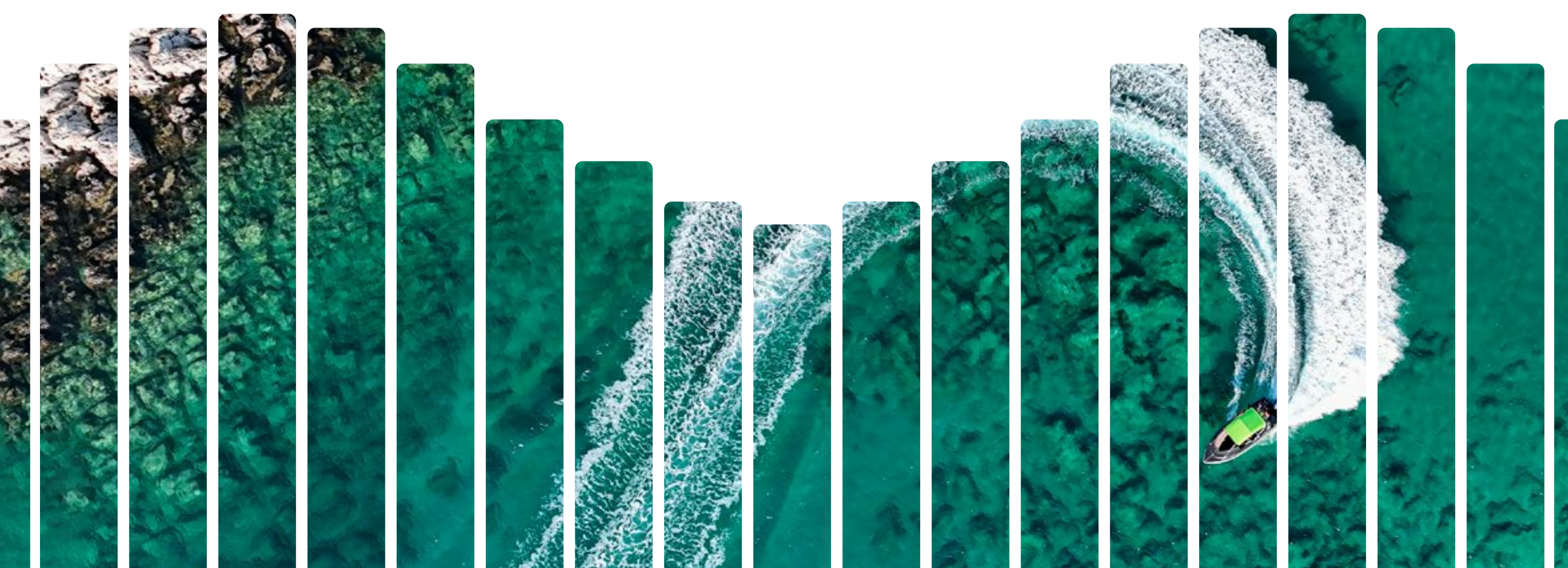

Tax News – at a glance

by TaxCounsel Pty Ltd

June – what happened in tax?

The following points highlight important federal tax developments that occurred during June 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 8 (at the item number indicated).

Medicare amendments

An amending Bill (the Treasury Laws Amendment (2023 Measures No. 2) Bill 2023) that was introduced into parliament on 10 May 2023 contains amendments that will give effect to the 2023–24 Budget Medicare levy changes and the reduction in the gross domestic product adjustment factor. **See item 1.**

Meaning of "school"

The Commissioner has issued a decision impact statement in relation to the decision of the Federal Court (McKerracher J) in *The Buddhist Society of Western Australia Inc v FCT (No. 2)* [2021] FCA 1363 in which the court considered the meaning of a "school" in the context of the deductible gift recipient provisions of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). **See item 2.**

Construction or creation of capital assets: labour costs

The Commissioner has released a final ruling that explains when certain labour costs related to constructing or creating capital assets (tangible or intangible) cannot be deducted as a general deduction under s 8-1 ITAA97 because of the capital or capital in nature exclusion from deductibility that is provided for in that section (TR 2023/2). **See item 3.**

Intangibles arrangements

The Commissioner has released a draft practical compliance guideline that sets out the ATO's compliance approach to intangibles arrangements involving international related parties (PCG 2023/D2). **See item 4.**

Residence of individuals

The Commissioner has released a final taxation ruling that outlines the residency tests for individuals for tax purposes as set out in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and when the Commissioner considers that a person will be a resident of Australia (TR 2023/1). **See item 5.**

Small business lodgment amnesty

The ATO is encouraging small businesses that have overdue income tax returns, fringe benefits tax returns or business activity statements to take advantage of the new amnesty announced in the recent Budget to get their lodgments back on track. **See item 6.**

Litigation settlement amount deductible

The Federal Court (Stewart J) has dismissed the Commissioner's appeal from a decision of the AAT in which the AAT held that an amount paid by the taxpayer to settle litigation qualified as a general deduction (*FCT v Wood* [2023] FCA 574). **See item 7.**

Asset betterment assessments

The Federal Court (Derrington J) has dismissed appeals by a taxpayer against default and amended assessments which were made by the Commissioner pursuant to s 167 ITAA36 on the asset betterment basis for the four income years ending 30 June 2015, 2016, 2017 and 2018 (*Condon v FCT* [2023] FCA 561). **See item 8.**

Employee or independent contractor

The Full Federal Court (Bromwich, Thawley and Hespe JJ) has unanimously allowed the taxpayer's appeal from a judgment of Wigney J and held that a contract between a lecturer and an education provider (the taxpayer) created an independent contractor relationship and not an employer/employee relationship and that the lecturer did not fall within the ordinary or extended meaning of employee pursuant to the superannuation guarantee legislation (*JMC Pty Ltd v FCT* [2023] FCAFC 76). The Commissioner is seeking special leave to appeal to the High Court from the decision of the Full Federal Court.

CGT improvement threshold

For the 2023–24 income year, the CGT improvement threshold under s 108-85 ITAA97 is $174,465.

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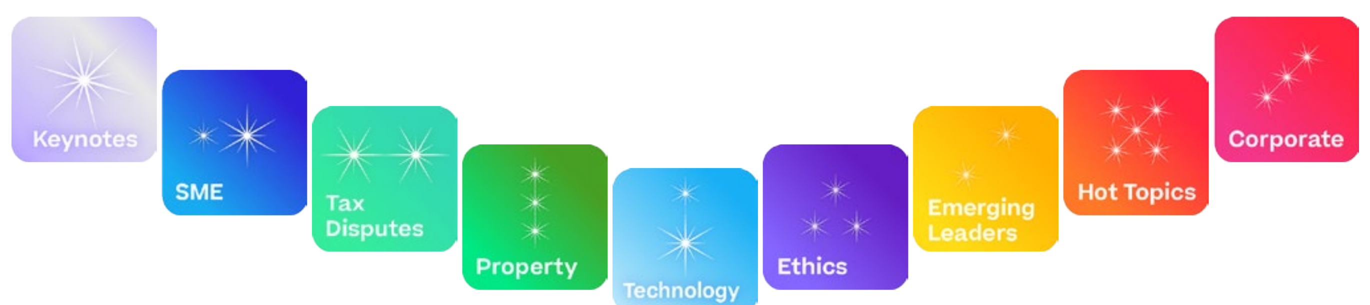

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President's Report

by Marg Marshall, CTA

Tapped into the world of tax

President Marg Marshall discusses putting tax in a global perspective at our upcoming event, The Tax Summit.

As tax practitioners, we know better than anyone how far-reaching the impacts of tax policy and tax practice can be. We say it often, but it bears repeating – tax touches everything.

Amid the hustle and bustle of everyday life, it's sometimes easy to lose sight of the bigger picture. It's so important to give yourself the time and space to consider your work as part of a wider community and economy. I find that doing so not only boosts personal motivation to continue doing good work, but also helps to craft policy and client advice with a positive impact.

A global perspective at The Tax Summit

As you no doubt know, our flagship event, The Tax Summit, is taking place this September.

This year, The Tax Summit looks at tax from a global perspective and asks what kind of future our tax system is setting us up for. More importantly, the program explores what we as tax practitioners can do to shape a robust, positive future for ourselves, our clients and our communities.

Day-to-day, tax professionals work to high standards, both in the quality of work and professional standards. This is crucial to what we do. However, sometimes it is necessary to take a step back and look at the big picture of how our work has an impact that ripples throughout the business, finance and legal professions.

This is the opportunity that The Tax Summit affords you and your team. The program caters to every aspect of the tax profession and explores current issues and future considerations. From an update on recent cases with Mark Gioskos, FTI, of the Victorian Bar, to an exploration of cyber risk and exposure in an increasingly digital world of work, the topics on the table are those that will define the profession of tomorrow.

As an SME practitioner myself, I'm excited to delve into the exceptional line-up of SME speakers and sessions. The Emerging Leaders stream, catering to those just entering the profession or levelling up their foundational knowledge, is also an important and exciting feature of the event. We work hard to ensure that emerging tax practitioners are considered in our event programs, and The Tax Summit encapsulates some of the key topics these up-and-coming professionals need to wrap their minds around. If you're just getting started, or if you have junior staff who are settling into the profession, this is a wonderful way to be immersed in all things tax.

I hope to see you all in Melbourne.

Our membership in 2023–24

It has been a wonderful start to the year and there's more resources, news, advocacy and events to come for The Tax Institute and our members.

With the end of the financial year now past, it's also past the time to renew your membership. For those who have already done so, thank you. We appreciate your support and presence and look forward to supporting you for another year.

If you've not yet renewed, this is the last *Taxation in Australia* journal you will receive as a member. I hope to have you with us for another year because I sincerely believe that our membership, and every voice in it, makes our organisation what it is. If you would like assistance to renew your membership, please get in touch with our team today.

CEO's Report

by Chair and Acting CEO, Clare Mazzetti

Your CPD for the rest of the year

Acting CEO, Clare Mazzetti, reflects on The Tax Institute's CPD events this year and their importance to our community.

It seems safe to say that most of us seem settled into the work-from-home life. For most, daily commutes and water cooler conversation would appear to be a thing of the past. On the whole, we have adapted very well to the shift in thinking, attitude and lifestyle that comes with remote working arrangements.

However, there is one occasion that in-person interaction will always be my personal preference: professional networking and development events. There is something very special about being in a room full of people dedicated to growing themselves and their career.

So far this year, we've welcomed thousands of tax practitioners from around the profession to our CPD events. Our Local Tax Clubs continue to address topical issues, while creating spaces for practitioners to meet and collaborate with like-minded professionals in their local area. Tax Forum Season brought sweeping, comprehensive technical programs to capital cities around Australia. Our line-up of conferences and conventions also created opportunities to dive deeper into specialist topics, including superannuation, financial services and trusts.

It's a busy time at the moment. It can be easy to lose track of our own priorities and personal goals amid client needs this end of financial year. However, I encourage you to consider how you might grow through a CPD event in the latter half of 2023.

I would love to see you in person at an event. There are some wonderful programs coming up, such as the Death & Taxes Conference, the National GST Conference and the State Taxes Convention. These are opportunities to get up to date on the latest in tax analysis and connect with the Institute community.

As Marg mentioned in her report this month, our major event, The Tax Summit, is also taking place this September. How time flies! I hope to see you in Melbourne for the Summit. It promises to be an exceptional event, with much technical insight to be gleaned and plenty of opportunity to network, socialise and experience Melbourne.

I recognise that it can be a challenge to get away from your desk and take the time to truly immerse yourself at an in-person event. If that's the case for you, give yourself the gift of time and the ability to work at your own pace. To facilitate this, we have made some of our recent events available as on-demand CPD.

However you fit it into your schedule, I hope you can find the headspace to prioritise yourself and your development this year.

To our volunteers: thank you for your contributions

I'd like to extend a huge thank you to all of our volunteers. Our volunteer event committees make it possible for us to hold the wonderful CPD events that we do. Through their efforts, we are able to offer some of the best technical programs around.

Our sessions are at the cutting edge of tax analysis, thought and opinion. That too is thanks, in large part, to our wonderful volunteer speakers who bring their expertise to each and every event we hold.

So, thank you to our volunteers. We look forward to the insights and expertise you'll bring in the latter half of 2023 and beyond.

To our members: thank you for renewing

Last but not least, I'd like to echo Marg's sentiments around our member community as we head into the new financial year. Our community is made strong through many voices coming together to address issues of importance to us all. We are glad to have each and every one of you with us.

Thank you for renewing and being with us for another year. We look forward to supporting and collaborating with you.

If you'd like assistance to renew your membership now, please reach out to our team – we will be happy to help.

Associate's Report

by Abhishek Shekhawat, ATI

Harmonising property taxes

We examine the factors that states and territories need to consider in the harmonisation of property taxes in an environment where they are slowly, but steadily, diverging.

With state Budget season for 2023 almost over, Treasurers of most states and territories have presented their Budgets to their constituents. An interesting aspect across many of the Budgets is the differing approaches that states and territories are taking with respect to property taxes.

Property taxes, stamp duty in particular, are a major source of revenue for most states. However, the current economic uncertainty fuelled by ongoing inflation, cost-of-living pressures, and increasing interest rates places significant pressures on landholders. Residential properties are seeing lower supply as people are less willing to sell. Meanwhile, increasing prices make the dream of owning a house less attainable for younger Australians, with Census results showing that the likelihood of owning a home at the age of 25–39 is decreasing for each successive generation. The commercial property market is facing uncertainties of its own. Recent survey results show industrial properties undergoing a growth stage, with the short to medium-term prospects for office and retail properties remaining uncertain.

The heavy reliance of the states and territories on stamp duties to fund public services means that even a moderate drop in property transactions can significantly impact their net fiscal position. Property taxes can also notably influence a taxpayer's ability and willingness to transact in the property market, with potential flow-on impacts on affordability and costs passed on to both residential and commercial tenants.

Diverging pathways between states and territories

The states and territories appear to be taking different approaches to these challenging conditions. Victoria announced a transition to an annual property tax (APT) for commercial and industrial properties. Broadly, the measure proposes to impose stamp duty on the sale of impacted land on the first transfer after 1 July 2024, with the land switching to an annual property tax 10 years after that purchase date. Some may argue that Victoria's approach is taking two bites at the tax apple. Property taxes for residential land in Victoria remains unchanged at this stage.

Meanwhile, the New South Wales Government has introduced legislation that proposes to abolish the previous government's APT plan, proposing to replace it with increased thresholds for stamp duty exemptions on residential properties for first home buyers. Similarly, South Australia has also announced a doubling down on the stamp duty model by increasing concessions for first home buyers of residential properties.

Property taxes in the Australian Capital Territory are currently in the process of a 20-year transition. At the conclusion of this transition, stamp duty on properties is expected to be replaced with an APT. Other states and territories have not announced any significant changes, likely indicating their commitment to the current stamp duty approach.

Taking steps towards harmonisation

This fragmented approach between the states and territories has left taxpayers in a difficult position, with compliance costs likely to increase as taxpayers are forced to manage changing regimes. Taxpayers also face uncertainty, not knowing whether governments will modify, reform or reverse existing or announced regimes.

There is a serious need for a harmonised approach to property taxes. As detailed several times before, The Tax Institute supports APTs over the archaic and inefficient stamp duty approach. However, reform is not a simple process. It requires broad consultation, difficult discussions and political courage.

It is important to recognise that complete harmonisation may not be possible. Some differences may be needed to account for the revenue needs and gulf in property values between the states and territories. Some potential differences include: different rates for APT; different thresholds for specific incentive programs (eg first home buyer exemptions); and the need to potentially grandfather previous announcements (eg enacted transitionary approaches) to provide greater certainty to taxpayers.

However, there are some aspects that can be and should be harmonised to reduce the compliance burden for taxpayers. These include: the valuation approach to land; how the indexation of rates and thresholds is determined; whether taxpayers are provided the ability to opt-in; whether, and if so how, historical stamp duty paid is taken into consideration; a consistent transitionary approach between jurisdictions; and the start date for the implementation of the reform.

Despite the challenges, it is important that harmonised reform is undertaken for property taxes. The longer-term benefits for Australians and the broader economy will outweigh short-term difficulties. Educating the public and ensuring extensive consultation to best balance the outcomes for taxpayers will better ensure a more successful pathway to reform.

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Tax News – the details

by TaxCounsel Pty Ltd

June – what happened in tax?

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

Government initiatives

1. Medicare amendments

An amending Bill (the Treasury Laws Amendment (2023 Measures No. 2) Bill 2023) that was introduced into parliament on 10 May 2023 contains amendments that will give effect to the 2023–24 Budget Medicare levy changes and the reduction in the gross domestic product (GDP) adjustment factor.

More particularly, the Medicare levy amendments will increase the following for the 2022–23 and later income years in line with movements in the CPI;

- the Medicare levy low-income thresholds for individuals and families (along with the dependent child/student component of the family threshold);
- the Medicare levy low-income thresholds for individuals and families eligible for the seniors and pensioners tax offset (along with the dependent child/student component of the family threshold); and
- the Medicare levy surcharge low-income threshold.

The GDP adjustment factor for the 2023–24 income year is being reduced to 6%. This factor is applied by the Commissioner to work out the amount of PAYG and GST instalments payable by a taxpayer in certain circumstances.

The Commissioner's perspective

2. Meaning of "school"

The Commissioner has issued a decision impact statement in relation to the decision of the Federal Court (McKerracher J) in *The Buddhist Society of Western Australia Inc v FCT (No. 2)*[1] in which the court considered the meaning of a "school" in the context of the deductible gift recipient provisions of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Following the Federal Court's decision, the Commissioner accepts that the views expressed in TR 2013/2 (income tax: school or college building funds) do not reflect the ordinary meaning of the term "school". The Commissioner agrees with the Federal Court's views that the ordinary meaning of school does not require a course of education to be "vocational as opposed to recreational". Therefore, the focus will be on the activities carried out to determine whether instruction is being given in an activity or area of knowledge.

When determining whether a building is "used, or to be used, as a school", the Commissioner will give consideration to the overall purpose (or purposes) for which the building was "established and maintained" and the activities which support its purpose. Where the "activities" include a mixture of school and non-school activities, the Commissioner will have regard to the connection of the activities and the extent to which both types of activities contribute to the purpose (or purposes) for which the building was "established and maintained".

The Commissioner will review and update TR 2013/2 and relevant website guidance to reflect the decision of the Federal Court.

3. Construction or creation of capital assets: labour costs

The Commissioner has released a final ruling that explains when certain labour costs related to constructing or creating capital assets (tangible or intangible) cannot be deducted as a general deduction under s 8-1 ITAA97 because of the capital or capital in nature exclusion from deductibility that is provided for in that section (TR 2023/2).

The circumstances in which TR 2023/2 applies are where the taxpayer incurs labour costs (called "capital asset labour costs") that are:

- salary and wages (including bonuses) for employees who perform functions in relation to the construction or creation of capital assets, and other costs associated with the employment of that labour (for example, amounts incurred for long service leave); or
- other amounts for labour, or principally for labour, incurred in relation to the construction or creation of capital assets.

For the purposes of the ruling, capital assets are those assets (tangible and intangible) constructed or created which form part of the profit-yielding structure of a business entity, structure or organisation.

TR 2023/2 states that, to the extent that capital asset labour costs are incurred specifically for constructing or creating capital assets, their essential character is considered to be capital or of a capital nature and therefore cannot be deducted under s 8-1 ITAA97. This is not limited to those involved in the construction work itself, but can include the costs of labour for those who perform functions in relation to the construction or creation of capital assets.

It is a question of fact and degree whether costs are incurred specifically for constructing or creating a capital asset. Not all capital asset labour costs will be regarded as being specifically incurred for constructing or creating capital assets. The cost of workers or employees whose role has a remote connection with constructing or creating

capital assets, or who have a broader role that involves incidental activities connected with constructing or creating capital assets, will generally not be regarded as being incurred specifically for constructing or creating capital assets and therefore will not be capital or of a capital nature.

Whether capital asset labour costs are incurred specifically for constructing or creating capital assets is ordinarily to be ascertained at the time the loss or outgoing is incurred, and so:

- costs in relation to an employee may be initially on capital account and later change to be on revenue account (and vice versa); and
- employees may be specifically employed for both constructing or creating capital assets and other duties, in which case, apportionment of the losses or outgoings will need to be considered.

Any apportionment that is required is to be conducted on a fair and reasonable basis.

TR 2023/2 gives a number of examples of how the approach adopted in the ruling operates. The following are two of the examples.

Example 1. General manager of Head Co salary

Offshore Parent Co is the head of a global enterprise and, a number of years ago, had established Australian Head Co to run its Australian operations through a number of subsidiaries. Australian Head Co is the head company of a consolidated group for income tax purposes. It has recently established a wholly-owned Australian Sub Co for constructing a facility which is a capital asset.

Australian Head Co has a longstanding general manager. Under the employment contract, the general manager has responsibility for the day-to-day operations of all the Australian operations, as well as developing strategy and plans for future operations. The general manager is not required to time-write their work hours. However, for accounting purposes, a portion of their labour cost is capitalised as part of overhead allocations. During the construction of the facility by Australian Sub Co, the general manager spends approximately one day a week discussing aspects of the construction project with other managers and contractors involved, and preparing reports on the progress of the construction project for Offshore Parent Co.

The salary of the general manager of Australian Head Co will be immediately deductible under s 8-1 ITAA97 as they are not considered to be specifically employed for the construction or creation of a capital asset. Rather, they are specifically employed in the ordinary recurrent working operations of the business. There is nothing in the circumstances of their employment, including their roles, responsibilities, time recording or the accounting treatment that changes the essential character from being an ordinary working expense. The fact that some

Example 1. (cont)

of their time is spent on activities related to the construction of the facility is an ordinary incident of the general manager role and does not change the essential character of, or call for apportionment of, their salary.

A similar outcome would arise for support functions, such as human resources or legal staff who are employed in the ongoing business of the Australian operations but devote an infrequent or incidental amount of their time to supporting the construction project.

Example 2. Centralised project management team salary

Following on from Example 1, a centralised project management and procurement team (that includes a project general manager, project human resources manager and project finance manager) is established in Australian Sub Co. The team is specifically employed to manage the project and recruit personnel for the construction of the facility. They periodically report to the general manager on the performance of Australian Sub Co during the construction of the facility. During this period, the team's labour costs are capitalised in accordance with Australian Sub Co's accounting policies. Once the facility is installed and ready for use, some members of the team are retained to manage and work in the Australian Sub Co business that utilises that facility.

For the period when the centralised project management and procurement function team are specifically employed for constructing the new facility, the essential character of their salary is wholly capital or capital in nature and their salary will not be deductible. In this example, the accounting treatment is not a determinative factor when considering all the facts and circumstances relevant to making a determination.

Once the facility is installed and ready for use, the retained employees are then specifically employed in the recurrent ordinary business operations. The essential character of their salary will then be an ordinary working expense on revenue account and deductible under s 8-1.

Other points

Other points made in the ruling that should be noted are:

- as indicated, not all capital asset labour costs will be considered capital or capital in nature. However, where labour is specifically employed or contracted for the construction or creation of a capital asset, it will be on capital account. This is to be distinguished from where employees are employed in the day-to-day and ongoing operations of a business and they engage in activities that are capital in nature (such that their labour costs could be categorised as capital asset labour costs for the purposes of TR 2023/2) but they engage in those

activities infrequently or those activities are considered minor or incidental in the context of their overall activities, duties and functions. The essential character of the capital asset labour costs of those employees is wholly revenue in nature and apportionment will not be relevant; and

- the accounting treatment is not a determinative factor of the character of expenditure incurred for income tax purposes. However, there is substantial case law indicating that the way the expenditure is classified and treated for accounting purposes and how the accounting systems record expenditure may be a useful indicator of the facts and circumstances surrounding the expenditure and can therefore assist in ascertaining its true nature when completing the full and complete assessment of all of the relevant facts and circumstances. Accounting treatment may also be a useful indication of a reasonable basis for apportionment of expenditure.

4. Intangibles arrangements

The Commissioner has released a draft practical compliance guideline that sets out the ATO's compliance approach to intangibles arrangements involving international related parties (PCG 2023/D2).

For the purpose of PCG 2023/D2, "intangibles arrangements" refers to cross-border arrangements relating to the development, enhancement, maintenance, protection and exploitation (DEMPE) of intangible assets, or the migration of intangible assets that the ATO has seen. A "migration" refers to any restructure or change associated with an entity's intangible assets that allows another entity to access, hold, use, transfer or benefit from the intangible assets.

Intangible assets refer to the property, assets and rights that are not physical or financial assets, which are capable of being controlled for use in commercial activities, and are not restricted by any accounting or legal concepts or definitions.

PCG 2023/D2 focuses on the ATO's compliance approach (primarily when the ATO is more or less likely to apply resources to consider the potential application of the general anti-avoidance rules or the transfer pricing rules) with respect to arrangements that the ATO has seen involving:

- the migration of intangible assets; and
- the mischaracterisation of Australian activities connected with the DEMPE of intangible assets.

PCG 2023/D2 does not affect the ATO's compliance approach to other tax issues that might arise in connection with intangibles arrangements (for example, the tax risks outlined in TA 2018/2 or TA 2022/2).

Where the basic rule in s 815-130 ITAA97 applies, transfer pricing in respect of, and valuation of, an intangible asset are dependent on the facts and circumstances of individual arrangements. It is therefore outside the scope of PCG 2023/D2 to determine the level of compliance risks associated with the transfer pricing of all related party dealings which arise in connection with properly characterised intangibles arrangements.

PCG 2023/D2 is divided into the following three parts:

1. the ATO compliance approach: this provides the ATO's compliance approach for intangibles arrangements;
2. the ATO risk assessment framework: this explains how the ATO assesses the compliance risks of intangibles arrangements; and
3. the ATO evidence expectations: this provides an outline of the types and level of evidence that the ATO will have regard to when examining intangibles arrangements.

5. Residence of individuals

The Commissioner has released a final taxation ruling that outlines the residency tests for individuals for tax purposes as set out in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and when the Commissioner considers that a person will be a resident of Australia (TR 2023/1).

TR 2023/1 consolidates and replaces the material in withdrawn IT 2650, IT 2681 and TR 98/17. It also updates the views reflected in those rulings to take into account developments in case law (including *Harding v FCT*,[2] *Pike v FCT*[3] and *Addy v FCT*[4]). IT 2650 and TR 98/17 have been withdrawn with effect from the date that the new ruling was issued as a draft for public comment (6 October 2022). IT 2681 has been withdrawn with effect from the date of issue of the new ruling (7 June 2023).

TR 2023/1 explains the Commissioner's views on a broad range of issues, including the ordinary concepts test, the 183-day test, the domicile test, temporary workers and working holiday makers, part-year residency and dual residency.

Interestingly, the whole of the ruling document is a public ruling (there is no explanatory section).

Self-assessment issues

The structure of both the domicile and 183-day tests is such that a person is a resident unless the Commissioner is satisfied as to certain matters in the relevant provisos within the tests. While this reserves to the Commissioner the role of reaching the relevant state of satisfaction, an individual, when self-assessing their residency status, should consider how the provisos would apply to them. The self-assessment system places responsibility on the taxpayer to comply with taxation laws, and in certain situations, such as this, the taxpayer will need to make an assumption about the way in which the Commissioner would apply the residency tests based on the taxpayer's particular facts and circumstances.

A taxpayer should take a reasonable view of how the Commissioner will regard the matters in the provisos in accordance with the guidance provided in TR 2023/1. Where, for example, an individual has been in Australia for more than 183 days in an income year but is on a holiday and will return to their home overseas at the conclusion of their holiday, the taxpayer should self-assess as a

non-resident. Where the taxpayer is domiciled in Australia but, consistent with the views expressed in TR 2023/1, it is likely that the Commissioner would consider that the taxpayer definitely abandoned their Australian residency and commenced living in a permanent way in an overseas town or country, the taxpayer should self-assess as a non-resident.

6. Small business lodgment amnesty

The ATO is encouraging small businesses that have overdue income tax returns, fringe benefits tax returns or business activity statements to take advantage of the new amnesty announced in the recent Budget to get their lodgments back on track.

The amnesty applies to tax obligations that were originally due between 1 December 2019 and 28 February 2022 and runs from 1 June 2023 to 31 December 2023. During this time, eligible small businesses can lodge their eligible overdue forms and the ATO will then proactively remit any associated failure to lodge penalties.

To be eligible for the amnesty, the small business must be an entity with an aggregated turnover of less than $10m at the time the original lodgment was due.

The amnesty does not apply to superannuation obligations and excludes other administrative penalties, such as penalties associated with the taxable payments reporting system.

Recent case decisions

7. Litigation settlement amount deductible

The Federal Court (Stewart J) has dismissed the Commissioner's appeal from a decision of the AAT in which the AAT held that an amount paid by the taxpayer to settle litigation qualified as a general deduction (*FCT v Wood*[5]).

From 1998 to 2011, the taxpayer was employed by a company, Carina Finance & Investments Pty Ltd (Carina), that was owned by him and his wife. Relevantly, the taxpayer provided consultancy services to Alleasing Pty Ltd (Alleasing) for which the latter paid fees to Carina, and Carina in turn paid a salary to the taxpayer.

The consultancy arrangement was governed by an agreement to which Alleasing, Carina and the taxpayer were parties. The agreement provided that the consultancy services to be provided by Carina would be performed "through" the taxpayer. A component of the consultancy fees to be paid to Carina was on an incentive basis. That most recently included the receipt by Carina of ordinary and preference shares in Alleasing's holding company, Headleasing Holdco Pty Ltd (Headleasing).

When the arrangement came to an end, Carina, the taxpayer, Alleasing and Headleasing concluded a deed referred to as a "separation deed". Under the separation deed, Alleasing was obliged to pay Carina all fees then outstanding under the consultancy arrangement and Headleasing was obliged to buy back its shares held by Carina. After the separation, the taxpayer took up new employment with an unrelated company.

Thereafter, Alleasing and Headleasing became aware of facts that caused them to allege that the taxpayer had negotiated a number of unauthorised transactions when performing the consultancy services for Alleasing in 2006 or 2007. Alleasing and Headleasing commenced proceedings against the taxpayer and Carina, in which they sought damages of some $2.4m. The claims included that the taxpayer had engaged in misleading or deceptive conduct in contravention of a statutory provision, that the taxpayer had breached fiduciary obligations to Alleasing, and that the taxpayer had breached the consultancy agreement. The claims were based on allegations that Carina and/or the taxpayer, when providing the consultancy services, had concluded a number of agreements on behalf of Alleasing with a third party that were not authorised by Alleasing and were not reported to Alleasing.

The taxpayer and Carina disputed the allegations and defended the proceeding. They also filed a cross-claim against Alleasing and Headleasing which included a claim for performance of the share buy-back which was the subject of the separation deed, and a claim for statutory leave entitlements based on the contention that the taxpayer was an employee of Alleasing during the consultancy arrangement. About $400,000 was claimed, of which a little more than half related to the leave entitlements claim, ie to the taxpayer's claim.

Separately from the proceeding, the taxpayer also threatened a defamation claim against Alleasing on the basis that one of its officers had made defamatory statements about him to his new employer concerning the allegations about unauthorised transactions.

In April 2013, Carina went into liquidation and the proceeding against it was stayed.

On 6 December 2013, the remaining parties settled the proceeding in a settlement deed on the basis that the taxpayer pay Alleasing $200,000, the proceeding be dismissed with no order as to costs, and the parties mutually release each other. The settlement was expressed to be "without admission of liability".

On the same day, the taxpayer and Alleasing entered into a deed of release concerning the threatened defamation proceeding. The terms included that Alleasing not publish or republish certain allegations concerning the taxpayer's conduct and character, and that Alleasing pay the taxpayer $180,000, with mutual releases.

On 29 January 2014, the taxpayer and Alleasing concluded an acknowledgment of settlement which provided for the set-off of the amounts payable under the settlement deed and the deed of release, resulting in an obligation on the taxpayer to pay Alleasing $20,000 which was paid by way of bank cheque on that day.

The taxpayer claimed as a deduction in the 2014 income year the payment of $200,000 to settle the proceeding (the settlement sum). The Commissioner disallowed the claimed deduction. On review, the AAT upheld the taxpayer's claim. The Commissioner then appealed to the Federal Court from the decision of the AAT.

In dismissing the Commissioner's appeal, Stewart J said that, in his view, the settlement sum was properly characterised as having been incurred in the course of gaining or producing the taxpayer's assessable income. The occasion of the liability that was discharged was the work done by the taxpayer as employee of Carina under the relevant consultancy agreement with Alleasing. It did not matter that the liability itself was created by the settlement deed because the claim that was compromised by that deed arose directly out of the taxpayer's employment; the taxpayer's conduct in his employment was at once the source of income and the cause of the risk of liability.

In much the same way as legal expenses incurred when contesting allegations (ie claims) about the conduct of an individual in their employment are regarded as being incurred when gaining income, the taxpayer's agreement to pay, and then payment, to bring allegations about his conduct in his employment to an end was similarly characterised – it was a loss or an outgoing that reduced his income from his employment. It was not to the point that the allegations, if established, would show that the relevant conduct was outside the scope of his employment. The conduct in question was conduct that the taxpayer engaged in as an employee when gaining his assessable income – indeed, the claims included that he was engaged in trade and commerce and that he breached the consultancy agreement under which he was employed. The claims therefore arose directly from his employment.

For these reasons, the settlement sum was incurred in the course of gaining or producing income and the occasion of the outgoing was to be found in the taxpayer's conduct as employee that was productive of his income. That is to say, the connection between the outgoing and the gaining or production of income was sufficiently close, noting in particular that a direct connection is not required. From a practical and business point of view, the outgoing was calculated to bring to an end a litigation risk that had as its source the taxpayer's employment with Carina and the consultancy agreement with Alleasing.

Stewart J rejected the Commissioner's submission that the outgoing could not have been incurred in gaining or producing assessable income in 2014 in relation to events in 2006–07. An outgoing may be referrable to an income year other than that in which it was incurred. The Commissioner's submissions were in search of the outgoing in question itself being productive of income, which directed attention to the 2014 year and thereafter, but that overlooked that a loss that is a reduction in past income can also qualify as a general deduction. None of the authorities place any significance on how much time has passed between the conduct in question that was productive of income and the year in which the loss is felt or the outgoing is incurred.

Finally, Stewart J held that there was no error by the AAT in its conclusions on the question of whether the loss or outgoing was capital or of a capital nature. The settlement sum did not involve the acquisition of any tangible asset, but rather arose out of the very activities that the taxpayer performed when gaining assessable income. The discharge of the liability that arose out of those activities could not sensibly be characterised as a loss or an outgoing of capital or of a capital nature – it was not to protect goodwill or widespread or general reputation, or to secure habitual patronage by clients or customers. To characterise it as capital or of a capital nature would elide the different nature and purposes behind the settlement deed and the deed of release. They were legitimately directed to different ends.

8. Asset betterment assessments

The Federal Court (Derrington J) has dismissed appeals by a taxpayer against default and amended assessments which were made by the Commissioner pursuant to s 167 ITAA36 on the asset betterment basis for the four income years ending 30 June 2015, 2016, 2017 and 2018 (the relevant years) (*Condon v FCT*[6]).

The Commissioner had allowed the taxpayer's objections against the assessments in part and determined that alterations ought to be made to reduce his taxable income, as set out in the original assessments. However, the objections for each income year were otherwise refused so that the taxpayer was treated as having understated his assessable income in each of the income years.

On appeal, the Federal Court held that the taxpayer had failed to establish what his actual taxable income was for each of the relevant years, and that the Commissioner's assessments were excessive. In very general terms, that conclusion was based on the following matters.

First, the taxpayer's challenge to the assessments appeared to have been diverted at an early stage of the objection process to focus on the correctness of the Commissioner's asset betterment statements for each relevant year. That focus was forensically inappropriate. While efforts were made to correct that, it meant ultimately that the necessary attention was not devoted to the proper issues on an appeal of this nature, as derived from the text of s 14ZZO of the *Taxation Administration Act 1953* (Cth), such that the evidence adduced in the proceedings fell short of that which was actually required by that section.

Second, the taxpayer's financial affairs were characterised by the regular use of cash where possible, the absence of written records of transactions, and even the absence of any correspondence referring to transactions. It followed that, in order to prove his assessable income in each of the relevant years, the taxpayer's testimony as to his affairs needed to be accepted. That became impossible once it was concluded that he was neither a reliable nor a credible witness.

Third, the taxpayer was unable to establish that expenditure or receipts by him across the relevant years in relation to alleged gambling, the buying and selling of motor vehicles, the receipts of so-called reimbursements from his employer, money received from a former partner and her daughter, and foreign currency transactions were not, or were not reflective of, assessable income.

Fourth, none of the relevant years was exceptional in any of these respects. When each was considered, the same conclusion as to the sufficiency of the evidence emerged.

Fifth, even if the taxpayer's credit was put to one side, to a very real degree, the evidence that was adduced was overly general, inconsistent and confusing. That also would have prevented any conclusion that he had discharged his onus in respect of each of the relevant years.

The decision of Derrington J contains an up-to-date consideration of the cases that are relevant to what a taxpayer's onus of proof is where an assessment issued by the Commissioner is a default or arbitrary assessment.

Other issues that were considered included whether the taxpayer, when buying and selling motor vehicles, was carrying on a business.

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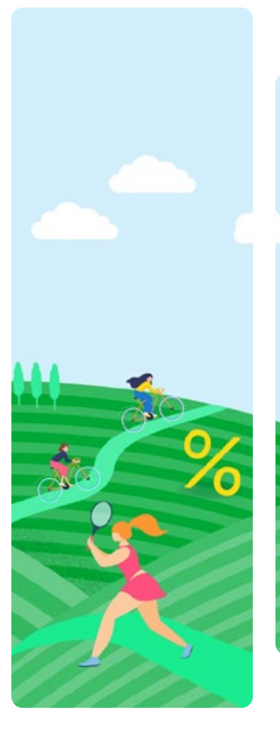
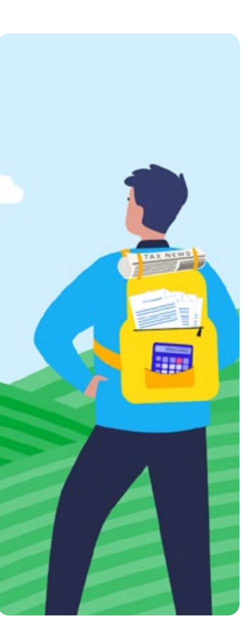

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Tax Tips

by TaxCounsel Pty Ltd

Lost trust deeds: "clear and convincing" proof?

Several recent Supreme Court decisions highlight issues that can arise if a trust deed is lost.

Background

The consequences of a trust deed being lost have arisen with surprising frequency over the years.

This article considers three recent Supreme Court decisions where the issues that can arise where a trust deed is lost have been considered. These are a decision of the Victorian Court of Appeal and two decisions of single justices of the New South Wales Supreme Court.

The decision of the Victorian Court of Appeal is particularly significant in that the court held that the relevant burden of proof in an application to the court in a lost trust deed case is not (as the prevailing view has been) "clear and convincing" evidence, but the ordinary civil burden of proof on a balance of probabilities. That approach was endorsed by one of the decisions of the NSW Supreme Court.

The other and most recent decision of the NSW Supreme Court is significant in that it opens up the possibility that relatively recent amendments to the *Trustee Act 1925* (NSW) may, in some circumstances, provide a better remedy.

Cases also arise where the original trust deed has been lost but there is a copy of the deed in existence. This situation was recently considered by the Western Australian Supreme Court in a decision which is also noted below.

Vanta

Chronologically, the first of the three recent decisions referred to above is the decision of the Victorian Court of Appeal (Kyrou and Sifris JJA and Forrest AJA) in *Vanta Pty Ltd v Mantovani*,[1] a decision that was given in relation to an application for leave to appeal from a decision of McMillan J.[2]

The parties to the application for leave to appeal were adult sons of Vincenzo Mantovani (Vincenzo) and Teresa Mantovani (Teresa), who were deceased. Two of the sons, Nicola (Nic) and Salvatore (Rocky), were directors of Vanta Pty Ltd (Vanta). Vanta was the trustee of the Mantovani Family Trust (the trust) which was a discretionary trust created by a deed dated 27 July 1976. Vanta, Nic and Rocky were the applicants for leave to appeal.

Giovanni (John), Nic and Rocky's brother, was neither a shareholder nor a director of Vanta. He was the first respondent to the application for leave to appeal. The remaining brother (Carmine) absented himself from the present dispute.

The four brothers, Teresa's grandchildren and any children or grandchildren of the brothers were the beneficiaries of the trust.

Vanta owned multiple residential and commercial properties in Cobram, Victoria, from which it derived income. In one way or another, the properties were transferred by Teresa to Vanta, as trustee of the trust.

In the 10 years preceding November 2021, Vanta operated, and continued to operate, as a trading trust. It had prepared financial statements and filed tax returns annually. It had made annual distributions to the beneficiaries. In the 10-year period, those distributions were solely to Nic and Rocky (the two directors of Vanta). It made no distributions to John or his children. He, understandably, became dissatisfied and sought access to the trust's records. Vanta denied this, prompting John to commence proceedings in the Trial Division of the Victorian Supreme Court.

In the course of those proceedings, and well before it reached trial, it became clear that the original trust deed that established the trust, and any true copy, had gone missing. Vanta, as a responsible trustee, should have possessed a copy. It did not. Nor did it come to the court, as it could have, to seek directions under the *Trustee Act 1958* (Vic) as to how to continue to operate the trust in the absence of the deed.

The only extant part of the deed was its schedule, which set out the following information: (1) the date of making the deed (27 July 1976); (2) the name of the trust; (3) the settlor (Rocco Orsida (Rocco)); (4) the trustee (Vanta); (5) the settled sum ($50); (6) the appointor (Teresa, and on her death, whoever was named in her will); and (7) the beneficiaries.

The trial judge (McMillan J) observed that it was common ground that the trust had been created, that certain residential and commercial units were held by Vanta as trustee, and that the deed which created the trust had been lost. Thus, the central issue was what, if any, legal consequences flowed from the loss of the deed and, in particular, whether the trust failed for uncertainty.

McMillan J concluded that the trust failed for lack of certainty as a result of the loss of the deed and the lack of clear and convincing proof of its contents. Her Honour went on to hold that Vanta held the trust property subject to a resulting trust in favour of the estate of Teresa.

The Court of Appeal granted leave to appeal and unanimously reversed the decision of McMillan J.

The Court of Appeal judgment

In a joint judgment, the court said that there could be no doubt about the end result: the "clear and convincing" test of the proof of the contents of a lost document (whatever its nature) was misconceived. Rather, in terms of proof of a particular fact or facts (or inferences to be drawn from them) relating to the existence or contents of a document, the burden on the party attempting to establish that fact is no more and no less than that imposed by s 140 of the *Evidence Act 2008* (Vic) — proof on the balance of probabilities, as elaborated on in the section itself.

The court then went on:

> "84. Moreover, the adoption of the clear and convincing proof test, as this case demonstrates, produces two anomalies.
>
> 85. First, it imposes too high a burden on the party endeavouring to prove the existence of the relevant fact. In truth, the *Evidence Act* allows a party to rely upon many forms of secondary evidence (oral and written) in establishing the contents of a missing document, provided the facts and inferences to be drawn from them are established on the balance of probabilities.
>
> 86. Second, in a number of the judgments (including the judge's judgment in the present case) the emphasis on the strictness of this test conveys that, in the case of a missing document, only a facsimile or duplicate of the original document will suffice in establishing sufficient proof of the terms of the document.
>
> 87. The vice of this approach, particularly on the question of uncertainty, is that it leads to an incorrect and conflated approach as to what, as a matter of law, needs to be proved to establish the existence of a discretionary trust."

In relation to the question of uncertainty, McMillan J (at first instance) said that it could be concluded that a dearth of clear and convincing proof of the contents of a trust deed, such that the terms and nature of the trust in question cannot be ascertained, will render a trustee incapable of fulfilling its obligations to give effect to the terms of the trust and therefore cause the trust to fail for uncertainty.

The Court of Appeal said[3] that this statement implied, if not expressly stated, that it was necessary for Vanta to provide clear and convincing proof of almost all (if not all) of the terms of the deed to avoid a finding that the trust failed for uncertainty.

The court went on to say that, in fact, the real question to be determined was whether, in accordance with the authorities (which the court went on to discuss), there was sufficient proof of the essential terms of the deed such that the trust did not fail for uncertainty. In the absence of the deed, proof of the relevant facts and inferences (to be drawn from those facts) was to be established on the available secondary evidence. Those facts and inferences were, in turn, to be determined on the balance of probabilities (applying s 140(1) of the *Evidence Act 2008* (Vic)).

The records of the trust (financial reports and tax returns) established that:

- it was a discretionary trading trust;
- it had operated for many years as a trading trust and had filed financial reports and tax reports annually;
- the properties owned by Vanta were trust property; and
- it made regular distributions to beneficiaries, namely, to Rocky and Nic.

Their Honours said that they were satisfied that the secondary evidence identified the essential terms of the trust and met the "three certainties" test, that is:

- as to *certainty of intention*, it was clear that it was Rocco's intention to establish a discretionary trust for the benefit of the beneficiaries identified in the schedule, and it was Teresa's intention that the properties she transferred to Vanta be held by it for the benefit of those beneficiaries in accordance with the terms of that discretionary trust;
- as to *certainty of subject matter*, it was equally clear that the assets Vanta was to hold on trust for the benefit of those beneficiaries included the properties transferred to it by Teresa; and
- as to *certainty of object*, it was also clear that there was an ascertainable and defined class of beneficiaries. There was no evidence to suggest that any other class of beneficiaries existed.

The court said that, in its view, once these essential requirements were satisfied, the remaining question was whether there was sufficient clarity of the terms of the trust to avoid the draconian remedy of declaring that a family trading trust failed for uncertainty (when it had carried on business for many years) on the basis that it was not a competent and lawful trading trust.

Their Honours went on:

> "110. It can be readily accepted (as the [trial] judge noted) that there is a lack of secondary evidence as to the management powers of the trustee and the date of vesting of the Trust. But does that mean the Trust should fail for uncertainty? For the following reasons, we think not.
>
> 111. First, a court should be hesitant in declaring a trust void for uncertainty because in doing so, it is likely that the settlor's intentions will be frustrated. In this case, when the Trust has carried on business for many years, that hesitancy is well founded, as annulling the Trust would have significant implications for the Trust and its beneficiaries.
>
> 112. Moreover, in this case, because it is not known when the Deed was lost, it is not possible to determine a precise time as to when the trust failed for uncertainty.
>
> 113. Second, the certainties necessary for the continuance of the Trust as an extant body have been established.
>
> 114. Third, there is scope for the Court (pursuant to statute, the Rules and the inherent jurisdiction of the

Court) to 'fill the gap' in cases where there is uncertainty as to the exact non-essential terms of the Trust …

116. As was pointed out in discussion with counsel, it has been and remains open to Vanta to apply to the Court for judicial guidance as to the administration of the Trust notwithstanding the loss of the Deed."

Indeed, as the result of observations by the court during the hearing of the appeal, the applicants filed an undertaking that they would give in the event that the application for leave to appeal was granted and the appeal was allowed. The proposed undertaking would be in the following terms:

"117. … The applicant undertakes, by its counsel, that within 2 months of the Court's delivery of judgment in this matter, it will commence a proceeding in the Supreme Court of Victoria under Rule 54.02 of the [*Supreme Court (General Civil Procedure) Rules 2015* (Vic)] and s 63 of the *Trustee Act 1958* (Vic), and on such further bases as it might be advised, in which orders shall be sought for the effective administration of the Mantovani Family Trust, and will prosecute that proceeding until final orders are obtained for the resolution of the proceeding (if such orders are required)."

Section 63 of the *Trustee Act 1958* (Vic) provides:

"**63 Power of Court to authorize dealings with trust property**

(1) Where in the management or administration of any property vested in trustees, any sale, lease, mortgage, surrender, release or other disposition, or any purchase, investment, acquisition, expenditure or other transaction, is in the opinion of the Court expedient, but the same cannot be effected by reason of the absence of any power for that purpose vested in the trustees by the trust instrument (if any) or by law, the Court may by order confer upon the trustees, either generally or in any particular instance, the necessary power for the purpose on such terms and subject to such provisions and conditions (if any) as the Court thinks fit and may direct in what manner any money authorized to be expended, and the costs of any transaction are to be paid or borne as between capital and income.

(2) The Court may from time to time rescind or vary any order made under this section, or may make any new or further order.

(3) An application to the Court under this section may be made by the trustees, or by any of them, or by any person beneficially interested under the trust."

The court noted that these or cognate provisions have been utilised in the past where it was necessary to fill a gap owing to a deficiency in ascertaining all of the terms of a trust, and gave the following two examples:[4]

"121. In *Re Porlock Pty Ltd*,[5] the trustee sought judicial guidance under s 63 of the *Trustee Act 1925* (NSW), as to whether it would be justified in dealing with trust property in a particular way where the trust deed could not be located. An accountant who once possessed the trust deed and had direct involvement in the administration of the trust gave evidence as to the operative provisions of the trust as he understood them, and how the income and capital of the trust were to be distributed. Young AJA held that the accountant had provided the 'best evidence' of the terms of the deed and that the trustee would be justified in acting in accordance with those terms as recalled by the accountant.

122. In *Re Cleeve Group Pty Ltd*,[6] the trustee sought judicial advice that it could 'operate its business on the basis that an unexecuted trust deed … was in fact executed and that that deed continue[d] to govern that trust'. Gorton J noted that the trust deed had been executed but later lost. His Honour found that the executed deed was probably in the form of an unexecuted deed prepared by solicitors. His Honour made an order pursuant to r 54.02 of the Rules to the effect that the trustee 'is and has been justified in managing and administering the [trust] according to the terms of the unexecuted trust deed prepared by [the solicitors]'."

DEK Technologies

The second lost trust deed case that is being considered in this article is the decision of Henry J of the NSW Supreme Court in *Application of DEK Technologies Pty Ltd as trustee for DEK Technologies Unit Trust*.[7]

In these proceedings, the plaintiff trustees were seeking judicial advice that they were justified in managing and administering four trusts on particular terms, as set out in an amended summons, in circumstances where the original trust deeds or copies of them could not be found.

The trustees and their respective trusts were:

- the first plaintiff, DEK Technologies Pty Ltd (DEK Technologies), as trustee for the DEK Technologies Unit Trust (DEK Unit Trust);
- the second plaintiff, Drini Mulla, as trustee for the Mulla Trust;
- the third plaintiff, Kerim Tanovic, as trustee for the Tanovic Trust; and
- the fourth plaintiff, Wisdom Consultancy (Vic) Pty Ltd (Wisdom Consultancy), as trustee for the Yim Tang Family Trust (Yim Tang Trust).

The applications were related and had been brought in the same proceedings as the trusts were connected to one another through a technology consultancy business, DEK Technologies (DEK), which was operated by DEK Technologies and DEK Corporation Pty Ltd (DEK Corp). The trustees wished to obtain judicial advice in a context where the business of DEK Technologies and DEK Corp was the subject of a potential commercial transaction that would likely involve restructuring the trust structure.

In support of their applications, the plaintiffs read affidavits from each of Mr Mulla, Mr Tanovic and Eddie (Ting Shing) Yim, a director and the secretary of Wisdom Consultancy. They also read affidavits from eight other persons, including

accountants and lawyers, who gave evidence about their involvement in establishing the trusts, their knowledge of the trusts, and the searches and enquiries that had been conducted to locate the missing trust deeds.

Henry J held that the court should provide judicial advice to each of the trustees that they would be justified in managing and administering the trusts in the terms set out in his judgment.

When considering whether judicial advice should be provided, Henry J said:

> "75. In this case, the trustees do not ask the Court to set up or establish a trust. Rather, they seek to obtain judicial advice as to whether they are justified in managing and administering the trust property of the respective trusts pursuant to the terms provided for in prayers one to four of the Amended Summons, in particular, the terms that identify who is entitled to the trust property and in what circumstances, and the powers of the trustees …
>
> 77. Reference was made to *Maks v Maks* (1986) 6 NSWLR 34 …, a case in which McLelland J (as his Honour then was) considered circumstances where a party to the proceedings claimed that the other party had declared a trust with respect to a part of real property pursuant to a document which was not produced at the hearing. His Honour stated (at 36):
>
>> '… where the original writing is not produced and secondary evidence is relied on, there must be clear and convincing proof not only of the existence, but also of the relevant contents, of the writing, of the same order as the proof required to establish an entitlement to the rectification of a written instrument …'
>
> 78. The need for 'clear and convincing proof, not only of the existence of the document, but also of the relevant contents' was adopted by Young J (as his Honour then was) in *Mack v Lenton*,[8] also in relation to a dispute regarding the existence of a trust.
>
> 79. Other first instance cases in this Court have adopted the 'clear and convincing proof' test in relation to the contents of a missing trust deed: see, for example, *Barp Nominees Pty Ltd*.[9]"

Importantly, Henry J[10] referred to the decision of the Victorian Court of Appeal in the *Vanta* case (which is considered above), stating that the Court of Appeal had observed that the requirement for clear and convincing proof imposed too high a burden on a party endeavouring to prove the existence of a relevant fact, and that proof of the contents of a missing trust deed by secondary evidence was an ordinary factual question to be determined on the balance of probabilities applying s 140(1) of the *Evidence Act 1995* (NSW). Henry J said:

> "81. In my view, the reasoning of the Court of Appeal in *Vanta v Mantovani* is compelling. I do not consider that 'clear and convincing proof, not only of the existence of the document, but also of the relevant contents' of a missing trust deed must be established by the evidence in this case. In my view, the relevant questions are whether the Court is satisfied, on the balance of probabilities, that trust deeds were executed and contained the terms proposed and/or of the existence and terms of the trusts, which may be established by secondary evidence …
>
> 84. Applying these principles to the facts in this case, I am satisfied that the evidence supports the grant of judicial advice on the trustees' applications notwithstanding that there is no direct evidence from anyone that they have seen trust deeds for the DEK Unit Trust or the Family Trusts."

Nyasa

The third and most recent lost trust deed decision being considered in this article is the decision of Kunc J of the New South Wales Supreme Court in *In the Application of Nyasa No. 19 Pty Ltd*,[11] which was handed down on 30 May 2023.

The proceedings in the *Nyasa* case commenced as an application pursuant to s 63 of the *Trustee Act 1925* (NSW) for judicial advice that the plaintiff trustee, Nyasa No. 19 Pty Ltd (the trustee), was justified in managing and administering a discretionary trust estate known as the "R.J. Canfield Family Trust" (the trust) on particular terms in circumstances where, despite extensive searches, the original trust deed (or copies) settling the trust had not been able to be found.

The basis of the application was that, at the time the original trust deed was settled, at least one other trust, known as the Labode Trust, the terms of which were in evidence, was settled for the benefit of another member of the same family. There was evidence that the two trusts were established as part of a family plan that was being implemented at that time.

Kunc J was satisfied that the trustee had brought "clear and convincing proof" not only of the existence, but also of the contents, of the missing trust deed, namely, that they were relevantly in the same terms as the other trust deed which was in evidence.

Interestingly, during the course of the hearing, counsel for the trustee successfully sought to amend the summons to seek, in the alternative, relief under s 86A of the *Trustee Act 1925* (NSW) (court may approve arrangement) in an endeavour to bring about a binding and final outcome otherwise to substantially the same result as the judicial advice application. This involved the court approving an arrangement, including a variation of the original trust deed (in this case, by modernising some of its provisions), so as to produce a definitive form of the trust deed by reference to which all interested parties accepted that the trust would be administered into the future. Kunc J was satisfied that that could and should be done.

Kunc J said that the deed of settlement for the Labode Trust was in evidence. Its front page identified the solicitors who prepared it as Abbott Tout Creer & Wilkinson (Abbott Tout). The deed was clearly a standard form of family discretionary

trust, drawn by Abbott Tout in such a way that most of the variable or individual features could be included by changes to a schedule to the deed rather than by alteration to its substantive provisions.

Judicial advice application

Kunc J said that he accepted that the case was on all fours with the circumstances considered by Pembroke J in *Barp Nominees Pty Ltd*[12] in which two trust estates were established at the same time for two children. Pembroke J said:

> "2. The circumstances which give rise to this application are that the evidence clearly and unequivocally satisfies me that two trusts were established by Giovanni Barp and Gilda Barp. They had two children, Giselda Sandrin and Clelia Cisera. The trusts were established for the Sandrin family and the Cisera family. The trust deed for the Cisera trust remains in existence and there is no issue about it. The trust deed for the Sandrin trust has been lost. Once again, the evidence is clear about this.
>
> 3. The evidence explains that the two family trusts were set up at the same time and that they shared equally in certain property interests which I assume were originally acquired by Mr and Mrs Barp or entities owned or controlled by them. I am satisfied that the two trusts mirrored each other and that the only differences were as to the beneficiaries and the person who controls the trust."

Kunc J said that he adopted Pembroke J's consideration of the relevant authorities in *Barp Nominees* and his Honour's conclusion that a party in the position of the trustee had to satisfy the burden of demonstrating "clear and convincing proof not only of the existence but also of the relevant contents" of the missing trust deed.

His Honour said that the trust deed for the Labode Trust was in evidence and was dated 27 June 1979. On the basis of the evidence that had been adduced, Kunc J had no hesitation in concluding that, on the same day, the trust was settled for the benefit of Mrs Rosemary Canfield and her side of the family, and that the terms of that trust were in identical terms to those of the Labode Trust, save for the identity of the particular beneficiaries (the lost trust deed). In his Honour's view, that conclusion was almost irresistible, given the use of the same professional advisers and the "standard form" appearance of the Labode Trust deed. There was no evidence that would suggest there was anything particular about the circumstances of Mrs Rosemary Canfield's side of the family that would have necessitated any material difference between the terms of the Labode Trust and the lost trust deed.

There was in evidence a form of trust deed for the trust which was in identical terms to that of the Labode Trust, save for the requisite changes to reflect the fact that there was a different trustee and that Mrs Rosemary Canfield and her family were the objects of the trust. Kunc J found that that document reproduced the terms of the lost trust deed and that, subject to the outcome of the application under s 86A of the *Trustee Act 1925* (NSW) (see below), he would give advice that the trustee was justified in managing and administering the trust in accordance with that document.

The application under s 86A

Kunc J pointed out that, although it was unlikely, it remained the fact that the trustee would not be able to point to a document identified in the court's order and say that it was in fact the actual trust deed. This could, for example, lead to inconvenience when dealing with financial and similar institutions, which would probably require further explanations about what had occurred and the fact of the court's advice.

His Honour gave leave for the amendment of the summons which sought, as an alternative, relief under s 86A of the *Trustee Act 1925* (NSW). The broad effect of that section is that, if property is held in trust under any instrument creating the trust, the court may, if it thinks fit, by order approve any arrangement to:

- vary or revoke all or any of the trust; or
- enlarge the powers of the trustees for the purpose of managing or administering any of the property subject to the purpose of the trust.

It was submitted for the trustee that, if the court were satisfied to the requisite standard of "clear and convincing proof not only of the existence but also of the relevant contents"[13] of the missing trust deed, the court would be satisfied (assuming there was proof of property held by the trustee) for the purposes of s 86A(1) that there was property "held in trust under any instrument creating the trust". This, it was submitted, opened up the possibility of the court approving an "arrangement" that the trust be administered in accordance with amended terms of the trust deed as contemplated by s 86A(1). It would have the practical effect of the court identifying a definitive form of the trust deed by reference to which the trust would be administered into the future. The result would be a more certain, final and binding outcome as to the terms of the trust than the trustee acting in accordance with judicial advice.

Kunc J said that, as a practical matter for the administration of trusts, this would seem a highly desirable outcome. In this case, the document in relation to which approval of the arrangement was sought was in the terms of the lost trust deed (which the court had found were the terms of the trust), but then with the arrangement to be approved being its administration in accordance with the addition of terms familiar in more modern trust deeds giving greater flexibility of management and investment, together with provisions tailored to the present family circumstances in relation to what is to occur on vesting of the trust.

His Honour accepted that the court could give consent to the proposed arrangement on behalf of all relevant persons, being all of the discretionary objects, including any minor and any unborn general beneficiaries, and was satisfied that the carrying out of the order approving the arrangement would be for the benefit of the persons just referred to. Whether something is for the benefit of a particular person is a fact-sensitive exercise to be approached in a practical

way having regard to the beneficial nature of s 86A. His Honour was satisfied that the proposed variations to the terms of the lost trust deed were in themselves beneficial to all of the putative beneficiaries by giving the trustee more modern, flexible powers of investment and administration.

Approval of the arrangement would leave the discretionary beneficiaries and the trustee a definitive form of trust deed, being a more certain outcome than the trustee proceeding in accordance with judicial advice. It followed from this that carrying out an order which achieved that result is for the benefit of all of the relevant persons within the meaning of s 86B(1) of the *Trustee Act 1925* (NSW).

Kunc J said that the issues which led the plaintiff to make an alternative application under s 86A, in preference to seeking judicial advice, were real. There was a potential, genuine practical benefit to trustees in cases of lost trust deeds to be able to approach the court to obtain a generally binding and conclusive determination as to the terms of a trust deed which would govern the future administration of the trust.

Kunc J made no reference to the decision of the Victorian Court of Appeal in the *Vanta* case and it would seem likely that his Honour's attention may not have been directed to the decision in the *Vanta* case.

Only a copy

Cases have also arisen where the original trust deed has been lost but there is a copy of the deed in existence.

It may be noted that, in a recent decision (*Willmington Investments Pty Ltd v Sarich*[14]) handed down on 2 June 2023, Acting Master McDonald of the Western Australian Supreme Court held, on the evidence, that he was satisfied to the requisite standard of the balance of probabilities that there was clear and convincing evidence that the original trust deed had been lost and that a scanned copy was a copy of the original deed. It was therefore appropriate to give a direction under s 92 of the *Trustees Act 1962* (WA) to enable the trustee in the proceedings to treat the scanned copy in its possession as the original deed and as the trust's constituting document.

This approach appears to seek to roll the "clear and convincing" evidence test and the balance of probabilities test into some form of composite test. It is suggested that, following the decision of the Victorian Court of Appeal in the *Vanta* case, the better view is that the only test to be applied is the balance of probabilities test.

Observations

The decision of the Victorian Court of Appeal in the *Vanta* case is clearly a significant one and provides a sensible and practical approach that should be able to be applied in many lost deed cases. As seen, the approach was adopted in NSW in the *DEK Technologies* case but not in the *Nyasa* case.

Also, the decision of the NSW Supreme Court in the *Nyasa* case, in so far as it concerns the potential for the operation of s 86A of the *Trustee Act 1925* (NSW) to produce an up-to-date version of a lost trust deed, is, it is suggested, a welcome development.

At a general level, trustees and their advisers should take appropriate steps to ensure that a lost trust deed issue does not arise.

TaxCounsel Pty Ltd

References

1 [2023] VSCA 53.

2 *Mantovani v Vanta Pty Ltd (No. 2)* [2021] VSC 771.

3 [2023] VSCA 53 at [91].

4 The Court of Appeal also pointed out that the court has an inherent jurisdiction to intervene where the circumstances are exceptional or urgent in nature.

5 [2015] NSWSC 1243.

6 [2022] VSC 342.

7 [2023] NSWSC 544.

8 (1993) 32 NSWLR 259.

9 [2016] NSWSC 990 at [6], and *In the application of Brailey Holdings Pty Ltd ACN 001 190 441* [2018] NSWSC 1493 at [13].

10 [2023] NSWSC 544 at [80].

11 [2023] NSWSC 578.

12 [2016] NSWSC 990.

13 Kunc J made no reference to the decision of the Victorian Court of Appeal in the *Vanta* case or to the decision of Henry J in the *DEK Technologies* case.

14 [2023] WASC 191.

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Mid Market Focus

by Tom Peskett, CTA, HLB Mann Judd

Small business CGT: asset versus share sale

This article examines the differences when accessing the small business CGT concessions between an asset or a share sale, highlighting the differences to consider by tax practitioners.

Introduction

When a small business owner is seeking to sell their business, the availability of the small business capital gains tax (SBCGT) concessions under Subdiv 152-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) is a key consideration for vendors and can often result in a material after-tax difference to the cash received by the vendor.

The ATO has noted that the SBCGT concessions attract its attention when reviewing private group transactions.[1] Therefore, it is important that a proper review of the availability of the SBCGT concessions is undertaken prior to any transaction taking place.

This article explores some of the considerations that vendors and their advisers should make when accessing the SBCGT concessions on the disposal of a business in the context of an asset or a share sale, including the concessions that can be accessed as a result of satisfying the basic conditions of the SBCGT concessions.

Taxpayer

The first point to consider when evaluating the SBCGT concessions under either an asset or a share sale is who the ultimate taxpayer will be.

To access the concessions, an entity needs to dispose of a CGT asset.[2] In relation to an asset sale, this is typically a company, a trading trust or a partnership. However, under a share sale, the disposing entity could be an individual or a discretionary trust that holds the shares in the trading company.

When looking to satisfy the basic conditions, the taxpayer is the entity that is tested and this can have an impact on the ability to satisfy the conditions. Further, there are additional testing requirements under a share sale scenario which are not required under an asset sale arrangement.

As an example, consider an individual who carries on a business of farming within a company that they wholly own. The company turns over $1m annually. However, the land that the farming activities are carried out on is valued at $10m. The market value of the shares in the company are worth $11m, due to the business activities.

The individual is looking to sell the either the shares in the company or the land held by the company. Under a share sale, the individual would not satisfy the basic conditions, as they do not:

- carry on a business; or
- have net assets valued below $6m.

Should the farmer dispose of the land that is used for the farming activities for $10m, the company may possibly be able to access the SBCGT concessions as the company (being the taxpayer) carries on a business that has an annual turnover of less than $2m.

Active asset

Under the basic conditions, it is a requirement that the CGT asset disposed of is considered an "active asset".[3] Broadly, an active asset is an asset that is held by the taxpayer and is used in the carrying on of their business.[4]

Under an asset sale scenario, each asset is tested separately to determine if it is considered an active asset, potentially creating a transaction where the disposal of certain assets will access the SBCGT concessions and the other assets will not access the concessions. It should be noted that certain active asset classes, namely, trading stock[5] and depreciating assets,[6] have their own set of rules which deal with their disposal.

Where a share sale occurs, the assets held in the underlying company can represent a mix of active and non-active assets. Testing needs to be undertaken to determine if the shares are considered an active asset. For shares to be considered an active asset, 80% of the market value of the assets of the company need to be considered active.[7] A share will satisfy the active asset test provided it is considered active for half the time it has been owned, or at least 7½ years if the shares have been owned for more than 15 years.[8]

Additional eligibility requirements

Following the changes made in 2018,[9] there are several additional eligibility considerations that need to be met where an entity is disposing of shares or units in a trust[10] that do not need to be considered when disposing of an asset.

Broadly, to satisfy the basic conditions of eligibility,[11] under a share sale the following additional eligibility requirements need to be satisfied:[12]

1. the CGT asset would still be considered active under the modified active asset test;[13]
2. if the taxpayer does not satisfy the maximum net asset value (MNAV) test, they must be a CGT small business prior to the CGT event;
3. the company in which the shares are being disposed of, referred to as the "object entity", either needs to be:

a. considered a CGT small business entity; or

b. satisfy the MNAV test;

4. when testing both (a) and (b) above, any subsidiary entities in which the object entity has at least a 20% interest are considered connected, rather than the normal 40% threshold; and

5. the taxpayer must be a CGT concessions stakeholder[14] in the company in which the shares are held.

Distribution of funds

Ultimately, under any business sale scenario, a vendor is trying to maximise their after-tax funds received.

The choice of either an asset sale or a share sale can impact on the ability to distribute the funds to the business owners and how much they ultimately receive.

Consider a company that, under an asset sale, as part of the SBCGT concessions, makes a $3m gross capital gain from the disposal of its goodwill. The company has two CGT concession stakeholders that each have $500k available under their retirement cap.

After satisfying the SBCGT concessions, the company chooses to utilise the "small business 50% reduction"[15] and the "small business retirement exemption"[16] concessions, in that order. The following occurs:

- the gross capital gain is reduced to $1.5m under the active asset concessions;
- the two CGT concessions stakeholders each utilise their $500k ($1m total) retirement cap, further reducing the gain to $500k; and
- the company pays tax at a rate of 25% on the remaining $500k capital gain, resulting in a $125k liability.

The company now has $1,875,000 of after-tax proceeds to distribute, with only $125k of applicable franking credits to apply to the distribution.

The resulting distribution to the shareholders to receive the proceeds will need to be an unfranked or partially franked dividend.

While effective tax planning can mitigate against the tax burden of receiving an unfranked dividend under an asset sale, it can lead to some poor tax outcomes for the shareholders of the company.

If the company is no longer required, one option available following an asset sale is to enter a members' voluntary liquidation. The benefit in this scenario is that, typically, a liquidators' distribution will trigger CGT event C2,[17] rather than being treated as a dividend.[18] The CGT event will potentially allow access to the SBCGT concessions.

Compare the above asset sale to a share sale scenario where the shareholder is a family trust with no cost base in the shares and where they dispose of the shares for $3m, rather than the goodwill. The result would be as follows:

- the general 50% CGT discount is applied, reducing the capital gain on the shares to $1.5m;
- the 50% active asset concession is then applied, reducing the capital gain to $750k;
- the two CGT concessions stakeholders each utilise their $375k ($750k total) retirement cap by receiving payments from the trust, further reducing the gain to nil; and
- the trust can then distribute the remaining $2.25m of proceeds remaining tax-free to beneficiaries.

Final comments

Many considerations need to be made by vendors and practitioners before accessing the SBCGT concessions. While this article does not cover all of the requirements of the SBCGT concessions, it highlights the differences that arise from either an asset sale or a share sale.

Often, the ability to access the SBCGT concessions can be greatly impacted by the terms of the disposal and whether the sale is a disposal of business assets or shares in a company.

The best time to plan for the sale of a business, whether via an asset sale or a disposal of shares, is prior to any notice of intent or binding contract of sale being signed. Proper planning and analysis can confirm the ability to access the SBCGT concessions under either an asset sale or share sale for a vendor, which provides commercial flexibility when negotiating with prospective purchasers.

The concessions available under the SBCGT concessions can provide varying tax outcomes under either an asset sale or a share sale and need to be considered as part of holistic tax planning.

As the ATO has highlighted the SBCGT concessions as a key focus area of review, it is important to ensure that, if a taxpayer wishes to access the concessions, consideration is given to the ability to access the concessions under both an asset and a share sale.

Tom Peskett, CTA
Manager, Tax Consulting
HLB Mann Judd

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16 Subdiv 152-D ITAA97.

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The attributes of success

The dux of the Corporate Tax subject for Study Period 3 2022 shares his key learnings from the subject.

Tanim Islam
Group Head of Financial Control and ESG
AUB Group Limited, NSW

Could you tell us about your role and what led you there?

I started my career within audit, predominately at EY. I audited the asset management arm of a Big 4 bank, a number of insurers and insurance broking businesses. I had a variety of opportunities, including seconding to New York. I moved from EY around three and a half years ago to one of my clients, AUB, where I was tasked to transform the finance capability at the group and de-risk from key personnel. My responsibility in AUB covers all technical functions, including tax and finance governance and reporting into the board on key matters.

Why did you undertake Corporate Tax?

Given my background (coming from audit), my tax knowledge wasn't as strong relative to my technical accounting or modelling skills. I enrolled in the Graduate Diploma of Applied Tax Law (including an intention to obtain my CTA) to complement my on-the-job learning and accelerate becoming a trusted adviser in relation to tax matters. The Tax Institute provided the flexibility to enable me to complete the program while working full time. Equally, the subjects were tailored to cover areas directly relevant to my work and at an appropriate level to have a strong understanding of the issues at play.

What did you learn in the subject that has been most valuable?

The subject is directly relevant to my work, with AUB engaged in M&A activity on a monthly basis. Tax is an important part of any M&A transaction or corporate governance, and having been through the course, it's solidified my understanding and confidence in the area. This, in turn with other skill sets, continues to improve my standing within my organisation and as a professional within the finance sector.

The key topics are about corporate tax management, restructuring, international tax, liquidations, and finally corporate tax incentives. For larger groups, these tax concepts are regularly part of the discourse. The international tax and tax incentive modules were particularly enlightening. Given the nature of my work, many concepts were already familiar. However, the subject helped to solidify my understanding.

What is the secret to your success?

I was actually due to complete the subject last year but had to pull out as there was a major acquisition which resulted in me being in the UK for two months. Since then, I've continued to travel back and forth from the UK and worked long hours, with tax study taking up many of my hours over the weekend. I've tried to squeeze in hours while on the plane or listening to tax webinars while in the car etc. I also have a supportive wife, who can't wait for me to be done with my studies again.

What's next for you in terms of education?

I've just completed Advanced Trusts, and plan to do CTA3 Advisory later this year. CTA3 will be my final subject for the Diploma of Applied Tax course and the last hurdle to achieve the CTA. This will also end my plans for formal education in the near future, but I'm a strong believer in life-long learning so I'm sure I'll be doing another course sooner or later.

Any tips for other tax professionals undertaking study?

Studying (again) can be a major decision so just take your time to consider all of the costs, benefits and impacts on yourself (and others in your life) as a result of this decision. Setting realistic expectations with everyone, particularly your family, is key to keeping people happy. Personally, also consider the why. Having a clear goal and understanding of why you're doing this course maintains motivation and helps, when you're tired, to continue to remain disciplined.

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The proposed intangibles anti-avoidance rule

by Jason Barnes, CTA, Special Counsel, and Thomas Wu, Senior Associate, King & Wood Mallesons

In March 2023, Treasury released exposure draft legislation proposing to amend the *Income Tax Assessment Act 1997* (Cth) by introducing a new specific anti-avoidance rule focusing on deductions for payments relating to intangible assets connected with low corporate tax jurisdictions. The proposed rule aims to deny deductions where income from exploiting intangible assets is derived by an associate of a significant global entity in a low or no corporate tax jurisdiction. A literal interpretation of the draft legislative text may result in substantial uncertainty as to whether the rule applies to a taxpayer's specific circumstances – or, in some cases, it may result in unexpected and surprising results. This article seeks to demonstrate, through three hypothetical examples, that there remains scope for a more balanced construction of the proposed provision to be adopted by reference to the statutory context and overall purpose of the rule.

Introduction

On 31 March 2023, Treasury released an exposure draft of the Treasury Laws Amendment (Measures for Consultation) Bill 2023: Deductions for payments relating to intangible assets connected with low corporate tax jurisdictions (the exposure draft). The exposure draft proposes to introduce a new anti-avoidance provision in the form of s 26-110 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

The proposed rule aims to deter "significant global entities" (SGEs) from structuring their arrangements so that income from exploiting intangible assets is derived by an associate in a low or no corporate tax rate jurisdiction, while tax deductions for payments attributable to intangible assets made by the SGE to an associate are claimed in Australia. This rule would prevent the SGE from claiming tax deductions for such payments.

Substantial commentary has been published in relation to this proposed new provision. This commentary has identified a number of difficult issues, including:

- the wide scope of the provision;
- the uncertainty that is likely to arise in its practical application; and
- the interrelationship with existing tax integrity measures.[1]

As at the date of this article, there has been no administrative guidance from the ATO on these issues.

This article seeks to contribute to the discourse on the proposed provision by:

- identifying the key statutory elements that we expect are likely to be relevant to the issues set out above; and
- applying the accepted rules of statutory interpretation to the provision to predict how the courts might resolve them.

At the time of publication of this article, a Bill had not been introduced into parliament in respect of the proposed anti-avoidance provision. Therefore, the discussion in this article proceeds on the basis that any Bill introduced will be in substantially the same form as set out in the exposure draft.

Text, context and purpose

The modern approach to statutory interpretation focuses on the text of a provision, considered in its context. Context includes the Act as a whole, linguistic canons of construction, the purpose of the provision, and any relevant extrinsic materials.[2] Within the context of taxation law, the High Court has frequently emphasised the importance of properly construing the statutory text when undertaking this interpretive task:[3]

> "This Court has stated on many occasions that the task of statutory construction must begin with a consideration of the statutory text. So must the task of statutory construction end. The statutory text must be considered in its context. That context includes legislative history and extrinsic materials. Understanding context has utility if, and in so far as, it assists in fixing the meaning of the statutory text. Legislative history and extrinsic materials cannot displace the meaning of the statutory text. Nor is their examination an end in itself."

Text

Proposed s 26-110(2) ITAA97 sets out the key operative provision of the new intangibles anti-avoidance provision. It provides:

> "You cannot deduct under this Act, for an income year, an amount for a payment you make to your associate (the ***recipient***), to the extent that the payment is attributable to a right to exploit an intangible asset, if:
>
> (a) you are a significant global entity for the year; and
>
> (b) as a result of the arrangement under which you make the payment, or a related arrangement, you or an associate of yours:

(i) acquire the intangible asset; or

(ii) acquire a right to exploit the intangible asset; or

(iii) exploit the intangible asset; and

(c) the entering into of the arrangement under which you make the payment, or the related arrangement mentioned in paragraph (b), the acquisition of the intangible asset, the acquisition of the right to exploit the intangible asset or the exploitation of the intangible asset results in:

(i) the recipient; or

(ii) another associate of yours;

deriving income:

(iii) in a low corporate tax jurisdiction; and

(iv) directly or indirectly from exploiting the intangible asset, or from a related intangible asset."

The key statutory concepts adopted in s 26-110 are:

- "intangible assets": for the purposes of s 26-110, the expression extends beyond the ordinary meaning that is used in many provisions in the ITAA97,[4] adopting a bespoke definition than can be further prescribed by regulations;
- "exploit": this is defined broadly and, notably, extends beyond the development, enhancement, maintenance, protection and exploitation (DEMPE) and/or migration of intangible assets – a key concept underlying the ATO's PCG 2021/D4 *Intangibles Arrangements* – and further includes the permission to exploit an intangible asset; and
- "low corporate tax jurisdiction": prima facie this is a headline 15% corporate tax rate. However, foreign jurisdictions with a corporate tax rate of at least 15% may be in scope due to the operation of foreign taxation laws (eg where certain income is the subject of an exemption from, or concessionary rate of, tax).[5]

For present purposes, the authors note that the breadth of these three concepts permits a number of interpretations. Consequently, reliance on the text alone may result in substantial uncertainty as to whether the rules apply to a taxpayer's specific circumstances – or, in some cases, it may result in unexpected and surprising results (see discussion below).

Context and purpose

Statutory context and purpose can be ascertained from a range of sources. As a starting point, the explanatory material to the exposure draft (EM) seeks to identify the relevant policy "mischief" by reference to two situations:[6]

- first, if an SGE structures their business such that:
  - income from the exploitation of intangible assets is derived in a jurisdiction with either a low headline corporate income tax rate or a regime that preferentially taxes income from intellectual property (ie a preferential patent box regime); and
  - deductions for payments for the intangible assets are claimed in full in Australia; and
- second, if an SGE mischaracterises payments for intangible assets that are in substance, if not in legal form, made for the right or permission to exploit the intangible assets with the result that no, or insufficient, royalty withholding tax (RWHT) is paid. For example, this can occur if no value is assigned to the right to exploit an intangible asset under an arrangement, instead specifying that the consideration is paid for the provision of services from a related party.

These appear to be only two possible examples. The EM unambiguously states that s 26-110 has been intentionally drafted to be broad in scope and applicable to a wide range of circumstances. Specific statements and examples contained in the EM emphasise the intended breadth of the provisions. For example:

- the term "intangible asset" includes things that are not strictly recognised as property for common law purposes. For example, the types of assets that would fall within the operation of the section include access to customer databases and algorithms;[7] and
- the term "exploit" includes within its definition "[doing] *anything else* in respect of the intangible asset" (emphasis added).[8] While a literal interpretation of this text may indicate an unlimited scope, the EM provides some examples of what activities are included in this catch-all term (for example, copying software, accessing information contained on a database, and deploying an algorithm).

Other extrinsic materials should be considered, including the ATO's public advice and guidance, as well as any relevant commentary from international tax sources. In this respect:

- the ATO's ongoing works in relation to public advice and guidance concerning intangible assets, including:
  - TA 2018/2 *Mischaracterisation of activities or payments in connection with intangible assets*;
  - TA 2020/1 *Non-arm's length arrangements and schemes connected with the development, enhancement, maintenance, protection and exploitation of intangible assets*;
  - TR 2021/D4 *Income tax: royalties – character of receipts in respect of software*; and
  - PCG 2023/D2 *Intangibles arrangements* (released on 17 May 2023 and updating PCG 2021/D4 *Intangibles arrangements*).

  The above public advice and guidance may assist taxpayers in forming a view on the likely way in which the proposed anti-avoidance provision may be applied by the Commissioner. However, such guidance is not binding on the Commissioner in the context of the proposed provision; and

- the OECD's guidance and commentary, including:
  - its periodic reviews regarding preferential tax regimes that are focused on intellectual property (eg the OECD's *Forum on harmful tax practices*); and
  - the commentary to art 12 (royalties) of the OECD model tax convention.[9]

While these sources are not binding under domestic law, it is generally presumed that legislation is intended to be construed consistently with international law, so far as the legislative text permits.[10]

Judicial consideration of anti-avoidance provisions

Based on the history of existing anti-avoidance rules, should the proposed intangibles anti-avoidance provision be passed, it will likely be some time before any judicial decision is handed down on the application of s 26-110.[11] Notwithstanding this, some historical guidance on how s 26-110 might be interpreted can be ascertained from the judicial consideration of the original general anti-avoidance provision, that is, former s 260 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

Former s 260 was recognised as being so widely drafted that it could hypothetically have applied to almost any transaction. It relevantly provided that:

> "(1) Every contract, agreement, or arrangement made or entered into, orally or in writing, whether before or after the commencement of this Act, shall so far as it has or purports to have the purpose or effect of in any way, directly or indirectly:
>
> (a) altering the incidence of any income tax;
>
> (b) relieving any person from liability to pay any income tax or make any return;
>
> (c) defeating, evading, or avoiding any duty or liability imposed on any person by this Act; or
>
> (d) preventing the operation of this Act in any respect;
>
> be absolutely void, as against the Commissioner, or in regard to any proceeding under this Act, but without prejudice to such validity as it may have in any other respect or for any other purpose."

Over time, the courts adopted a narrower approach towards the interpretation of former s 260 based on its purpose as a general anti-avoidance provision, and eventually read it down to such an extent that it became almost ineffective. The interpretive canon frequently adopted at that time was that an Act should not be interpreted to impose tax, absent words which evinced with clear precision parliament's intention to impose a charge on the taxpayer.[12]

Partly as a result of the general ineffectiveness of former s 260, Pt IVA ITAA36 was subsequently introduced in 1981 and operated by reference to the now well-understood statutory concepts of "scheme", "tax benefit" and "purpose".[13]

In contrast to the general anti-avoidance rules, the proposed intangibles anti-avoidance provision operates by reference to fundamentally different statutory mechanics and, perhaps most notably, dispenses with any "purpose" requirement. Given the broad scope of s 26-110 and its potential to apply to almost any transaction involving an intangible asset, it is possible that courts may elect to read down one or more of its statutory elements to make its text workable, based on a purposive approach and depending very much on the factual matrix involved.

Case studies of interpretive issues

The following section sets out three examples of interpretive issues that could arise in practice when applying the proposed intangibles anti-avoidance provision based on a literal interpretation of its text. The discussion sets out hypothetical case studies that demonstrate how certain parts of s 26-110 might be read narrowly, with possible alternative constructions, to resolve such issues by reference to the provision's context and purpose. In this respect, the authors note the general canon of construction that a provision may be read down or narrowly in circumstances where a literal interpretation would result in absurd, unreasonable or impossible consequences.[14]

Low corporate tax jurisdiction

First, the term "low corporate tax jurisdiction" includes within its definition several statutory modifications to what might otherwise be considered to be a foreign country's corporate income tax rate. In particular, one of the modifications provides that:[15]

> "… if … there is no income tax on a particular amount of income – treat the rate of income tax on that amount as being nil."

Applied literally, this modification could result in a foreign country with a greater than 15% corporate income tax rate (eg a 30% rate), but that exempted a single item of income from tax (even if it was entirely unrelated to a possible exploitation of an intangible asset), being considered a low corporate tax jurisdiction. On one view, this result would be consistent with the broad scope of the provision and could be compelled by a literal interpretation of the text. On another view, this result goes beyond the mischief to which the provision is targeted (ie preventing income from the exploitation of intellectual property being preferentially taxed).

In line with this latter view, it is open to construe the text consistently with international law. For example, a literal application of the modifications to the definition of a low corporate tax jurisdiction could lead to inconsistencies with Pillar Two of the OECD Inclusive Framework on BEPS, being measures that Australia has committed to support. In particular, the Global Anti-Base Erosion Rules (GloBE Rules) under Pillar Two operate on the basis of *effective* tax rates and not *headline* tax rates.[16]

On this view, the modifications in s 960-258(2) ITAA97 could be interpreted to have regard to the effective rate of foreign taxes separate, and in preference, to the headline

tax rates – or any other specific exemptions that may arise under foreign law that apply to single items of income. Such an interpretation would similarly include those foreign taxes that are included as part of a qualified domestic minimum tax or are subject to an income inclusion rule. Such an interpretation also reconciles those statements in the EM that make clear that, when determining preferential patent box regimes, the rule is not designed to capture all patent-box regimes, but only those that provide tax concessions without sufficient economic substance (and, relatedly, that when determining such regimes, the Minister will have regard to relevant OECD guidance).

Indirect derivation of income

A second example arises in respect of the proposed anti-avoidance provision's application to income derived "indirectly from exploiting the intangible asset, or from a related intangible asset" and that "it does not matter … whether [the taxpayer] make[s] the payment to the recipient directly or through one or more entities". The EM makes clear that, where income is derived indirectly, strict tracing through the flow of funds is not required. It is not necessary to demonstrate that each payment in a series of payments funds the next payment or is made one after the other. Rather, it is sufficient if the payments merely exists between each entity.

An immediate issue that arises is what limit, if any, can be said to apply when analysing payment flows made indirectly through one or more interposed entities. By way of contrast, in the context of the imported hybrid mismatch rules, s 832-625(3) ITAA97 states in comparable terms:

> "For the purposes of determining whether a payment is made indirectly through one or more interposed entities to the offshore deducting entity:
>
> (a) it is sufficient if payments exist between each interposed entity, and it is not necessary to demonstrate that each payment in a series of payments funds the next payment, or is made after the previous payment; and
>
> (b) each payment made by an interposed entity must:
>
> (i) give rise to a foreign income tax deduction in a country that does not have foreign hybrid mismatch rules; and
>
> (ii) not give rise to a deduction/non-inclusion mismatch."

Notably absent from the proposed intangibles anti-avoidance provision are the limiting conditions set out in s 832-625(3)(b) of the imported hybrid mismatch rules. Absent this, it would appear that the payments that may be analysed under the intangibles anti-avoidance provision are potentially unlimited in scope.

One solution may be to interpret the term "indirectly" narrowly and to read in an implied limitation that, in substance, picks up a set of limiting conditions comparable to those under s 832-625(3)(b).[17] Such a construction would be based on the provision's context and reading the ITAA97 as a whole. For example, when determining whether income is indirectly derived in a low corporate tax jurisdiction from exploiting an intangible asset, or from a related intangible asset, it is unclear why the analysis should not stop once a payment is taxed in a jurisdiction that is *not* a low corporate tax jurisdiction having regard to the mischief to which the provision is targeted (ie preventing income from intellectual property being preferentially taxed). On this view, the scope of income being derived "indirectly" could be read down.

Royalty withholding tax and double taxation

A third issue that could arise in practice relates to circumstances where a payment may, in effect, become subject to "double" taxation due to the operation of Australian RWHT and the intangibles anti-avoidance provision. For example, if a royalty under Australian domestic tax law is paid by an Australian resident to an entity not resident in a treaty country *and* the proposed anti-avoidance provision applies in respect of that same payment, this could lead to an effective rate of 60% (being the 30% RWHT *plus* the effective 30% resulting from the denied deduction).

This seemingly surprising result may be prevented by construing the chapeaux of s 26-110(2), which states that a deduction will be denied "*to the extent that* the payment is *attributable* to a right to exploit an intangible asset", in a way that prevents a double taxation result. Currently, the EM recognises that this text contemplates some degree of apportionment. The text could, arguably, also be relied on to limit the scope of the anti-avoidance provision so that it would not apply to amounts that are already subject to RWHT. That is, on this interpretation, a deduction for a payment would not be denied under s 26-110 where Australian RWHT is imposed on the payment. This interpretation is also consistent with the surrounding context. That is, s 26-110 effects a *specific* anti-avoidance rule targeted towards certain factual matrices, as opposed to the *general* anti-avoidance provisions which, on one view, may be afforded more breadth in their application (including potentially prevailing over any international tax treaties in the event of any inconsistencies).

Such a construction also finds favour based on a purposive interpretation. The EM explicitly identifies one of the policy mischiefs to which the provision is targeted as being the mischaracterisation of a payment that typically results in RWHT not being paid.[18] More generally, the EM refers to arrangements that result in insufficient tax being paid.[19] Therefore, it would seem appropriate that the anti-avoidance provision should *not* apply in circumstances where a full amount of RWHT is payable on an amount that might otherwise be subject to s 26-110.

Conclusion

This article has sought to demonstrate how, by applying standard principles of statutory interpretation, there is capacity to adopt a construction of the proposed new intangibles anti-avoidance provision that strikes an appropriate balance between, on the one hand, placing the text in its proper context vis-à-vis the other provisions of

the ITAA97 and the ITAA36 and, on the other hand, giving the text sufficient work to do by reference to its broad language and overall purpose. The otherwise strict results that may arise based solely on a literal interpretation of its text are not a foregone conclusion, and it is not unreasonable to think that a trend to read down s 26-110 could emerge once the provision is judicially considered.

While the hypothetical case studies in this article have focused on three illustrative examples, it is expected that a significant number of other interpretive issues will arise if/once the provision is administered in practice. In such cases, it is possible that the courts may adopt a balanced construction by reference to the provision's text, context and purpose to resolve such interpretative issues.

Addendum

Shortly before publication of this article, Treasury released revised exposure draft legislation in respect of denying deductions for payments relating to intangible assets connected with low corporate tax jurisdictions. While the text of proposed s 26-110 has been amended in response to consultation and to better achieve the policy intent of the new intangibles anti-avoidance provision, most of the key statutory concepts discussed in this article continue to be broadly drafted. Therefore, most of the issues discussed in this article, and the application of standard principles of statutory interpretation to resolving them, remain relevant.

However:

- amendments have been made to clarify that it is the national headline corporate income tax rate that is relevant for the purposes of determining whether a jurisdiction is a "low corporate tax jurisdiction". For example, exemptions for particular industries and for particular types of income are disregarded when determining if the rate of corporate income tax under the laws of a foreign country is less than 15%;
- where a deduction would otherwise be denied because of the operation of s 26-110, but the taxpayer has withheld an amount from a royalty payment and remitted it to the Commissioner as required, and no other provision denies a deduction, amendments have been made to reduce the amount of the deduction denied to reflect the withholding tax paid; and
- amendments have been made to double the base penalty amount where the penalty results from an application of s 26-110. This is in addition to the doubling of the base penalty amount that already applies to a penalty of an SGE for making a false or misleading statement.

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Disclaimer

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1. See, for example: Corporate Tax Association, *Government election commitments: Multinational tax integrity and enhanced tax transparency*, submission to Treasury, 1 September 2022; CPA Australia, *Government election commitments: Multinational tax integrity and enhanced tax transparency*, submission to Treasury, 6 September 2022; Law Council of Australia, *Government election commitments: Multinational tax integrity and enhanced tax transparency*, submission to Treasury, 9 September 2022; The Tax Institute, *Government election commitments: Multinational tax integrity and enhanced tax transparency*, submission to Treasury, 5 September 2022.
2. P Herzfeld and T Prince, *Statutory interpretation principles*, Thomson Reuters, 2nd ed, 2021, p 14, para 1.140.
3. *FCT v Consolidated Media Holdings Ltd* [2012] HCA 55 at [39], quoting *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* [2009] HCA 41 at [47].
4. See, for example, ss 40-30, 152-40, 820-310 ITAA97.
5. S 960-258 ITAA97.
6. Paras 1.7–1.16 of the EM.
7. This is despite the fact that such concepts are not typically recognised as "property" within the ordinary legal sense of the term unless they constitute recognised intellectual property (eg copyright) or confidential information: see *Breen v Williams* (1996) 186 CLR 71 at 81, quoting *Phipps v Boardman* [1967] 2 AC 46 at [127] and [128].
8. S 26-110(9) ITAA97.
9. OECD, *Model Tax Convention on Income and on Capital*, July 2010.
10. *Firebird Global Master Fund II Ltd v Republic of Nauru* [2015] HCA 43 at [44] (French CJ and Kiefel J) and [134] (Gageler J); *Minister for Immigration and Ethnic Affairs v Teoh* (1995) 183 CLR 273 at 287; *Jumbunna Coal Mine NL v Victorian Coal Miners' Association* (1908) 6 CLR 309 at 363; *Thiel v FCT* [1990] HCA 37.
11. For example, it was approximately 13 years after the enactment of Pt IVA before the High Court of Australia handed down a decision relating to this provision.
12. Cf *Western Australian Trustee Executor & Agency Co Ltd v Commissioner of State Taxation (WA)* [1980] HCA 50 at [12]. The difficulties raised by the broad language of former s 260 was understood by the courts from early on and was the subject of continued decisions over time: see *DCT v Purcell* (1921) 29 CLR 464 at 466; *FCT v Newton* (1957) 96 CLR 577 at 646; *Cridland v FCT* (1977) 140 CLR 330 at 337; *Davis v FCT* (1989) 89 ATC 4377 at 4400.
13. Since this time, parliament has passed a number of amendments to Pt IVA. This has included the "new" Pt IVA in 2013 which conferred on the Commissioner the power to identify and determine a tax benefit either through the "annihilation approach" or the "reconstruction approach". More recently, parliament has introduced specifically tailored additions designed to counter certain tax avoidance behaviour undertaken by SGEs. For example, in 2015 and 2017, the multinational anti-avoidance law (MAAL) and the diverted profits tax (DPT) were introduced, both of which only require the "scheme" to be entered into or carried out for a principal purpose (as opposed to the dominant purpose) of obtaining a tax benefit. At the time of publication, the MAAL provision has not yet been considered by the courts, and in respect of the DPT provisions, judgment has been reserved in *Pepsi Co, Inc v FCT* (unreported, Federal Court, Victorian Registry, 20 March 2023 to 29 March 2023, VID74/2022). This is the first time the DPT will be considered judicially.
14. *FCT v Barton* (1957) 96 CLR 359 at 368; cf *Cooper Brookes (Wollongong) Pty Ltd v FCT* (1981) 147 CLR 297 at 305 (Gibbs CJ), 310 (Stephen J) and 320 (Mason and Wilson JJ).
15. S 960-258(2)(d) ITAA97.
16. See Chapter 5 of the GloBE Rules.
17. In respect of the limiting conditions set out in s 832-625(3)(b) ITAA97, the explanatory memorandum to the Bill that became the *Treasury Laws Amendment (Tax Integrity and Other Measures No. 2) Act 2018* notes (at paras 1.336 and 1.337) that, in principle, payments must be tax-neutral (that is, assessable and deductible), and that payments which are not deductible are not taken into consideration when determining a nexus between payments.
18. Para 1.13 of the EM.
19. Para 1.16 of the EM.

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In our sights at the start of a new financial year

by Robyn Jacobson, CTA, Senior Advocate, The Tax Institute

We've crossed the finish line for 2022–23 and you can't ask anyone for more time to get your clients ready for year end. Now is the time to turn your minds to the array of considerations specific to the start of the 2023–24 financial year, as well as some perennial issues that should not be overlooked. It's also timely to check in on the status of some of the key announced but unenacted measures, including those announced in the Federal Budget 2023–24. Some of these have start dates that are not imminent, but which entail substantial design ahead of their implementation. Amid the regular activity associated with making submissions and providing feedback on proposed measures and administrative approaches, The Tax Institute remains stalwartly committed to our over-arching objective of achieving holistic tax reform and a better tax system for all Australians.

General observations about the Federal Budget 2023–24

This year's Federal Budget 2023–24 (the Budget), delivered by the Treasurer, the Hon. Dr Jim Chalmers MP, on 9 May 2023, was a safe Budget in difficult economic times. While there were no significant surprises, the process of understanding the measures in greater detail begins.

Budget measures commonly lack the level of detail needed to better understand their impact on taxpayers and tax practitioners. The absence of details at this stage is not unusual but leaves us with questions regarding how the law will be designed to give effect to the policy intent and how the measures will be implemented by the ATO.

Although several of the Budget measures are before parliament, most remain as simply announced policy. Enacting law now is not vital when Budget measures are proposed to commence in a year or two, but it become more pressing when measures start much sooner, in some cases, from the date of announcement.

From a policy perspective, the Budget understandably sought to assist those most in need, the most vulnerable, those most impacted by the broader macroeconomic situation who are struggling with the cost-of-living challenges resulting from inflation levels not seen for more than three decades. It's good to see investment in Medicare and improved access to GP services, as well as support for the National Disability Insurance Scheme and the aged care sector.

The challenge in providing any relief to middle and higher income earners is that, although they may also be struggling with the cost of living and rising interest rates (which, to July, have risen 12 times in 15 months), it would be counter-intuitive to the government's objective of lowering the impacts of inflation. This underpinned the government's decision not to provide targeted relief to this sector.

Silence on the ABUMs

The list of announced but unenacted measures (ABUMs) was disappointingly not dealt with in the Budget, other than the government confirming that it will not proceed with any of the three patent box measures announced by the former government; this will not come as a surprise to many.

In terms of ABUMs, what is more important here is what was not said. We still need clarity on so many measures that have been announced over the years, but which remain unenacted. As a matter of system maintenance, the government really needs to address the systemic issue of this list becoming unmanageable and how to better manage it going forward. Greater certainty means a better tax system.

Business measures

The Budget contained a range of targeted measures designed to support small businesses. These should be considered in the context of previously announced measures or those which have ceased.

Ending of temporary full expensing measure

The temporary full expensing measure ended on 30 June 2023, so it is crucial that you and your clients get the timing right. To fully expense a depreciating asset under these sunset provisions,[1] the business needed to first use the asset, or install the asset ready for use, by the end of 30 June 2023. Merely signing a contract, paying a deposit or receiving an invoice by that elapsed date is not sufficient.

If the asset is not first used or installed ready for use until after 30 June 2023, the asset is subject to the rules that apply for the 2023–24 income year (see below).

The tax treatment of any depreciating assets that were sold during 2022–23 and which had previously been fully expensed should be considered. When a balancing adjustment event[2] happens to a depreciating asset in these circumstances, the proceeds received on sale are generally assessable.[3]

Increase in small business instant asset write-off threshold

The proposed temporary increase in the instant asset write-off (IAWO) threshold from $1,000 to $20,000 for small business entities (SBEs) is welcome, but a permanent measure to provide certainty is more desirable. The measure will allow SBEs (with an aggregated turnover of less than $10 million) that choose to apply the simplified depreciation rules in Subdiv 328-D ITAA97 to claim an immediate deduction where the depreciating asset is first used or installed ready for use from 1 July 2023 to 30 June 2024. The threshold is expected to revert to $1,000 (which has been temporarily suspended since 12 May 2015) from 1 July 2024, unless there is a further legislative change.

The yet-to-be-legislated measure will not permit the first $20,000 of the cost of any asset to be deducted, irrespective of its cost, with the balance of the cost added to a general small business pool. If the cost of the asset is $20,000 (GST-exclusive where the purchase is a creditable acquisition) or more, the cost of the asset must be pooled to the extent of its taxable purpose proportion.

Some practitioners may be rusty advising on general small business pools for their clients, as pools had to be fully expensed if the balance was less than $150,000 on 30 June 2020 and irrespective of the balance on 30 June 2021, 2022 and 2023. Practitioners need to reacquaint themselves with the pooling rules and the tax consequences of selling an asset that was fully expensed or pooled.

From 1 July 2023, if an SBE chooses to use the simplified depreciation rules and the cost of the asset is:

- less than $20,000 (GST-exclusive), the SBE will be able to fully deduct the cost under the IAWO (only for 12 months); or
- $20,000 or more, the asset needs to be allocated to a general small business pool and depreciated according to the pooling rules.[4]

An asset that is immediately deducted under the IAWO is not allocated to a pool.[5]

Larger business taxpayers (with an aggregated turnover of $10 million or more) need to calculate the asset's decline in value in accordance with the normal depreciation rules in Div 40 ITAA97, but may be able to utilise the ATO's administrative approach in PS LA 2003/8 for low-cost assets that cost up to $100 (GST-inclusive).

Loss carry back

This COVID-19-era temporary measure also ended on 30 June 2023. Any corporate tax entity with an aggregated turnover of less than $5 billion that made a tax loss in 2022–23 can choose to carry that loss back against taxed profits made from 2018–19 to 2021–22.[6] The refundable income tax offset is claimed by lodging the 2023 income tax return.

Small (to medium) business boosts

A third boost announced in the Budget, the small business energy incentive, will provide an additional 20% deduction (to a maximum of $20,000) to businesses with an aggregated turnover of less than $50 million for eligible capital expenditure that supports electrification and more efficient use of energy. This boost will be available only for eligible assets first used or installed, and eligible improvement costs incurred, between 1 July 2023 and 30 June 2024. The measure is yet to be legislated; however, exposure draft legislation was released on 4 July 2023 for comment until 18 July 2023.

Meanwhile, the enabling legislation giving effect to the two original boosts – the skills and training boost and the technology investment boost, announced on 29 March 2022 as part of the Federal Budget 2022–23 – has received royal assent.[7] Accordingly, eligible businesses can claim qualifying expenditure for the period from 7:30 pm AEDT on 29 March 2022 to 30 June 2023 in their 2023 income tax returns (for both boosts) and to 30 June 2024 in their 2024 income tax returns (for the skills and training boost only). An entity can claim the technology investment boost for expenditure on a depreciating asset only if the asset is first used, or installed ready for use, by 30 June 2023.

Measures that encourage businesses to invest in their operations and sustainability are commendable, but a failure to promptly legislate such measures creates uncertainty. This can result in businesses understandably holding off on making those important investment decisions, which undermines the purpose of the measures.

Professional practice profits

The ATO's guidance in PCG 2021/4 on its compliance approach to the allocation of profits or income from professional firms applies from 1 July 2022. Professional firms need to review their position and self-assess whether they satisfy the two gateways – whether there is a sound commercial rationale for the arrangement and whether it exhibits 'high-risk features' – to ascertain their risk zone. The risk zone indicates the likelihood of the ATO reviewing the arrangement, not the likelihood of the arrangement falling foul of the law.

The first year of the ATO's compliance approach has concluded, and firms needs to stay on top of this to minimise the risk of ATO compliance resources being allocated to review their arrangements.

Small business lodgment penalty amnesty

The small business lodgment penalty amnesty (the amnesty) was announced by the government as part of the Budget. Under the amnesty, clients can bring their overdue income tax returns, business activity statements (BAS) and FBT returns up to date. For lodgments eligible for the amnesty, failure to lodge penalties will be remitted without the need for small businesses or tax agents to apply.

To be eligible for the amnesty, your clients must:

- have had an aggregated turnover of less than $10 million at the time the original lodgment was due;
- have overdue income tax returns, BAS or FBT returns that were due between 1 December 2019 and 28 February 2022; and
- lodge those overdue forms as soon as possible between 1 June 2023 and 31 December 2023.

The ATO has advised that the amnesty does not apply to privately owned groups or individuals controlling over

$5 million of net wealth. The amnesty also does not extend to outstanding superannuation guarantee (SG) statements or taxable payments annual reports.

No other penalties or general interest charge (GIC) will be remitted as part of this amnesty. If your client has an existing debt, or accrues a new debt through their late lodgment, GIC may continue to apply to those debts. You or your client can ask for interest charges to be remitted where it is fair and reasonable, and the ATO will consider their circumstances on a case-by-case basis.

Division 7A and trust issues

Proposed reforms to Div 7A

The proposed legislative reforms to Div 7A of Pt III of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) still need more work and further consultation is necessary to ensure that any changes improve the operation of the provisions without resulting in undesirable or unfair outcomes. The reforms are proposed to apply to income years commencing on or after the date the enabling legislation receives royal assent.

Unpaid present entitlements and Div 7A

The Commissioner's revised position in TD 2022/11 on unpaid present entitlements (UPEs) and Div 7A was finalised mid-last year and applies from 1 July 2022. Broadly, all UPEs will be considered to be the provision of financial accommodation (and therefore a Div 7A loan) where the corporate beneficiary (a private company):

- consents to the trustee retaining an amount that it can demand immediate payment of and continuing to use it for trust purposes; and
- does not demand payment of the amount.

Where a UPE arises in an income year, based on TD 2022/11, the company will generally be taken to provide financial accommodation to the trust – and therefore make a Div 7A loan – sometime during the following income year.

The first minimum yearly repayment (MYR) for a loan that is taken to be made by a company that becomes entitled to a share of trust income is due by the end of the income year that follows the income year in which the loan is taken to be made, which generally follows the income year in which the UPE arose.

This means that, for UPEs arising during 2022–23 (typically, on 30 June 2023) that become a Div 7A loan based on TD 2022/11, the company will generally be taken to provide financial accommodation to the trust sometime during the 2023–24 income year. To avoid a deemed dividend arising for the 2023–24 income year, the UPE would need to be fully repaid or placed on complying loan terms before the company's lodgment day for the 2023–24 income year (typically, May 2025). If the loan is managed as a complying loan, the first MYR would be due by 30 June 2025.

Sub-trust arrangements previously endorsed by the Commissioner for managing UPEs may continue their legacy[8] and can be managed as a new complying loan on their maturity if the principal is not fully repaid by that time. However, new sub-trust arrangements consistent with those in the Commissioner's withdrawn guidance[9] are no longer effective for Div 7A purposes for UPEs arising on or after 1 July 2022.

Historical UPEs (those arising before 16 December 2009) continue to be grandfathered, meaning the corporate beneficiary is not taken to provide financial accommodation to the trustee where it does not demand payment of these UPEs.

Division 7A loan repayments

New loans made by a private company to a shareholder or an associate of a shareholder during 2022–23 should be identified, so that they can be either managed as a complying Div 7A loan or fully repaid before the company's lodgment day for the 2022–23 income year. If the loan is managed on complying loan terms, the first MYR is due by 30 June 2024 and interest is charged back to 1 July 2023. If a repayment is made during 2023–24, interest for the 2023–24 income year needs to be calculated considering the timing of the repayment. If the loan is fully repaid on 1 July 2023, no interest is required to be charged.

For complying loans made in 2021–22 or earlier, the MYR was due by 30 June 2023. Any shortfall in the MYR is a deemed dividend taken to be paid at the end of the 2022–23 income year.[10]

If using a journal entry to set-off a dividend payment against the shareholder's obligation to make the MYR, ensure that:

- the dividend was properly declared by 30 June 2023, as evidenced by a directors' resolution, otherwise the purported dividend payment may not conform with the 'principal of mutual set-off'[11] – if the dividend is not an effective and valid payment, the shareholder will not have made the requisite MYR and there will be a shortfall for Div 7A purposes, resulting in a deemed dividend;
- the company issues the shareholder with a distribution statement by 31 October 2023;[12]
- all related documentation is correctly prepared and filed;
- the later journal entry correctly reflects these transactions; and
- this approach is used only for loans made to shareholders in respect of which an MYR is due, and not associates of shareholders (as a dividend cannot be declared in favour of a shareholder's associate).

Section 100A

Section 100A ITAA36 occupied the time and minds of many tax practitioners during the course of 2022 as they came to terms with the Commissioner's draft, then final, guidance on trust reimbursement agreements. If you've not yet familiarised yourself with the ATO's public advice and guidance, this should be a priority as the ATO will be using the risk assessment framework in PCG 2022/2 to determine how to allocate its compliance resources. Arrangements that are characterised as 'high risk' (red zone) or outside the green zone are more likely to attract the ATO's attention.

We wait for updated ATO guidance following the Full Federal Court appeals in:

- *FCT v Guardian AIT Pty Ltd ATF Australian Investment Trust*[13] – the court decided that s 100A ITAA36 did not apply to the arrangement in question for the relevant years but Pt IVA ITAA36 applied to the arrangement for the 2012–13 income year; and
- *B&F Investments Pty Ltd as trustee for the Illuka Park Trust v FCT*[14] (the appeal from *BBlood Enterprises Pty Ltd v FCT*[15]) – the court dismissed the taxpayer's appeal on s 100A ITAA36 and necessarily upheld the appeal by the related corporate beneficiary, BBlood Enterprises Pty Ltd.

The ATO has released a draft decision impact statement on the *Guardian* decision which advises that the ATO intends to make minor updates to TR 2022/4 to reflect aspects of the court's decision, and update PS LA 2005/24 to reflect the views expressed by the court with respect to the application of the provisions in Pt IVA ITAA36 following the 2013 amendments.

In the meantime, the unlimited period of review that applies to s 100A means that trustees must retain sufficient records to explain transactions that have happened. Likely to be the most challenging aspect for practitioners and trustees is the vague scope of the exemption for 'ordinary family or commercial dealing'. Guidance on the term exists, but further judicial interpretation is needed to lessen the uncertainty.

Finally, on trust distributions, the importance of reading the deed and ensuring that all distributions comply with the deed and are made to valid beneficiaries cannot be understated. The ATO has released a checklist to assist trustees in getting their resolutions right. This includes checking that beneficiaries became presently entitled for the 2022–23 income year by 30 June 2023. If no beneficiary was presently entitled to trust income as at 30 June 2023, the trustee will be assessed on the trust's net (taxable) income.

Other business issues

GST adjustments

As the tax period for the month of June or the June quarter has now ended, don't forget about any increasing or decreasing adjustments that may need to be made under Div 129 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GST Act). Adjustments are required to input tax credits under Div 129 where there has been a change in the extent of creditable purpose of an acquisition, subject to a cap on the number of adjustment periods which is determined by the amount and type of the acquisition. An adjustment under Div 129 is only ever made in a June business activity statement.[16] More information can be found in GSTR 2009/4, particularly as the provisions apply to new residential premises.

PAYG and GST instalments

The reduction in the uplift factor to work out the amount of GST and PAYG instalments for the 2023–24 income year from (what would have been) 12% to 6% is contained in Sch 4 to the *Treasury Laws Amendment (2023 Measures No. 2) Act 2023*. The reduced GDP-adjusted rate applies to instalments for the 2023–24 income year and that become due on or after 24 June 2023.

Franked distributions funded by capital raisings

The previous government announced in the Mid-Year Economic and Fiscal Outlook 2016–17[17] that it would prevent the distribution of franking credits where a distribution to shareholders is funded by particular capital raising activities. This measure would address the issues raised by the ATO in TA 2015/2.

Schedule 5 to the Treasury Laws Amendment (2023 Measures No. 1) Bill 2023 (the Bill) contains proposed amendments to give effect to this measure. The Bill originally proposed a start date of 19 December 2016. However, the government announced as part of the Federal Budget 2023–24 that it would delay the start date to 15 September 2022. This revision has been reflected in Sch 5 to the Bill.

Since then, the Senate Economics Legislation Committee tabled its report into Sch 5 to the Bill. The Committee recommended that the government consider opportunities to clarify Sch 5 to the Bill to ensure that it appropriately targets the identified behaviour and addresses feedback provided to the Committee. The Tax Institute made a submission on the exposure draft legislation and provided feedback during a Committee hearing.

In Senate Estimates held from 30 May 2023 to 1 June 2023, Treasury conceded that the exposure draft Bill was cast too wide, and the Bill before parliament is narrower. However, hopefully, the legislative amendments are further pared back to ensure that their effect is limited to the extent of the mischief originally identified in TA 2015/2.

Residency rules

Any progress on the proposed legislative amendments to the corporate residency rules and individual residency rules remains elusive, but the ATO has recently finalised its new ruling on the residency tests for individuals, TR 2023/1. The ruling consolidates and replaces a number of previously issued rulings and updates the ATO's views in those rulings to take into account developments in case law.

The proposed corporate residency reforms, announced on 6 October 2020 as part of the Federal Budget 2020–21, were welcomed by industry at the time, yet they have not progressed.

Separately, the proposed individual residency reforms, announced on 11 May 2021 as part of the Federal Budget 2021–22 in response to the Board of Taxation's recommendations, require further consultation to address some undesirable or unfair outcomes.

Digital games tax offset

The digital games tax offset is a refundable income tax offset that is available to companies that develop digital games in Australia. The offset is 30% of a company's total

qualifying Australian development expenditure incurred on developing new or existing digital games, capped at $20 million (equivalent to incurring $66.7 million of qualifying Australian development expenditure) per income year.

The measure applies to qualifying Australian development expenditure incurred in relation to eligible game development from 1 July 2022. The enabling Bill has received royal assent.[18]

Electric car discount

Since 1 July 2022, employers are not liable for FBT on eligible electric cars and associated car expenses (including registration, insurance, repairs and maintenance, and fuel).

Importantly:

- the provision of a home charging station by an employer to an employee is not an eligible exempt car expense for this purpose and remains a taxable fringe benefit;
- while the private use of an eligible electric car is exempt from FBT, the value of the benefit must be included when working out whether an employee has a reportable fringe benefits amount.

Superannuation

Making contributions

Employers have until 28 July 2023 to ensure that they do not have an SG shortfall for the June 2023 quarter for their employees. This requires the superannuation fund to actually receive the payment by the due date, except in the case of employers who use the ATO's Small Business Superannuation Clearing House (SBSCH) – it is sufficient for SG purposes that the SBSCH receives the payment by 28 July.

However, for income tax purposes, employers can claim a deduction in 2022–23 for contributions they make for their employees only if they were made by 30 June 2023.[19] This includes payments made using the SBSCH. The ATO's view in para 12 of TR 2010/1 is that "the contribution will be made when the funds are received by the superannuation provider".

If the fund did not receive the payment by 30 June 2023, the contribution is deductible to the employer in the 2023–24 income year (instead of 2022–23). It is particularly important when using external payroll services and commercial clearing houses to check whether the contribution was received by the fund by the end of 30 June and not merely paid (and still sitting within the banking system such that the fund did not receive the payment until July).

The rate of SG increased again on 1 July 2023 to 11% (from 10.5%). Importantly, the higher rate applies based on the date of payment of the salary or wages, not when the work is done.

Remember, treating a late payment (by even one day) as non-deductible for income tax purposes does not absolve the employer from being liable for the SG charge and the obligation to lodge an SG statement with the ATO. There are some limited circumstances, set out in PS LA 2007/1 (GA), where ATO officers may decide, for administrative reasons, to not raise an assessment of SG charge against an employer or to allow an employer's objection to an SG charge assessment.

Changes to the work test from 1 July 2022 have removed the need for individuals aged 67–74 years to pass the work test when making non-concessional contributions and salary sacrifice contributions, but the work test still applies when making personal deductible contributions.[20]

Transfer balance cap and income streams

The increase in the transfer balance cap (TBC) to $1.9 million from 1 July 2023 will treat more earnings on superannuation balances in retirement phase as tax-free. However, calculating the proportionate indexation of an individual's personal TBC will become even more complex as the general TBC continues to increase.

The required percentage for making minimum annual payments to income stream recipients returned to normal levels on 1 July 2023, following a halving of the rate due to the pandemic from 2019–20 to 2022–23.

Failure to make the minimum payment:

- causes the income stream to cease for tax purposes;
- treats the fund as not having paid an income stream from the start of the income year;
- treats any payments made as lump sum payments; and
- prevents the fund from treating any income as exempt current pension income, so the fund loses its tax exemption on the earnings for that year.

Payday super

One of the most significant proposed policy changes announced in the Budget will require employers to pay SG contributions on the same day they pay salary and wages. Since 1 July 1992, employers have been imposed with a penalty, the SG charge, if they have an SG shortfall for an employee for a quarter (which can arise for a variety of reasons, including not paying SG contributions on at least a quarterly basis).

This change will require substantial consultation with industry stakeholders, including the profession, representatives of APRA-regulated funds, as well as the SMSF sector, digital service providers, payroll providers, commercial clearing houses, and the ATO. Every moment between now and the delayed start date of 1 July 2026 will be needed to formulate and draft well-designed provisions and processes to give effect to this measure. The government has flagged that consultation and consequential changes to the design of the SG charge will occur.

Consequential reform of the SG charge is essential, as it would be unreasonable, if not unworkable, for an employer with weekly payroll to face 12 lots of SG charges and Pt 7 penalties for the quarter if they pay their SG contributions one day late each week. More broadly, this proposed measure provides a golden opportunity to redesign the SG charge to make it more equitable for employers who

are merely late in paying but retain its punitive nature for employers who fail entirely to meet their obligations.

It will be interesting to see how many employers with weekly or fortnightly payroll may consider switching to monthly payroll; however, they will need to consider any legal impediments imposed by industrial law, awards or agreements in doing so. Over the years, some employers have suggested that the introduction of 'payday super' would be a sensible approach to dealing with their employer obligations, while others have baulked at the thought as they've pondered the impact on their cash flow. Irrespective of an employer's view on this, payday super is coming.

Some initial questions on this measure include:

- How will be the SG charge be redesigned to deal with more frequent payments, as often as weekly?
- What will the penalty be if an employer is just one day late?
- How will the timeframes be practically condensed when using external payroll providers and clearing houses, where the timing of the receipt of the contribution by the fund is usually beyond the control of the employer once the payment leaves their bank account?
- How will it work when the employer pays some of or all the salary and wages in advance?
- What changes will be made to reporting obligations?

Non-arm's length income rules

Following extensive consultation over many years, the government has announced that it will amend the non-arm's length income (NALI) provisions to ensure they operate as intended. This includes limiting the income that is taxable as NALI to double the amount of a general expense, ensuring fund income that is taxable as NALI excludes contributions and exempting large funds from the NALI provisions for both general and specific expenses. Exposure draft legislation that will give effect to this measure was released for comment on 19 June 2023. The amendments are proposed to commence on the start of the first quarter after the day the enabling legislation receives royal assent.

It is pleasing that consultation has resulted in change, but it is uncertain whether the broader underlying concerns raised by the professional associations, including The Tax Institute, will actually be addressed.

Individuals

The ATO has advised that this Tax Time, it will focus on the accuracy of claims for work-related expenses, rental properties and CGT liabilities.

The following checklist may assist:

- the rate per kilometre for claiming car expenses is 78 cents per kilometre for 2022–23. The rate for 2023–24 has been set at 85 cents per kilometre.[21] The ATO's draft administrative approach for electric vehicles in PCG 2023/D1 indicates 4.2 cents per kilometre will be allowed for these vehicles using the logbook method and for FBT purposes for 2022–23. You cannot claim both 78 cents per kilometre plus another 4.2 cents per kilometre;
- refresh your understanding of the limited circumstances in which claims for conventional clothing are allowable, such as occupation-specific clothing, protective clothing, compulsory work uniforms, and registered non-compulsory work uniforms (plus the cleaning of such clothing);
- the $250 non-deductible threshold for claiming self-education expenses was removed from 1 July 2022;
- the fixed rate method (52 cents per hour) and the temporary shortcut method (80 cents per hour) for claiming working from home (WFH) expenses both ended on 30 June 2022. From 1 July 2022, the ATO's administrative approach in PCG 2023/1 advises that the ATO will not apply compliance resources if taxpayers claim WFH expenses at the rate of 67 cents per hour. From 1 March 2023 to 30 June 2023 (and later income years), taxpayers must keep a record of the total number of actual hours WFH, while from 1 July 2022 to 28 February 2023 only, the ATO will accept a representative record of the total number of hours WFH;
- the ATO's occupation and industry specific guides are a useful reminder to your clients about what they can and cannot claim;
- ensure clients declare all rental income received, and do not declare net rent (instead of gross rent) then claim expenses (such as property management fees) again against the net rent;
- ensure interest expenses are correctly apportioned where the property is used for private use, the property is not genuinely available for rent, or there is mixed use of borrowed funds;
- correctly apportion borrowing expenses over the five-year period (but not on a straight-line basis), or over the term of the loan if less;
- correctly characterise building expenditure as a deductible repair, a non-deductible initial repair, or capital works;
- the limitation on travel expenses and second-hand depreciable assets relating to residential rental properties applies from 1 July 2017; and
- ensure all capital gains on cryptocurrency, shares and properties (as well as other CGT assets) are correctly calculated and reported. Record-keeping is essential to this.

Robyn Jacobson, CTA
Senior Advocate
The Tax Institute

References

1 Sections 328-180 and 328-181 of the *Income Tax (Transitional Provisions) Act 1997* (Cth) (IT(TP)A) for small business entities that choose to apply the simplified depreciation rules in Subdiv 328-E of the *Income Tax Assessment Act 1997* (Cth) (ITAA97), and Subdiv 40-BB IT(TP)A for other eligible entities.

2 S 40-295 ITAA97.

3 Where a small business entity has claimed the cost of an asset using the instant asset write-off under s 328-180 ITAA97 (including as modified by ss 328-180 and 328-181 IT(TP)A), the taxable purpose proportion of the asset's termination value is included in the entity's assessable income under s 328-215(4) ITAA97.

Other entities that claimed an immediate deduction under s 40-82 ITAA97 or the temporary full expensing measure in Subdiv 40-BB IT(TP)A need to calculate a balancing adjustment amount under s 40-285 ITAA97. Where an asset is fully expensed under these provisions, the asset's adjustable value is reduced to nil under s 40-85(1) ITAA97. Once the balancing adjustment amount is calculated, this results in the asset's termination value being included in the entity's assessable income under s 40-285(1) ITAA97.

4 Ss 328-185 to 328-210 ITAA97.

5 S 328-185(1) ITAA97.

6 Div 160 ITAA97.

7 See Sch 4 and Sch 5 to the *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*.

8 See PCG 2017/13 which continues to apply to legacy sub-trust arrangements.

9 See TR 2010/3W and PS LA 2010/4W.

10 S 109E(1) ITAA36.

11 See MT 2050 for ATO guidance on making payments by journal entry in the context of reducing the taxable value of a fringe benefit, but the principle applies equally to Div 7A. The principle is that, for a payment by journal entry to be effective, there must be two mutual obligations. In the context of Div 7A, the obligation of the shareholder to the company to make the MYR is set-off against the company's obligation to make a payment of a dividend to the shareholder. There can only be an effective set-off if the obligation by the company to pay the dividend exists by the time the MYR is due for payment.

12 S 202-75(3) ITAA97.

13 [2023] FCAFC 3.

14 [2023] FCAFC 89.

15 [2022] FCA 1112.

16 S 129-20(1) GST Act.

17 At p 24.

18 Sch 1 to the *Treasury Laws Amendment (2022 Measures No. 4) Act 2023*.

19 S 290-60(3) ITAA97.

20 S 290-165(1A) ITAA97.

21 See the *Income Tax Assessment (Cents per Kilometre Deduction Rate for Car Expenses) Determination 2023* which was registered on 13 June 2023.

Due diligence, tax structuring done … what next?

by Sally Pace, Senior Manager, and
Chris Dunne, CTA, Partner, Grant Thornton

This article explores the basics of the enterprise to equity value bridge, and how this is typically used to structure an offer to purchase the equity of a company. It will then consider how the findings identified during the due diligence process are used to shape equity value, and how these adjustments are used to balance the interests of the vendor and purchaser, with a particular focus on the adjustments required at completion of a transaction. It provides an overview of the two mechanisms available to balance these interests, being the traditional completion accounts mechanism and the locked box approach. It will also consider the typical provisions that are included in a sale and purchase agreement in relation to financial accounting and tax issues.

So, I want to buy this business …

As a trusted adviser, this is probably a statement you are used to hearing from your clients. But as an experienced professional, you are probably aware that this statement does not always have a happy ending.

This article is based on the premise that your client has acquired said business after completing a thorough due diligence exercise, agreed on an enterprise value based on a multiple of maintainable earnings, and is now at the point of negotiating a sale and purchase agreement (SPA). Although this may be an over-optimistic assumption, it has been made in the interests of answering the question "what next?", and helping you to ensure that your client's interests are protected.

Although we cannot always prevent our clients from making over-ambitious acquisitions, we can do our best to make sure that an SPA is drafted to properly assign value and protect their interests.

This article will:

- explore how an enterprise value is formed and how this is driven by maintainable earnings. It will then briefly consider the impact of COVID-19 on maintainable earnings;
- explain how the enterprise to equity bridge is used to ensure that a buyer is provided with the working capital required to run the business, and the seller is provided with any net cash that they have generated;
- consider the mechanisms that can be used in an SPA to correctly accrue value between the buyer and the seller, regardless of the timing of the transaction or the level of funding required or existing in a business; and
- consider typical provisions included in an SPA in relation to financial accounting and tax issues.

Enterprise value

A potential purchaser will typically make an offer based on the "enterprise value". The most common pricing mechanism to arrive at this amount for mergers and acquisitions (M&A) transactions is the capitalisation of future maintainable earnings methodology. This is a calculation that brings together two assumptions:

1. a pricing multiple, which is usually reflective of market sentiment in relation to a particular sector and size of business, similar to how real estate may be priced on a per square metre basis. For example, a large business in the utilities sector may have a multiple of 12.1x, whereas a similar sized business in the IT space may only have a multiple of 7.9x;[1] and
2. a target's maintainable earnings, which are typically represented through normalised earnings before interest, taxes, depreciation and amortisation (EBITDA).

As an example, an offer might be structured as:

> "$10m, based on $2m normalised EBITDA for the last financial year and a 5 times multiple."

In this example, the $10m will be referred to as the enterprise value.

In the world of financial due diligence, a key focus is on maintainable earnings as this is the portion of the equation that we are able to interrogate and potentially question to best represent the interests of our client.

How has COVID-19 impacted maintainable earnings?

How COVID-19 has impacted maintainable earnings is a highly subjective area and is dependent on the sector and whether you are representing the buyer or the seller. A majority of businesses in Australia received the benefit of the cash flow boost and JobKeeper, which we would typically make an adjustment to reverse given its non-recurring nature. However, this adjustment alone is very simplistic.

When considering maintainable earnings or adjusted EBITDA, an assessment is being made of what earnings the business can reliably generate, without any one-off

aberrations, in a typical business-as-usual environment. The impacts of COVID-19 have challenged this formulation, as the circumstances have meant that, in many industries:

- companies have not operated in a typical business-as-usual environment for several years; and/or
- the change in the economic environment may mean that the pre-COVID-19 "business-as-usual" is no longer applicable.

COVID-19 has impacted different sectors in different ways. For instance, some online retailers experienced a temporary boom in sales that, if representing a purchaser, we would look to make a downward adjustment for. On the other hand, a seller in the hospitality sector may argue an upwards adjustment for a "temporary" loss of earnings over the period.

In a nutshell, when we are assessing maintainable earnings (often proxied by adjusted EBITDA), we will take the impacts of COVID-19 into consideration, and this may take on a wider dimension than just government stimulus.

It is worthwhile noting that COVID-19 has also had an impact on business working capital and this is something that also needs to be considered in the preparation of an SPA. This is explored further below.

Equity value adjustments

Once an assessment has been made in relation to the enterprise value, the next item to consider is the methodology to be used at completion to ensure an equitable split of the balance sheet between the two parties. This is broadly split into two considerations:

1. **net debt/cash:** a typical SPA is drafted on the basis that the transaction will be on a cash-free and debt-free basis. This is done to ensure that:
   a. the seller can benefit from surplus cash that has accumulated under their ownership; and
   b. the buyer is not responsible for debts incurred pre-purchase; and
2. **working capital:** for maintainable earnings to represent a fair proxy of cash flows in the formulation of the enterprise value using the capitalisation of future maintainable earnings valuation approach, the business needs to start with a "normal" amount of working capital. For instance, if a supermarket generated annual EBITDA of $2m (and this was used as the basis for the enterprise value), what level of starting inventory would be required to generate this without the need for additional funding? If the supermarket needed to be totally restocked, it would need to quickly fund a large operational cash outflow to restock or be very unlikely to achieve this EBITDA due to starting from a high cost base.

To reflect these two considerations, an offer is typically structured as set out in Table 1. This is usually known as the "enterprise to equity value bridge".

Table 1. Example of enterprise to equity value bridge

	$'000	$'000
Enterprise value (eg $2m EBITDA x 2)		4,000
Net cash/(debt)		(425)
Actual working capital	25	
Less target/normal working capital	(500)	
Difference = working capital adjustment		(475)
Equity value		**3,100**

Working capital targets

To ensure that a business has adequate working capital to generate maintainable earnings, it is typically specified in the SPA that the business will be acquired with a "normal level of working capital".

For this purpose, a target level of working capital is typically calculated when a deal is being negotiated, and an adjustment is then made to ensure that the buyer is compensated if the working capital provided at the point of the transfer of economic risk is not adequate. Alternatively, a seller may be compensated if they hand over more than the normal level of working capital (for instance, if the company receives, and pays for, a large inventory order just before transfer of economic risk).

When assessing how the target working capital has been calculated and defined, it is crucial to consider which party has prepared the calculations/document. Remember, it is in the seller's best interests to calculate the lowest working capital target possible, as this will create a reduced obligation at point of transfer.

When calculating the normal level of working capital, the following three questions need to be considered.

What is "working capital"?

There is no definitive legal or accounting definition of "working capital", and what is regarded as working capital is strongly dependent on the nature of the business in question. However, a typical starting point is current operating assets (excluding cash) less current operating liabilities. This will include inventory, trade debtors, net GST payable, trade creditors, prepayments, accruals and payroll liabilities.

Because of the lack of strict definition, it is critical that both parties agree on what working capital is and ensure that this is defined in the SPA. For extra clarity, it is good practice to also include a mapping of accounts (by code) in the SPA, using a completion accounts approach, that considers the treatment of each individual account.

Any balance sheet items that are debt or cash-like in nature should be excluded from the definition to avoid double counting.

Some more contentious items include the treatment of deferred revenue, vested long service leave or annual leave balances in excess of 20 days, all of which have

debt-like elements. We typically assess whether the purchaser will have to take over an obligation from which they will receive no benefit, in which case, an item would be considered debt-like. For example, if a staff member has worked continuously without taking leave for many years, the purchaser will most likely suffer from a large annual leave cash outflow/employee absence at some point in the future (from which they will receive no benefit).

What abnormal items are contained in working capital?

Once working capital items have been defined, they should be reviewed carefully over the historical period to ensure that the "normal" position is being properly considered in line with typical accounting pronouncements. For instance:

- debtors well in excess of normal trading terms (eg 90 days) where they are considered as "one-off" may be regarded as uncollectable. Thus, they could arguably be normalised. This also applies to surplus inventory and stretched trade creditors (potentially debt-like, given a free-form of funding);
- improperly calculated employee liabilities; and
- incorrect use of accrual accounting.

Where an adjustment is made to historical working capital in order to set a target, and this involves a change in accounting policy, it is critical that the accounting policy is specified in the SPA. For instance, where an adjustment is made to provide for debtors that are in excess of 90 days, a definition should be included in the SPA to the effect of:

> "A provision for doubtful receivables is to be established where there is evidence that the receivable may not be collectable in full as well as [x]% for debtors over [x] days."

This ensures that, when debtors are being assessed at completion, there is no dispute as to what should be provisioned. Additionally, completion accounts must be prepared using the same accounting principles that were applied when the target was set. Therefore, this definition and consistency are important.

Sometimes adjustments may be made to working capital to reflect a more "normal" go-forward position. For instance, some companies may have stockpiled inventory over the last 12-month period in relation to supply chain constraints, but argue that this is not reflective of their "normal" trading position, and believe that a lower working capital target should be set.

What period of time should be used?

Typically, the average level of working capital over the last 12-month period would be calculated in order to cover the full seasonality cycle. However, this period may be shorter if a business is in a high-growth phase, or if we are trying to avoid an unusual economic event (such as COVID-19) that impacted working capital.

Adjustment for net cash/debt

Paraphrasing the above, an adjustment needs to be made to ensure that the vendor benefits from any cash generated by the business, and that the seller is not responsible for any debts incurred pre-purchase.

The key questions here are set out below.

What balance sheet items are regarded as cash?

The obvious starting position is cash contained in bank accounts and sitting in petty cash. However, an assessment then needs to whether this cash can easily be extracted without harming the business. If cash is "trapped", it may be classed as working capital or excluded from the equity value adjustment.[2] Examples of this are:

- when cash is acting as security or deposit (ie leased properties); and
- cash required for regulatory or contractual purposes.

Once again, if there are definitional requirements in relation to the status of cash items, these should clearly be articulated in the SPA.

What balance sheet items are regarded as debt?

The commercial reality is that most businesses are financed through borrowings, which a buyer should not have to assume liability for. Debt will typically include not the just the principal amount, but also debt-related items such as accrued interest and redemption costs.

Other items usually regarded as debt include corporate tax obligations, finance leases and related party loans.

More contentious items are those where an assessment has to be made as to the value provided to the purchaser in comparison to their adoption of the liability. As discussed above, items such as stretched creditors may provide a purchaser with a liability outside normal credit terms that is being used as a free and unsustainable form of financing.

Once again, the treatment of these items and any accounting policy regarding same should be clearly articulated in the SPA to avoid the risk of future dispute.

The value assignment mechanism

Transactions can be structured with a number of different mechanisms governing the above adjustments, with the most typical being completion accounts and locked box.

The options are set out below.

The traditional completion account mechanism

This is the "old faithful" of the Australian corporate landscape. The SPA will state a future date when completion needs to occur (or the date of signing, under simultaneous signing and completion). It is at this date that:

- an initial equity price will be paid (typically, the enterprise value, but it could be an estimate of the equity value, later "trued up"); and
- economic risk and return are transferred to the buyer.

The company will then prepare its management accounts as at this date (hopefully, this is set at month end for accounts closure ease) and adjustments will be made between the parties in relation to working capital and net debt. However, given the period required to prepare management accounts and the time required for both parties to review, this often means that the ultimate final adjustment payment may not occur until months after completion.

This is relatively simple approach at a high level, in that a price is agreed and then adjustments are made at settlement to equitably apportion costs associated with the business. It is also accurate and fair in the sense that all profits generated by the business to the account of the vendors leading up to completion would, on the face of things, be reflected in the closed loop as either working capital, cash or debt repaid, which they would be rewarded for in the completion accounts.

However, the issues with applying this mechanism to the corporate environment are time and cost. For instance, although the transfer of economic risk and control may occur on 31 March, it will typically take several months for the parties to establish what the actual working capital and net cash/debt position was at this point in time. The cost of this exercise can be large, when both the buyer and the seller have a team of accountants trying to tie monthly management accounts to the definitions contained in an SPA. It also gives no certainty to either party at the start of the transaction.

The locked box mechanism

The premise of this mechanism is that working capital[3] and net debt positions should be set at the locked box date, which is a date *before* completion occurs. The transfer of economic risk and return is also transferred to the buyer at this locked box date, ie ahead of completion.

What is the benefit of this? All parties can clearly understand what the balance sheet position used to calculate the equity value will be, providing certainty. It is also useful when a seller is trying to compare several different offers, as all parties are assessing the same position. However, this mechanism does raise challenges of its own, including, if completion is going to occur after the locked box date, how either party can be sure of what they are going to get. The following two questions should be asked.

What is in the box?

The seller will typically provide warranties in relation to the accuracy of the accounts used to establish the locked box. This provides potential buyers with confidence that they can put forward an offer, based on the numbers provided, with certainty.

What isn't in the box?

Until the date of completion, a seller will still typically:

- have their capital tied up in the business; and
- be managing the business on a day-to-day basis.

Therefore, how is the seller compensated for profits earned between the locked box date and completion when they have been running the business?

Conversely, the new owner is also in a relatively grey area as they have agreed and are contractually bound by a "value" but may not practically have any day-to-day control over the potential erosion of that value over the period between the date of the locked box accounts and completion.

The locked box mechanism provides the following controls to manage this dilemma:

- **leakage provisions:** these are controls included in the SPA to limit or prohibit the extraction of value from the company during this period (such as the payment of dividends or payments to related parties), which would otherwise escape the box. Alternatively, there can be provisions for permitted leakage if these items are known in advance; and
- **value accrual:** these are provisions included in the SPA that ensure "value" that is earned between the locked box date and completion is properly assigned to the seller, since they still have their capital tied up in the business. This value needs to be fixed ahead of time and can be calculated in a number of ways, eg an equity return rate or, more commonly today, a daily cash profits amount that has been earned between the two dates. The challenge with this of course is that actual profits over the period leading up to completion will inevitably differ from the value accrual.

Theoretically, the end result for both the seller and the buyer should be similar under both mechanisms.

Earnouts

Typically, an earnout is an extended payment to the vendor following the closing of the deal, which is based on *actual* future earnings of the asset acquired, rather than *predicted*. Earnout arrangements are a well-known way of pricing the sale of a business where there is uncertainty about value (in particular, regarding future earnings). Private equity generally tends to use earnouts as a way to bridge the gap between the vendor's expectations and the buyer's valuation of the business.

Vendors need to be cognisant of the potentially disparate tax outcomes depending on the particulars of an earnout arrangement. In certain instances, tax law allows taxpayers to treat the consideration under a qualifying look-through earnout right (LTER) as related to the original asset and therefore as part of the capital proceeds received by the seller and the cost base for the buyer. Importantly, this treatment allows vendors to defer the taxing point of qualifying earnout arrangements until such time as the cash

payment subject to the earnout right is actually received (and if it is never received, there is no resulting tax liability on that component). Also, importantly, it allows vendors to ensure that any amounts received from the earnout rights are able to qualify for the same CGT concessions that were applicable to the original business sale.

Not every earnout arrangement qualifies as an LTER. Given the potential importance of being an eligible LTER, advice should be sought to confirm the position. The conditions in s 118-565(1) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) must be satisfied for a right to be an LTER. The key criteria are that:

- the right must be a right to receive future financial benefits that are not reasonably ascertainable at the time the right is created;
- the right must be created under an arrangement that involves the disposal of a CGT asset (ie the disposal must cause CGT event A1 to happen);
- the CGT asset that has been disposed of must be an "active asset" of the entity which disposed of the asset just before the CGT event (note that this definition is broader than the small business CGT concession);
- the right must not require financial benefits to be provided more than five years after the end of the income year in which the CGT event happens;
- all of the future financial benefits must be contingent on the future economic performance of the asset or a business in which the asset is used;
- the value of all of the future financial benefits must reasonably relate to the future economic performance of the asset or a business; and
- all parties to the arrangement must deal with each other at arm's length when making the arrangement.

Notably, to qualify for tax deferral, the right to future payments must be contingent on, and reasonably related to, the future economic performance of the asset, and cannot extend beyond a period of five years.[4] In this regard, there may be situations where future payments are made contingent on, for example, key-person retention which may not (alone) qualify for tax deferral under the look-through approach. Clearly, introducing contingencies based on future financial performance (rather than just key-person retention) introduces a greater risk that the vendors will not receive all or some of the potential consideration.

Care must be taken to ensure that any earnouts not only achieve the commercial objectives of vendors and buyers, but also maximise their after-tax outcomes. The earlier that tax advisers can be involved in reviewing draft term sheets and/or sale documentation allows us to ensure that the parties to the transaction are not left with unintended tax consequences subsequent to the transaction.

Where an earnout is used, there are a number of practical considerations:

- there is a possibility that the vendor will have a "dry" income on sale (ie a tax liability from an event with no (or insufficient) cash proceeds), or at least a timing impact;
- if the vendor wants to move on with their life, they may not be willing to wait for another five years for the earnout periods to run their course. Accordingly, they may prefer to accept a lower total guaranteed amount on completion, but the following should be considered:
  - the mechanics of the share purchase agreement, that is, while earnouts are often tied to year end, there can sometimes be another 10 to 12 months post-year end by the time the amount is actually due and payable (ie after the audited accounts are finalised and each party has reviewed); and
  - how much confidence the vendor may have that the earnout thresholds can be met and are genuinely within their control;
- vendors should consider whether they will have access to the relevant information throughout the earnout period to ensure that the calculations and the operation during that period are not unduly "sabotaged" by the buyer. Key issues may include:
  - cut-off measures relating to accounting policies; and
  - variations to accounting treatment pre-acquisition to post-acquisition (this is particularly relevant where the business prepared special purpose pre-acquisition and there is a change to general purpose post-acquisition; and
- from the buyer's perspective, a genuine LTER can lead to multiple updates and amendments of tax returns, particularly where the target is joining a tax consolidated group (given the potential changes to the step 1 amount each year, an earn-out is actually paid). Circumstances can arise where tax liabilities are created upfront which become refunded over time as the earnout is paid. It requires frequent re-visiting and often creates unwanted administrative burden and costs (ie tax agent fees).

Tax warranties in SPAs

A comprehensive tax due diligence will allow a purchaser to assess the level of tax risk. Following the tax due diligence, tax warranties and indemnities in an SPA provide protection against tax claims that may arise as a result of the target's past activities.

Most experienced legal practitioners will insert a standard set of tax warranties and indemnities in an SPA. However, it is crucial that these warranties are reviewed by the tax due diligence team to provide any recommendations regarding the context of the particular transaction. It would be the rare occurrence that an "off-the-shelf" standard tax warranties and indemnities clause/s was completely appropriate.

There is a natural tension between the buyer and the seller with respect to the level of risk to be accepted and how that risk should be mitigated. It is likely that the greater confidence the buyer has in the target, the less onerous the conditions of the SPA will be. So there are generally a

number of considerations to navigate when negotiating, or planning to negotiate, an SPA, including the following:

- **cash held in escrow:** any tax warranty and indemnity is only as good as the seller's ability and willingness to pay on the claim. The purchaser will be assessing not only the risks attached to the business, but also the risk of not being able to receive payment should a given risk eventuate. A purchaser may request to withhold a portion of the purchase price in escrow. This amount would be held on trust (typically by the lawyers) and only released to the seller on evolution of time or resolution of a particular tax risk. Naturally, sellers would prefer to avoid the use of escrow;
- **time limits:** time limits for any claims and any maximum and minimum claim amounts are important negotiating points which require input based on the tax due diligence. Time limits can vary greatly and generally depend on the period of review and nature of the potential issues identified in due diligence;
- **disclosure exclusions:** often the standard clauses in an SPA will exclude any "disclosed matters" from being the subject of a claim. It is important to understand how any disclosed matter exclusion relates to tax warranties. Normally, it would be appropriate for any amount of tax liability included in the completion accounts to reduce the amount payable under the tax warranty. However, a disclosure exclusion should not extend to a matter identified in due diligence. This is appropriate because while a due diligence may identify a risk, it is not always possible to be fully conclusive or quantify the risk;
- **following legally agreed processes:** attention should be given to the procedural elements of any tax claim. For example, SPAs will specify how soon after an issue is known that the buyer must inform the seller. What rights does the seller have to take carriage of any tax issue that is disputed in the future by a revenue authority? If the legally agreed processes are not followed, the buyer may find themselves in breach and not be able to make a claim;
- **understanding terms of the SPA:** the definition of terms fundamental to the ability to make claims are critical, eg "tax", "credits", "event", and so on;
- **interest and penalties inclusion:** whether or not interest and penalties are included within the definition of what can be claimed (generally they should be);
- **all jurisdictions included:** whether claims can be made for tax exposures in any jurisdiction, including outside Australia;
- **tax liabilities:** care should be taken to ensure that the tax indemnity covers not just actual tax, but also liabilities that are not strictly tax themselves but which are clearly tax related, eg legal costs of a dispute;
- **tax consolidated groups:** if purchasing a subsidiary out of a tax consolidated group, it is crucial that the SPA has a "clear exit mechanism" under the SPA (otherwise it may be necessary to perform due diligence on the complete tax consolidated group which, depending on the seller, may not be acceptable);
- **each party's roles:** the other important area of review is agreeing on the respective responsibilities of each party post-completion. The SPA should specify who is lodging any straddle tax returns and review rights of each party, who will take carriage of a tax dispute, and who will bear the costs. Similarly, the SPA should state who receives the benefit of pre- and post-completion returns (eg the R&D refundable tax offset receivable on lodgment of a stub period tax return which covers the period up to the date of acquisition); and
- **changes between pre- and post-acquisition:**
  - consideration should be given to implications of the taxpayer's tax rate where it may be different pre-acquisition and post-acquisition, due to aggregated turnover; and
  - accounting policies for completion statements, particularly for future deductions where there is no tax effect accounting included.

Documenting roll-overs

From a tax perspective, it is important that those responsible for the review of the SPA have a clear understanding of the tax structure and the wishes of the buyer and the seller (although, generally, the adviser will only be acting on behalf of one party, not both). There are a number of scenarios where the SPA is used (or should be used) to document agreement in relation to tax elections.

Documenting a roll-over in writing

Depending on the particulars of the transaction, the vendors may intend to utilise a CGT roll-over. Often a CGT roll-over, where relevant criteria are satisfied, is either at the sole choice of the vendor, or it may automatically apply. However, depending on the specific CGT roll-over[5] (and the nature of the transaction), it may be necessary that the choice to apply the CGT roll-over is documented in writing and agreed to by the buyer and the vendor (to enable the vendor to be eligible for the CGT roll-over).

It is important that the parties reviewing the SPA have a detailed understanding of the transaction step plan, the nature of the taxpayers involved, and their intentions with respect to CGT roll-overs. In the case of significant stakeholders,[6] it is also important that the additional consequences of the roll-over are understood, eg the impact on the cost base of the shares acquired (which may have a flow-on tax consolidation impact). Generally speaking, where a roll-over needs to be agreed in writing by both parties, it would/should be documented in the SPA.

Scrip-for-scrip

With particular consideration of Subdiv 124-M ITAA97 (scrip-for-scrip roll-over), there is a condition that requires the arrangement be one in which participation was available on substantially the same terms for all of the owners of interests of a particular type in the original entity.[7]

It is not uncommon where a target (company) has multiple shareholders, the buyer really only wants a select few (or only one) of the original (key) shareholders and does not want to continue with the other original shareholders.

The requirements of s 124-780(2)(c) ITAA97 can generally be managed via an offer with alternatives, eg original shareholders can choose either:

1. 100% cash for their shares; or
2. 80% cash and 20% replacement shares in the buyer.

However, it is not uncommon for the nature of the offer to change several times from the commencement of discussions through to the execution of the final SPA. The SPA generally documents the final position and, with reference to schedules in the SPA, names specific shareholders who are taking option 1 and those who are taking option 2.

There may be a practical challenge for a seller who is seeking to rely on the scrip-for-scrip roll-over to clearly evidence to the ATO (should they need to) that there is an offer on substantially the same terms to all shareholders (of a particular type). The numerous iterations of draft letters of intent, emails and phone conversations that ultimately lead to the execution of a final SPA (which really just documents the outcome and not the offer) is arguably not effective. Accordingly, it would be prudent to ensure that there is an updated final offer document that taxpayers can point to prior to the completion of the SPA.

Foreign tax elections

Where the buyer is foreign controlled, it is not uncommon for the buyer to have a desire for certain elections to be made by the target with respect to the foreign tax jurisdictions. For example:

- an Australian company (the target) may make an election to be treated as transparent for US tax purposes (commonly referred to as a "check the box election"); or
- a US buyer may make a 338(g) election (which may permit the purchasing company to treat a share purchase (qualified stock purchase) as an asset purchase, and allow the buyer (for US tax purposes) to obtain a step-up in basis of the target's assets in what is otherwise treated as a sale of shares).

It is common that the SPA would include agreement by the Buyer and Seller that a specific election either has been made or will be made by the relevant party (e.g. the company being acquired). It will be important that the nature of the elections are understood by both the buyer and the seller.

Responsibilities and control over unlodged returns

Generally speaking, the SPA should detail whether the buyer or the seller takes responsibilities for the preparation of unlodged returns. While there are rules of thumb as to who is responsible, in practice, it should be an approach which is fair and reasonable for all parties and should be considered in the context of the particulars of the transaction and the parties involved.

Typically, the lodgment of returns, for periods ending before completion, would be the responsibility of the vendor. However, if the vendors are a couple who are retiring and are not remaining in the business, it does not make sense for them to take carriage of this responsibility.

If the target is exiting a large tax consolidated group, it would generally be the responsibility of the vendor as it would not make sense for the buyer (who will have no knowledge or control over information for the entire tax consolidated group) to be responsible for the return.

Practically, it makes most sense to align the preparation of completion accounts and the tax return. The completion accounts will generally tie into the tax calculations and often include tax balances so there is a natural efficiency for these to be aligned with the same party.

Additional considerations include:

- the rights of the other party to review the returns prior to lodgment;
- which party has control over tax authority audits/reviews for periods prior to acquisition. It may be important to the seller that they have a level of control here to ensure that the buyer does not just accept any position issued by the tax authority (where the seller is effectively paying for the shortfall through tax warranties or indemnities);
- who has entitlement to refunds from lodgment of the returns:
  - typically, the benefit of anything up to acquisition should go to the vendor and anything post-acquisition should go to the buyer; and
  - consider a scenario where the target has a refundable R&D tax offset in a stub period tax return up to the acquisition date. Generally, the vendor would have the benefit of this, but it is important that they have then considered the ability to control the preparation and lodgment of the return to ensure that this aligns (where control of the preparation sits with the buyer, they may choose not to apply for the R&D tax incentive as there is no benefit to them).

While there are "rules of thumb", it very much depends on the scenario and is always important that the tax adviser reviewing the SPA understands the broader context of the transaction and the goals of their clients.

Summing up

In summary, when your client is looking to purchase a business, it is important to ensure that they understand the role of financial and tax due diligence and structuring before submitting an offer. The most important takeaways are:

- an offer should typically be made on a "normal level of working capital, debt-free/cash-free, subject to due diligence" basis. A binding offer should not be made purely on face value EBITDA. It also needs to consider

potential adjustments to EBITDA (identified during the course of due diligence), the normal level of working capital required to generate EBITDA, and debt/cash that needs to be taken out of the business at completion;

- where there is doubt about future earnings of the business (that may be identified during the course of due diligence), earnout provisions can be used. However, an assessment needs to be made of both the commercial and tax implications;
- the work of financial and tax due diligence advisers does not stop at the initial due diligence. Both financial and tax due diligence advisers should be involved in drafting the SPA to ensure that their findings and concerns are reflected in the document, and thus the purchaser's best interests are protected. This will include not only the formulation of working capital/net debt and accounting definitions, but also the inclusion of appropriate tax warranties and lodgment responsibilities. It is also vital that tax advisers are involved in drafting the SPA to ensure that the tax structuring of the transaction is reflected in the document; and
- the transaction does not finish on the signing of the SPA. Depending on the completion mechanism used (either completion accounts or locked box), assistance will be required from financial and tax due diligence advisers at completion to ensure that the final split of value in the acquisition is made correctly under the terms of the SPA.

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References

1 For more information in relation to current multiples in relation to particular sectors, and overall M&A market activity, see Grant Thornton, *Dealtracker 2022: Australian M&A and IPO market insights*, March 2022. Available at www.grantthornton.com.au/link/12c4568abf9f47b68376a46dd3692e14.aspx.

2 Which is similar to the treatment of other balance sheet items, such as plant and equipment.

3 It should be noted that an adjustment will still be made to ensure that the buyer will be provided with a "normal" level of working capital. However, this adjustment will be determined at the locked box date rather than at the completion date.

4 Subdiv 118-I ITAA97.

5 For example, see the requirements for scrip-for-scrip roll-over: s 124-780(3)(d) ITAA97.

6 S 124-783(7) ITAA97.

7 S 124-780(2)(c) ITAA97.

A Matter of Trusts

by Jan Harnischmacher, Sladen Legal

Trust law principles and challenging BDBNs

A recent Supreme Court of Queensland decision serves as another reminder that strict adherence to the requirements in the trust deed is paramount for BDBNs.

Superannuation fund deeds are trust deeds that are governed by trust law principles. In this article, we will examine how trust law principles and a superannuation fund trust deed interact with binding death benefit nominations (BDBNs).

Death and superannuation

Regulation 6.21 of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR) requires death benefits to be paid "as soon as practicable" after the member dies. Superannuation death benefits are not considered to be testamentary in nature, meaning they do not automatically form part of the estate of the deceased.[1]

The payment of a death benefit is generally a matter of trustee discretion, subject to an exception in the case of BDBNs. A superannuation fund trust deed may allow members of the fund to give the superannuation fund trustee a direction, setting out how they wish their superannuation death benefits to be distributed on their death, and such nominations may bind the trustees. Notwithstanding that the interaction of laws governing superannuation, trusts and tax contain pitfalls for the unwary, properly drawn BDBNs provide great certainty, especially where blended families are involved.

Validity of BDBNs

Section 59 of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA) provides that a fund's governing rules can allow discretion to be exercised by someone other than the trustee in respect of the paying out of death benefits, provided that the requirements in reg 6.17A SISR are complied with. Regulation 6.17A is very prescriptive and one of the conditions is that any such nomination can only last for a maximum of three years.

The recent High Court case of *Hill v Zuda Pty Ltd*[2] confirmed that the requirements imposed by s 59 and, accordingly, reg 6.17A do not apply to a self-managed superannuation fund (SMSF). This means that a BDBN relating to an SMSF can last indefinitely, subject to the specific terms of the trust deed. It is therefore crucial that trustees and members review BDBNs periodically, especially where the member's circumstances have changed.

The most important lesson from *Hill v Zuda Pty Ltd* is a reminder of the primacy of the trust deed.[3] BDBNs have two basic requirements. First, the trust deed must allow such nominations. Second, a BDBN may only nominate beneficiaries who are eligible to receive death benefit payments under the SISA (ie the legal personal representative or the deceased's spouse or de facto spouse, a child of the deceased of any age or a person who is a financial dependant of, or in an interdependency relationship with, the deceased).[4] The courts have taken a strict approach to the interpretation of a BDBN. The cases in this article concern the court's consideration of whether a BDBN was valid and effective under the relevant trust deed. The background facts are broadly similar, arising from a blended family dispute following the demise of an SMSF member.

Failure to deliver BDBN to both trustees

In *Williams v Williams*,[5] the executor of the deceased estate, one of the deceased's sons from the deceased's first marriage, challenged the BDBN on the basis of its validity. The deceased made his last BDBN directing the trustees to pay 50% of his death benefit to his second spouse and 50% to his personal legal representative. The trust deed of the SMSF provided that, if the *trustees* are given a written BDBN, the *trustees* must accept the terms of the nomination.

The first respondent, the other son from the deceased's previous marriage, who was then the co-trustee with the deceased, denied that he was given written notice of the nomination in his capacity as trustee. However, the applicant, the second spouse, argued that the term "trustees" need not be interpreted as meaning all of the trustees as the general provision of the trust deed provided that the plural includes the singular, and that the nomination contained a "trustee confirmation" in which the deceased confirmed that he accepted the nomination in his capacity as trustee.

Referring to the decision in *Cantor Management Services Pty Ltd v Booth*,[6] the court noted that, to give effect to a BDBN, the trustee must know which BDBN is current and which has been superseded, and that it could not be said that "the knowledge of the deceased affects his co-trustee with knowledge of the transaction".

The court addressed the term "trustees" defined in the trust deed as follows:

> "[20] … the Trustees or the Trustee for the time being of the fund and 'Trustee' has the same meaning …"

The court held that the general provision to the effect that the plural includes the singular did not apply to this

particular definition, and the machinery provisions of the trust deed envisaged the giving of notice to all of the trustees. Hence, the BDBN was declared invalid due to non-compliance with specific requirements of the governing rules of the superannuation fund.

Incorrect terminology

In *Munro v Munro*,[7] the deceased made his last BDBN directing the trustee to pay 100% of his death benefit to the "Trustee of Deceased Estate". On the deceased's death, his stepdaughter was appointed as co-trustee with her mother, the deceased's second spouse (the trustees). The trustees notified the deceased's daughters from his previous marriage, who were named executors in the deceased's will, that the nomination was invalid as the definition of "legal personal representative" in s 10 SISA does not extend to the "trustee of his estate".

The particular trust deed permitted the trustee of the fund to pay a benefit on the death of a member in accordance with a binding nomination only if the benefit was specified to be paid to one or more nominated dependants or the legal personal representative of the member and complied with the "relevant requirements". "Relevant requirements" was defined in the trust deed to include the provisions of the SISA.

The court held that:

> "[44] The nomination form must be construed on its face and having regard to its purpose … It is not appropriate to construe the nomination form by reference to the will when the nomination is for the purpose of payment of the death benefit from the fund."

The court referred to the definition of the term "legal personal representative" in s 10 SISA, which includes "executor of the will or administrator of the estate of a deceased person", and held that the role of "executor" and "trustee" are distinct (*Commissioner of Stamp Duties (Qld) v Livingston*[8]).[9]

The court therefore determined that the nomination did not comply with superannuation law and the trust deed, which both required death benefit payments to be made to either "dependants" or a "legal personal representative", and the nomination failed due to incorrect terminology.

Can attorneys make a BDBN?

In *Re Narumon Pty Ltd*,[10] the deceased made his last BDBN directing the trustee to pay 47.5% of his death benefit to each of his second spouse and their son, and the remaining 5% to his sister. The trust deed provided that, for a nomination to be binding on the trustee, the nomination must be signed by the member within three years of the member's death. The second spouse and the sister, in their capacity as the attorneys for the deceased, signed a new BDBN in favour of the second spouse and her son to each receive 50% of the death benefit. The court action commenced as the trustee sought declaratory relief from the court as to the application of the death benefit of the deceased.

The court held that the validity and application of a nomination are separate issues. The nomination was found to be valid as the trust deed provided that "a binding death benefit notice may be in a certain form" and that the use of the word "may" does not require strict compliance with a particular form.

However, it was found that, if a member gives notice to the trustee nominating a person who is not a dependant or legal personal representative, the nomination is to that extent of no effect. Although the deceased's sister was one of the deceased's legal personal representatives, the nomination was not of her in this capacity, and, as she was not a dependant of the deceased, the nomination was found to be ineffective.

The court found that whether the attorneys had the power to make a new BDBN depended on consideration of the terms of the trust deed, the state legislation governing an enduring power of attorney, and the relevant Commonwealth superannuation legislation.

First, the court referred to the terms of the trust deed and found that there was nothing in the trust deed itself that would prohibit an attorney from signing a nomination for the member.

Second, it was found that there was no restriction in both the SISA and the SISR preventing an attorney under an enduring power of attorney from signing a nomination on behalf of the member.

Third, the court held that making, varying, extending and revoking a BDBN fall within the general scope of the financial and legal matters defined under the *Powers of Attorney Act 1998* (Qld). However, here, the actual exercise of the power of attorney was found to be defective as attorneys must avoid personal conflicts of interest unless they are expressly authorised by the principal to undertake conflict transactions under s 73 of the *Powers of Attorney Act 1998*. The power of attorney granted by the deceased did not have a relevant express authorisation permitting the attorneys to enter into a conflict transaction.

A wish is not a direction

In *Donovan v Donovan*,[11] the deceased wrote a letter to the trustee:

> "I hereby advise that it is my wish that the balance of any amounts standing in my name in the above named superannuation fund, on my demise, be paid to my Legal Personal Representative for inclusion in my estate assets."

His second spouse and his daughter from his previous marriage were appointed as executors of his estate. On the passing of the deceased, the second spouse became the sole director of the corporate trustee and claimed that the nomination was invalid because the letter did not constitute a BDBN as it did not show an *intention* that it was to bind the trustee.

The court found that, although the trust deed did not require a nomination to follow any particular form, the trust

deed envisaged both a binding and non-binding nomination and that the letter did not manifest an *intention* to make a BDBN.

Conclusion: practical implications

In the absence of a BDBN, the trustee must exercise their discretion with good faith and give real and genuine consideration to all eligible beneficiaries before paying the deceased member's death benefits.[12] The proper carriage of this discretion is a common source of legal disputes, based on claims against trustees brought by aggrieved beneficiaries, especially with complex family arrangements.

BDBNs can provide greater certainty and reduce the risk of a challenge to an exercise of the trustee's discretion and fiduciary conflicts. It is common for the surviving spouse of a deceased member to be the executor of the will, and a potential and real conflict may arise between their obligations as executor of the estate and their desire to receive superannuation death benefits in their personal capacity.[13]

A BDBN may also be used to limit any potential claims on the deceased's estate as the death benefits paid to a dependant pursuant to a BDBN are not available under the court for the purposes of making a family provision order, except in New South Wales.[14]

The cases in this article illustrate that care needs to be taken when preparing and delivering BDBNs. A BDBN can be challenged based on its validity, including a lack of legal capacity. A valid BDBN will stand, even if the effect of it may be said to be "unfair".

The provisions of a superannuation fund's trust deed are paramount in relation to dealing with superannuation death benefits. In all cases, it is important to ensure that the current trust deed provides appropriate and robust death benefit provisions and, in particular, BDBN provisions. Where BDBNs are used, it is vital that the BDBN is drawn (and, where applicable, delivered) in accordance with formal requirements under the trust deed.

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References

1 *McFadden v Public Trustee for Victoria* (1981) 1 NSWLR 15; *Baird v Baird* [1990] 2 AC 548.

2 [2022] HCA 21.

3 However, the trust deed may impose a requirement to comply with these regulations: *Donovan v Donovan* [2009] QSC 26; *Munro v Munro* [2015] QSC 61.

4 The governing rules of a superannuation fund must not allow the benefits of a deceased member to be cashed otherwise than in accordance with the operating standards in the SISR: s 55A SISA.

5 [2023] QSC 90.

6 [2017] SASCFC 122.

7 [2015] QSC 61.

8 [1964] UKPC 2.

9 An executor holds the property of a deceased and carries out the administrative duties of collecting the assets, paying the debts of the deceased, and setting the assets aside to give effect to the gifts in the will on completion; a trustee then steps in once the assets are applied to the trusts under the will.

10 [2018] QSC 185.

11 [2009] QSC 26.

12 *Owies v JJE Nominees Pty Ltd* [2022] VSCA 142.

13 *McIntosh v McIntosh* [2014] QSC 99.

14 *Succession Act 2006* (NSW).

Superannuation

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

Draft NALE legislation released

The proposed 2 x NALE change only applies to a lower general expense relating to an SMSF and not to lower expenses relating to specific assets. Advisers should monitor NALI\E risks.

In January 2023, Treasury proposed that a non-arm's length (or nil) expense (NALE) should be multiplied by 5.[1] For example, a NALE of $1,000 would give rise to $5,000 (5 x $1,000) of non-arm's length income (NALI), taxed at 45% ($5,000 x 45%), resulting in $2,250 tax or an effective tax rate of 225%.[2]

On 9 May 2023, the Federal Budget (the Budget) announced some good news on NALE. The key change for the SMSF industry was the 5 x multiple being reduced to 2. This will result in a lower NALE expense of $1,000 being multiplied by 2 (2 x $1,000) and then taxed at 45% ($2,000 x 45%), resulting in $900 tax or an effective tax rate of 90%.

On 19 June 2023, Treasury released the exposure draft Treasury Laws Amendment (Measures for Consultation) Bill 2023: Non-arm's Length Expense Rules for Superannuation Funds (NALE Bill), together with exposure draft explanatory materials (NALE EM).

The NALE Bill and NALE EM provide guidance on the NALI changes announced in the Budget which are discussed below.

NALE changes

The proposed 2 x change only applies to a lower general expense relating to an SMSF or small APRA fund and not to expenses relating to specific assets (or income sources). The NALI rules in relation to specific assets (or income sources) have been operating well before the NALE changes which commenced from 1 July 2018.

Example applying a 2 x multiple

If an SMSF trustee uses a member's brother's accounting firm's services, which would usually cost $5,000 under an arm's length relationship but the SMSF trustee is not charged any fee, this is considered NALE as the parties were not dealing at arm's length. Therefore, the tax payable would be calculated as follows:

- 2 x $5,000 = $10,000 NALE;
- $10,000 x 45% = $4,500 tax payable by the fund.

Note that, where the product of 2 x the NALE is greater than the fund's actual taxable income, an "upper cap" will be the fund's taxable income for the income year, not including any assessable contributions or any deductions against assessable contributions.

Referring to the above example of the SMSF member's brother's firm providing accounting services valued at $5,000 for free, where the amount of NALI under a 2 x is $10,000 but the fund's actual taxable income is only $6,000, the upper cap would result in $6,000 of actual taxable income being taxed at 45% rather than $10,000 of "notional" NALI.

Other proposed changes

Capital expenses

The 2 x multiple in the NALE Bill will not apply to a loss, outgoing or expenditure of capital or of a capital nature. This is a new development as, previously, NALE was focused on a general expense, whether of a revenue or a capital character.

Advisers will therefore have to apply their tax skills to determine whether NALE will be capped by the 2 x multiple if the NALE is not on capital account. Thus, a general expense of a revenue nature should qualify but a capital expense of a general nature will not.

Specific versus general expense

The NALE EM states:

> "1.5 Any non-arm's length expense will be either a specific expense or a general expense. A general expense will be an expense that is not related to gaining or producing income from a particular asset of the fund. A specific expense will be any other expense. An expense incurred in relation to gaining or producing income as a beneficiary of a trust through holding or acquiring a fixed entitlement to the income of a trust will always be a specific expense.
>
> 1.6 For specific expenses the existing treatment will continue to apply, and the amount of income that will be taxed as non-arm's length income will be the amount of income derived from the scheme in which the parties were not dealing at arm's length."

The severity of NALI in relation to a specific expense is highlighted in example 9 in LCR 2021/2 where Trang, a plumber, renovated the kitchen and bathroom to her SMSF's rental property which exposed the net rental income and future capital gain to NALI.

Contributions

Under current legislation, general expenditure NALE would result in assessable contributions such as superannuation guarantee contributions, salary sacrifice contributions and personal deductable contributions being taxed as NALI at 45%.

The ATO in LCR 2021/2 stated:

> "19. In some instances, the non-arm's length expenditure will have a sufficient nexus to all of the ordinary and/or statutory income derived by the fund."

Under the ATO's view of the current NALI provisions, a lower general expense would cause all income to be NALI, including statutory income such as:

- concessional contributions;
- net capital gains; and
- franking offsets that are associated with any franked dividends.

Fortunately, the NALE Bill confirms that NALI will exclude contributions assessable under Subdiv 295-C of the *Income Tax Assessment Act 1997* (Cth).

Pre-1 July 2018 expenditure to be exempted

Under the current legislation, NALE could apply retroactively as it could apply to income derived after the introduction of the mid-2018 NALE changes.

Fortunately, the NALE Bill confirms that expenditure incurred prior to 1 July 2018 will be exempt from NALI.

Large APRA funds exempt from NALE

Large APRA funds will be exempted from NALE in relation to general expenses.

Current status of NALI/E

Until the NALE Bill is finalised as law, advisers and SMSF trustees need to be careful to minimise any NALI/E risks. Importantly, the ATO's administrative practice in PCG 2020/5 no longer applies after 30 June 2023. This practice involves the ATO not applying compliance resources to NALE of a general nature prior to 30 June 2023. Thus, technically under current legislation, NALE of a general nature can give rise to all ordinary and statutory income (including concessional contributions) until the new legislation applies.

Conclusion

Many SMSF trustees are not aware of the breadth of these provisions and advisers should ensure that there is ongoing education and monitoring for NALI/E risks in their client base.

While this is good news for general NALE, hopefully, more consultation will occur before the legislation is finalised as further changes to NALI were sought by the superannuation industry. In particular, specific NALI remains an ongoing serious concern that exposes all future ordinary and statutory income to a 45% tax rate, including a future net capital gain on disposal of an asset.

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Events Calendar

Upcoming months

JULY
19–20
Wed–Thu

NT

State Taxes Convention

11 CPD hours

AUGUST
9–11
Wed–Fri

SA

Barossa Convention

12 CPD hours

SEPTEMBER
5–7
Tue–Thu

VIC

The Tax Summit

20 CPD hours

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The Tax Institute would like to thank the following presenters from our June 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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