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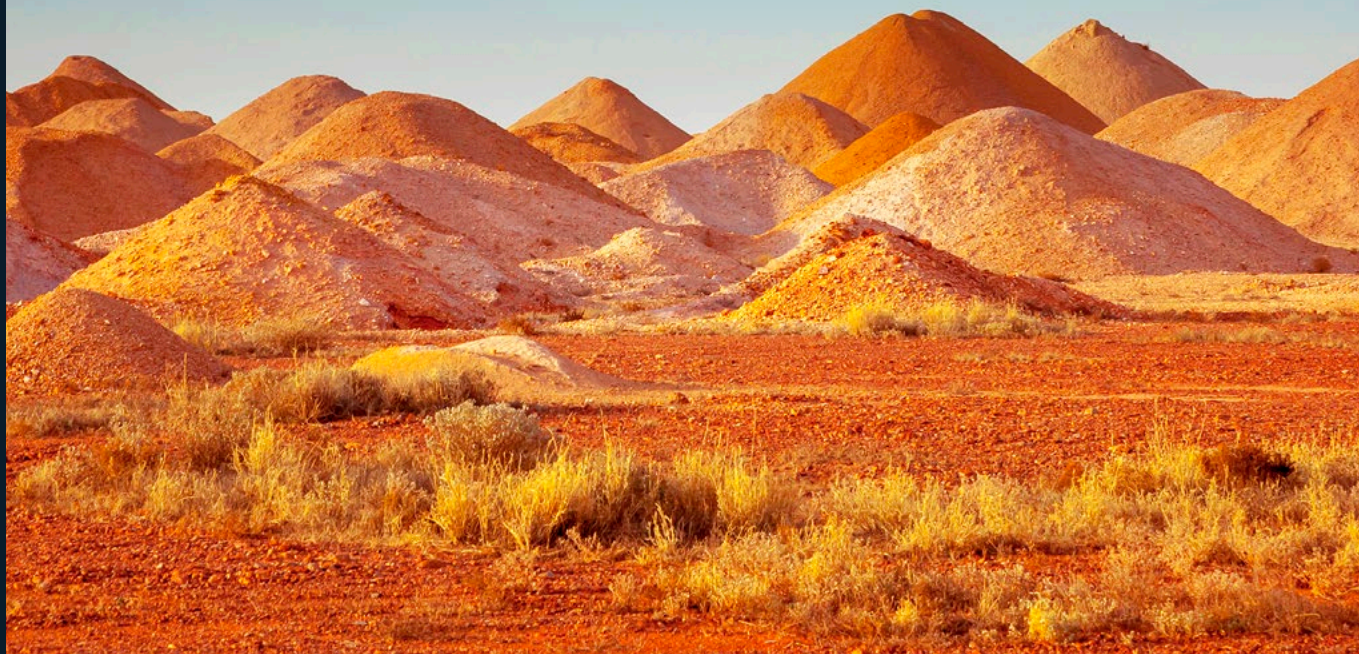

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Reliability of evidence in tax disputes

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THE TAX INSTITUTE

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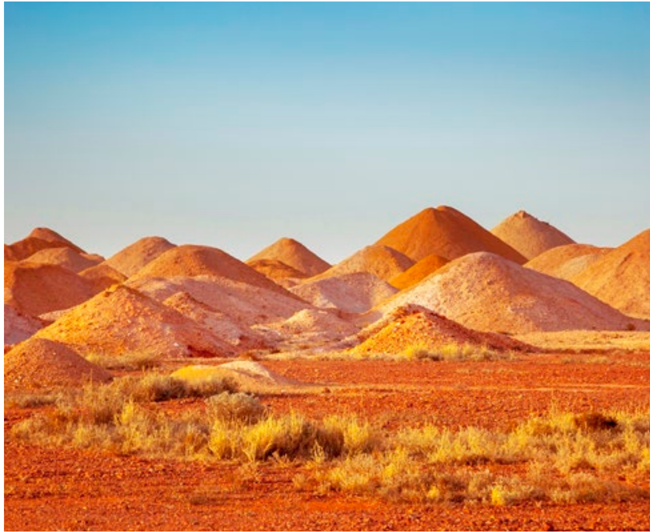

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Invitation to write

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

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

Tax News – at a glance

by TaxCounsel Pty Ltd

November – what happened in tax?

The following points highlight important federal tax developments that occurred during November 2019. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 289 (at the item number indicated).

Tax compensation claims

On 4 November 2019, the government gave its response to the review of the treatment of small business tax cases under the Scheme for Compensation for Detriment caused by Defective Administration. **See item 1.**

Amending legislation

The *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019,* which makes a variety of amendments including in relation to the CGT small business concessions and deductions in respect of vacant land, was passed by parliament with amendments on 22 October 2019 and received the royal assent (and became law) on 28 October 2019. **See item 2.**

Foreign investors: CGT amendments

On 23 October 2019, an amending Bill (the Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019*)* was introduced into parliament to make several CGT changes that affect non-residents. **See item 3.**

New IGTO reviews

On 31 October 2019, the Inspector-General of Taxation and Taxation Ombudsman announced the launch of two new investigations into aspects of the ATO's systems and procedures. **See item 4.**

Exploitation of restructure roll-over

The Commissioner has released a taxpayer alert in relation to certain arrangements that seek to exploit the CGT roll-over for trust restructures and that purportedly allow a unit trust to effectively dispose of a CGT asset to an arm's length purchaser with no CGT consequences (TA 2019/2). **See item 5.**

Assumed liabilities and cost base

A recently released draft taxation determination is to the effect that where a liability is assumed on the acquisition of a CGT asset, the assumed liability is excluded from the cost base of the asset to the extent that expenditure on discharge of the liability is deductible (TD 2019/D11). **See item 6.**

Work expense deductions

The Commissioner has released a draft ruling that sets out when an employee can deduct a work expense (often called a work-related expense) under the general deduction provision (s 8-1 ITAA97) (TR 2019/D4). **See item 7.**

Capital gains and foreign income tax offset limit

A recently released draft taxation determination is to the effect that capital gains are not included under s 770-75(4)(a)(ii) ITAA97 when calculating the foreign income tax offset limit (TD 2019/D10). **See item 8.**

Backpacker tax: test case

The Federal Court (Logan J) has held that the Australia–UK double tax agreement protected a British working holiday-maker, who was an Australian tax resident, from the so-called "backpacker tax" (*Addy v FCT* [2019] FCA 1768). **See item 9.**

Capital or revenue expenditure

The High Court (Keifel CJ, Bell, Gagelar, Nettle and Gordon JJ) has unanimously reversed a majority decision of the Full Federal Court and held that certain expenditure incurred by a taxpayer in acquiring gaming machine entitlements under statutory provisions was properly to be regarded as on capital account and so was not allowable as a general deduction (*FCT v Sharpcan Pty Ltd* [2019] HCA 36). **See item 10.**

Discount capital gain concession

The Full Federal Court (Kenny, Kerr and Moshinsky JJ) has unanimously dismissed appeals brought by taxpayers from a decision of Thawley J in which his Honour held that the special rules that can extend the period of ownership of a CGT asset for the purposes of applying the CGT discount capital gain concession where certain CGT roll-over relief has operated were not satisfied in the particular circumstances of the case before the court (*Hart v FCT* [2019] FCAFC 179). **See item 11.**

President's Report

by Tim Neilson, CTA

Not goodbye, but reflection and thanks

President Tim Neilson pens his last report as president of The Tax Institute.

In *The world is not enough*, Q tells James Bond that he should "always have an escape plan".

Mine is an excellent one. At midnight on New Year's Eve, the presidency will pass to Peter Godber, who has an outstanding record of leadership, both at Grant Thornton and in The Tax Institute. He will be able to rely, as I have, on the wise guidance of our national councillors, the professionalism and dedication of the Institute's staff, and the enormous resources of expertise, talent and energy that our magnificent volunteer membership provide for us all so generously.

I am very confident that next year will see more continuous improvement in the services that the Institute provides to you, the members. Work that was commenced under my predecessors is now bearing fruit. We have made great strides in efficiency in our operations, but we're very focused on further upgrading all aspects of delivering value to our members.

Our major events are going from strength to strength, and we believe that The Tax Summit 2020 will be the biggest and best event yet. We're rolling out initiatives to help members develop vital skills, such as the Speakers' Academy and the mentoring program. We're upgrading our digital presence — such as the digitalised blue journal you're reading now — and there's more to come on that front. We've been heavily involved with the Review of the Tax Practitioners Board and the *Tax Agent Services Act 2009* (among many other tax developments this year) and look forward to continuing next year in our quest for a tax system that's better for our members and for the rest of Australia. And we're doing a lot more that I don't have space to mention.

It has been an immense privilege to be your president. It has been a formidable responsibility to try to live up to the stellar example of my predecessors, but I've received enormous help along the way. My thanks go to vice president Peter Godber, and to all members of National Council, who have been unflagging in their commitment to leading the Institute to ever-greater heights.

I thank also Giles Hurst for his dynamic, versatile and adept leadership, and the whole Institute management team and staff for their professionalism and dedication. There are some I've worked more closely with, particularly Bob Deutsch and the Tax Policy and Advocacy team who have been exceptional in promoting the Institute's views, but every one of the Institute's staff who I've come into contact with, even briefly, has impressed me with their skills and unstinting effort.

Thanks also to all of our volunteers. The lifeblood of the Institute is members' generosity to each other. To those who have served on councils or committees or in other roles, or who have spoken at events, contributed to journals, helped write papers, chaired sessions or contributed in any other way, thank you on behalf of us all. I'm confident that it will have been a rewarding experience for you, but the effort you've made is hugely appreciated, nevertheless.

I must also pay tribute to someone else who's stepping down from a role soon. Andrew Mills has had a wide-ranging career in tax, at the ATO, in professional practice, and in trade and commerce. He is also a past president of the Institute. Most recently, he has been Second Commissioner with responsibility for the ATO's Law Design and Practice Group. I was lucky enough to have Andrew as a colleague, and as a boss as our managing director, at Greenwoods. In every role in which I've known him, Andrew has been selfless, dedicated, extremely accomplished, and a pleasure to work with. In his Second Commissioner role, he has been immensely supportive of good relations between the ATO and the Institute. I trust that those good relations will continue, but we'll miss Andrew's great contribution to that important relationship.

I've been so lucky with regard to the people around me, not just this year but throughout life. I've mentioned some but I also want especially to thank my immediate predecessor Tracey Rens from whom I learned so much when I was her vice president. Thanks also to all of my colleagues at Greenwoods over the years for their support of my involvement in the Institute and for so many life lessons in practising tax. I owe so much to huge numbers of others who I've worked with, and sometimes against, in professional life, and who I've shared duties with at the Institute, right back to that time in 1987 when someone at Blake & Riggall (now Ashurst) suggested that I join the Institute and get involved in the technical committee — and even before that to my first job interview at Blakes when they revealed that they wanted me to work in tax. There are far too many to name, but my gratitude is nonetheless to each of them.

Of course, even before that there were friends, colleagues and mentors at work, university and school, starting with the best and wisest person I've ever known, that long-time Tax Institute member, the late Geoffrey Neilson.

And of course there's you, the Institute's members, some unassuming, some flamboyant, some cautious and thoughtful, some boundlessly optimistic and entrepreneurial, some calm and reflective, some fiercely passionate — some just wildly idiosyncratic — but all filled with dedication to excellence in your roles in the tax community and with that shared sense of collegiate commitment that makes the Institute the best place for tax in Australia.

This isn't "goodbye". I've got no intention of dropping out of the Institute's activities. It's just thanks and hoping to see you all again soon.

CEO's Report

by Giles Hurst

Another eventful year at The Tax Institute

CEO Giles Hurst reflects on a busy year, just ahead of the festive season.

As we wind down to the end of the year, I am thrilled to reflect on the achievements of The Tax Institute, its members and volunteers. This time of year is one of festivity, reflection and looking to the future.

Festivity

First cab off the rank is the much-awaited head office move to level 37, 100 Miller Street, North Sydney 2060. As much as it is a topic of great excitement and celebration for members and Institute staff alike, this move reflects the evolution of The Tax Institute. Our new home will be a great place for members to relax and use our facilities, and for the Institute's staff to host an exciting program of new events and initiatives in 2020. With stunning views of Sydney Harbour, as well as a clear line of sight to the north and west of Sydney, we are sure our new home will support our efforts to continue to modernise and invigorate the Institute.

This time of year is also a festive one, and a time to celebrate the efforts of our hardworking volunteers. We thank all of you for your dedication and commitment to maintain The Tax Institute's vital contributions to the tax debate and the broader tax community in Australia.

Reflection

The Tax Policy and Advocacy team has positioned the Institute as a leader in effecting systemic change with regard to the quality of guidance being placed into the tax system from Treasury and the ATO. Submissions have been made capturing members' rising concerns about guidance, and both Treasury and the ATO have responded positively by committing to consult on the role of legislation, explanatory memoranda and ATO guidance in the tax system.

On another note, I am pleased to acknowledge the success of our two final signature events for the year. The Noosa Tax Intensive was a complete sellout, and for the first time, it was a member-only event. Testament to the popularity of the event and the program, more than 30 people, new to The Tax Institute, took out membership in order to guarantee their attendance at this marquee event.

The Women in Tax National Congress was also a huge success, with attendees leaving the event with enhanced skills. Through this event, we look to equip attendees with the practical tools needed to accelerate their career. The flagship Women in Tax event is not tax technical; rather, it is an important reminder of how "soft skills" and technical expertise should work hand-in-hand in order to enjoy a high-performance career in tax.

Looking to the future

It's clear that there has never been a more challenging — or exciting — time to be working in tax. And what's the hottest ticket for a tax professional? The Tax Summit 2020.

This event will feature an unrivalled array of over 90 speakers, drawn from every area of tax, including corporate, professional practice, legal, technical, SME, domestic and international.

Tailor your experience over the three days to get the insights, tools and tips you need. Don't miss this unique opportunity to engage, reflect, feel "challenged" and learn. Use this link to take advantage of early bird pricing and save $200 on standard ticket pricing.

I mentioned earlier that our head office move is part of the Institute's evolution. Another key part of this evolution is getting the balance right in all aspects of diversity across our councils and committees. In conjunction with the broader efforts of National Council, the leadership team and I are also addressing the balance of gender and all aspects of diversity across the Institute's dealings and endeavours.

In closing, I want to thank you all for a successful year at The Tax Institute. We have made significant strides forward in tightly managing the organisation to ensure that it continues to strengthen, and that it remains future-fit for the benefit of members and a robust voice in the broader tax community.

Our members, volunteers and staff are the lifeblood of this fantastic organisation. There is more work to be done in 2020 but, until then, on behalf of all staff at the Institute, we wish you safe and happy holidays.

Tax Counsel's Report

by Angie Ananda, CTA

Trade-offs and the federal Budget

The Tax Institute's recent federal Budget 2020-21 submission discusses the need to look at trade-offs that can be made to ensure a strong tax system.

2020-21 federal Budget submission

The Tax Institute has recently prepared and lodged a submission[1] to the Treasurer in relation to the 2020-21 federal Budget.

To achieve a structurally sound Australian tax system, one must cast an honest and critical eye over the current system and decide whether all of the features of the current system should remain or should be removed in favour of new or modern features that better support Australia's economic needs.

The Tax Institute submitted that certain trade-offs will have to be made between current features of the Australian tax system in order to ensure that a structurally sound tax system is set up for the future.

The Tax Institute proposal: trade-offs

The government needs to look at where trade-offs can be made in the Australian tax base to ensure that Australia has the requisite tax system to support the Australian economy into the future. A trade-off will involve changes being made to the Australian tax base that may increase or decrease revenue. For example, the repeal of a particular tax will reduce revenue and narrow the tax base. Removal of certain exemptions and concessions will increase revenue and broaden the tax base.

A thorough consideration of where trade-offs can be made in the Australian tax system needs to be undertaken.

Reduce the number of tax bases

In the Budget submission, we also took the position that the number of tax bases needs to be reduced. This is in line with recommendation 1 in *Australia's future tax system: report to the Treasurer* (the Henry Review) released in December 2009.

To move towards the four clearly defined tax bases suggested in recommendation 1 of the Henry Review would require an enormous number of very small taxes to be repealed. This would require serious consideration being given to which of the 115 taxes should be repealed, a review of the policy behind the taxes, and whether the effect of the tax (eg to institute behavioural change or to address a mischief) is still a relevant consideration today. This would also require cooperation from the states and territories as many of the numerous smaller taxes are state and territory based.

The "trade-off" that would occur would be between the loss of revenue and the relevant impact of the taxes. Proper consideration needs to be given to repealing the 115 taxes that do not contribute much to the revenue. While collectively these taxes contribute 10% to revenue, they contribute very little when considered individually. Repeal of these taxes would have the additional benefit of simplifying the Australian tax system.

Move towards more efficient tax bases

Australia's current tax mix relies heavily on income tax bases (both personal and corporate) for the majority of the revenue collection. This mix is out of step with Australia's counterparts in the Organisation for Economic Co-operation and Development (OECD) whose tax systems rely more heavily on broad-based consumption taxes.

The effects of this discrepancy should be analysed. The discrepancy could be mitigated by the government adopting a policy of shifting away from being dependent on income tax for the bulk of revenue collections towards more simple and efficient consumption taxes.

Simplify the tax bases to be retained

Personal income tax base

The personal income tax base should be simplified as much as possible. Further, the personal marginal tax rates should be reassessed in light of the fact that Australia is ranked second highest in the OECD for rates on personal income, profits and gains.

There should be a transparent personal marginal tax rate system so that individual taxpayers can clearly identify which marginal tax bracket they fall into and therefore what tax rate they face.

Corporate income tax rate and base

A single corporate tax rate should apply in Australia. Currently, Australia has a dual corporate tax rate system — a headline rate of 30% that applies to all companies other than to "base rate entities" with a lower aggregated turnover to which a lower rate applies.

GST base

A comprehensive review of the current exemptions and special rules in the GST law which impact the size of the GST base should be reviewed. There is a trade-off between making concessions and exemptions available for certain classes of taxpayers and the increased revenue that could be obtained by removing them.

Conclusion

For a detailed discussion of these issues, please refer to our Budget submission.[1]

Reference

1 The Tax Institute, *2020-21 pre-Budget submission*, 23 October 2019. Available at taxinstitute.com.au/tisubmission/2020-21-pre-budget-submission.

Tax News – the details

by TaxCounsel Pty Ltd

November – what happened in tax?

The following points highlight important federal tax developments that occurred during November 2019.

Government initiatives

1. Tax compensation claims

On 4 November 2019, the government gave its response to the review of the treatment of small business tax cases under the Scheme for Compensation for Detriment Caused by Defective Administration (CDDA).

The review made 12 recommendations to improve outcomes for small businesses who make complaints about defective administration in the tax system. The government has accepted all 12 recommendations of the review, either in full, in part or in principle.

Key actions that the government is implementing include:

- ensure fair handling of CDDA claims by ensuring that claims are investigated and decided by officers who are not from a part of the ATO that was involved in the tax matters which may have led to the claim;
- for more serious cases, the investigation of a claim will be separated from the decision-making. These cases will also be escalated to senior levels for decision, with the Commissioner of Taxation himself deciding the outcomes where an independent reviewer is involved;
- for the most serious matters, there will be an opportunity for a complainant to comment on an investigator's preliminary views before a final decision is made and an opportunity to request a review of a decision;
- plausibility will be adopted as the standard of proof in CDDA tax matters to establish whether defective administration has occurred (instead of balance of probabilities);
- ATO procedures will require its staff to take into account a small business financial and personal capacity to respond to a review, audit or other compliance process;
- the Australian Small Business and Family Enterprise Ombudsman will establish a new assistance function to help small businesses understand how they can pursue CDDA claims; and
- the ATO will review and update its guidance material to ensure that making a claim is as simple as possible and decisions are explained in succinct everyday language.

2. Amending legislation

The *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019,* which makes a variety of amendments including in relation to the CGT small business concessions and deductions in respect of vacant land, was passed by parliament with amendments on 22 October 2019 and received the royal assent (and became law) on 28 October 2019.

The amendments that are made by the amending Act relate to:

- the tax treatment of concessional loans involving tax exempt entities;
- enhancing the integrity of the small business CGT concessions in relation to partnerships;
- the limiting of deductions for vacant land. It was these amendments that were the subject of amendment while the Bill was passing through parliament. The amendments are considered in the Tax Tips column of this issue of the journal (see page 294);
- the extension to family trusts of the anti-avoidance rule that applies to other closely held trusts that undertake circular trust distributions;
- the disclosure of business tax debt information of a taxpayer by taxation officers to credit reporting bureaus when certain conditions and safeguards are satisfied;
- the conferral on the Commissioner of functions and powers to develop and/or administer a framework or system for electronic invoicing; and
- the improvement of the integrity of the superannuation system by ensuring that an individual's salary sacrifice contributions cannot be used to reduce an employer's minimum superannuation guarantee contributions.

3. Foreign investors: CGT amendments

On 23 October 2019, an amending Bill (the Treasury Laws Amendment (Reducing Pressure on Housing Affordability Measures) Bill 2019*)* was introduced into parliament to make several CGT changes that affect non-residents.

These changes will, with effect from 7.30 pm (AEST) on 9 May 2017:

- remove the entitlement to the CGT main residence exemption for foreign residents other than where certain life events occur during the period that a person is a foreign resident where that period is six years or less; and
- modify the foreign resident CGT regime to clarify that, for the purpose of determining whether an entity's underlying value is principally derived from taxable Australian real property, the principal asset test is applied on an associate inclusive basis.

For properties held before 7.30 pm (AEST) on 9 May 2017, the CGT main residence exemption will only be able to be claimed for disposals that happen up until 30 June 2020, provided they satisfy the other existing requirements for the exemption. For disposals of these properties that happen from 1 July 2020, at the time of the CGT event, they will no longer be entitled to the exemption unless any of the following life events occur within a continuous period of six years of the individual becoming a foreign resident:

- either the foreign resident, their spouse or their child who was under 18 years of age has a terminal medical condition;
- their spouse, or their child who was under 18 years of age at the time of their death, dies; or
- the CGT event involves the distribution of assets between the foreign resident and their spouse because of their divorce, separation or similar maintenance agreements.

For properties acquired at or after 7.30 pm (AEST) on 9 May 2017, the CGT main residence exemption will no longer apply to disposals from that date unless certain life events (listed above) occur within a continuous period of six years of the individual becoming a foreign resident.

4. New IGTO reviews

On 31 October 2019, the Inspector-General of Taxation and Taxation Ombudsman announced the launch of two new investigations into aspects of the ATO's systems and procedures.

The investigations will examine and explore the following matters:

1. the rise in collectable debt levels — the underlying causes for the rise in uncollected, undisputed tax debts (called "collectable debts" by the ATO) will be examined; and
2. the tax administration of deceased estates — the ATO's approaches to dealing with deceased estate tax matters will be reviewed.

In a media release announcing the reviews, the Inspector-General of Taxation and Taxation Ombudsman stated that the reviews have arisen in response to both market feedback and the ATO's own annual report which showed a debt book of almost $45b, with collectable debt accounting for more than half of that amount. According to the ATO's figures, that collectable debt has risen every year for (at least) the past four years, both at a headline level as well as within each of the components making up the collectable debt.

In relation to the ATO management of deceased estates, the Inspector-General said that her office has received complaints about how difficult it can be to deal with tax matters for deceased estates. The management of this area by the ATO, its communications and processes, and any legislative constraints will be looked at in order to see what improvements might be made to streamline, improve and de-stress the process.

The Commissioner's perspective

5. Exploitation of restructure roll-over

The Commissioner has released a taxpayer alert in relation to certain arrangements that seek to exploit the CGT roll-over for trust restructures and that purportedly allow a unit trust to effectively dispose of a CGT asset to an arm's length purchaser with no CGT consequences (TA 2019/2).

Under the particular arrangements, a trustee of a unit trust (transferring trust) sells a CGT asset (relevant asset) with a large unrealised capital gain to an arm's length purchaser (purchaser) for an agreed purchase price (purchase price) by way of:

- transferring the relevant asset to a trustee of a new unit trust (receiving trust) for the purchase price, which gives rise to a debt owing to the transferring trust;
- choosing roll-over under Subdiv 126-G of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) for the transfer;
- the purchaser subscribing for new units in the receiving trust equal in value to the purchase price; and
- the receiving trust repaying the debt to the transferring trust with the funds received from the issue of the new units.

By entering into these arrangements, rather than selling the relevant asset directly to the purchaser, the transferring trust is able to transfer the underlying ownership of the relevant asset to the purchaser, but purportedly avoids tax on the large capital gain that would otherwise have been made with an asset sale.

The taxpayer alert lists a number of aspects of the arrangements that concern the ATO, including whether, for a number of reasons, the conditions for Subdiv 126-G roll-over relief are met in respect of the arrangement.

Interestingly, the reasons mentioned also include:

- the parties have entered into the arrangement in circumstances where a direct sale of the relevant asset by the transferring trust to the purchaser would have been simple, viable and commercially expected;
- the commercial substance of the arrangement is a sale of the relevant asset by the transferring trust to the purchaser, but the divergent form of the arrangement is explicable only by the tax advantage purportedly obtained by the transferring trust; and
- the transferring trust receives (and the purchaser pays) the same total sum under the arrangement as would have been the case if the asset were sold directly to the purchaser.

These reasons appear to attempt to invoke the fiscal nullity doctrine that is applied by the United Kingdom courts but which was rejected by the High Court in *John v FCT*[1] as having any application in Australia because of the presence of a general anti-avoidance provision.

The Commissioner indicated in the taxpayer alert that it is considered that Pt IVA of the *Income Tax Assessment Act 1936* (Cth) may apply to the arrangements where they would otherwise qualify for roll-over relief.

6. Assumed liabilities and cost base

A recently released draft taxation determination is to the effect that, where a liability is assumed on the acquisition of a CGT asset, the assumed liability is excluded from the cost base of the asset to the extent that expenditure on discharge of the liability is deductible (TD 2019/D11).

If a taxpayer acquires a CGT asset from another entity and that asset is subject to a liability, the first element of the cost base of the asset includes the amount of the liability that is assumed by the taxpayer (s 112-35 ITAA97). However, the liability subsequently does not form part of the cost base of the asset to the extent that the taxpayer has deducted, or can deduct, the expenditure in discharging that liability (s 110-45(2) ITAA97).

The draft determination states that it is considered that there will be limited circumstances in which a deduction is available for the discharge of a liability to which s 112-35 applies.

7. Work expense deductions

The Commissioner has released a draft ruling that sets out when an employee can deduct a work expense (often called a work-related expense) under the general deduction provision (s 8-1 ITAA97) (TR 2019/D4).

One point highlighted by the draft ruling is the importance of facts and circumstances. For expenses incurred by employees, the fundamental question is whether an expense is incurred in the course of earning employment income. This involves considering the proper scope of the particular taxpayer's work activities to determine if the circumstances of the expense have a sufficiently close connection to earning the employment income.

This means that an expense deductible for a taxpayer in one job is not necessarily deductible for another taxpayer holding a similar job. Variations in employment duties may have a significant bearing on the extent of connection between an expense item and the earning of income, which could explain differences in deductibility outcomes.

However, some expense types almost always have a relevant connection to employment activities. For example, union membership or relevant professional association subscriptions relating to employment usually have a sufficiently close connection to earning income as an employee.

More difficult are cases where an expense ordinarily bears the characteristics of an everyday personal expense. Although generally not deductible, a deduction may be allowed if the particular employment context creates a close connection between the expenditure and the production of assessable income through work activities; that is to say, "the occasion of the expenditure is to be found in the income-earning activity itself".

It is pointed out that the principles outlined in the draft ruling are supported by additional guidance which covers specific occupations and common situations. Specifically, the *Employees guide for work expenses* was co-developed with the draft ruling to provide practical guidance on the most common scenarios, and to provide contextual information on related topics such as apportionment and substantiation.

In addition, the ATO has published a wide variety of other material that deals with more specific issues or expense types. This material includes legally binding taxation rulings and taxation determinations, as well as products that are not legally binding, including income tax rulings, miscellaneous taxation rulings, ATO interpretative decisions and law administration practice statements.

8. Capital gains and foreign income tax offset limit

A recently released draft taxation determination is to the effect that capital gains are not included under s 770-75(4)(a)(ii) ITAA97 when calculating the foreign income tax offset limit (TD 2019/D10).

A foreign income tax offset (FITO) may be available to a taxpayer under Div 770 ITAA97 to reduce or eliminate Australian income tax that would otherwise be payable on amounts included in the taxpayer's assessable income, where foreign income tax has also been paid on the same amounts. The amount of the offset is based on the foreign income tax paid that counts towards the taxpayer's offset, subject to the FITO limit determined under s 770-75.

The FITO limit calculation involves a comparison between Australian tax actually payable and the Australian tax that would be payable if certain income, and deductions reasonably related to that income, were disregarded. The income to be disregarded is set out in s 770-75(4)(a)(i) and (ii) which are to the effect:

> "(i) so much of any amount included in the taxpayer's assessable income as represents an amount in respect of which the taxpayer paid foreign income tax that counts towards the tax offset for the year; and
>
> (ii) any other amounts of ordinary income or statutory income from a source other than an Australian source ..."

Generally, the higher the amount of income captured under (i) and (ii) above, the higher the FITO limit.

If the taxpayer has made a capital gain in respect of which the taxpayer has not paid any foreign income tax, no amount in respect of that capital gain will be included under (i) above. The capital gain will also not be included under (ii) above because:

- amounts are included under (ii) above if they are amounts of "ordinary income" or "statutory income" from a "source other than an Australian source";
- a net capital gain is an amount of statutory income. Each capital gain is not an amount of "statutory income";
- a net capital gain does not have a source; and
- (ii) above does not allow a net capital gain (the singular amount of "statutory income") to identify capital gains that have been included in working out a net capital gain.

Recent case decisions

9. Backpacker tax: test case

The Federal Court (Logan J) has held that the Australia–UK double tax agreement (DTA) protected a British working holiday-maker, who was an Australian tax resident, from the so-called "backpacker tax" (*Addy v FCT*[2]).

The taxpayer (Ms Addy) was a British citizen who lived in Australia from 20 August 2015 to 1 May 2017, apart from a two-month period in early 2016 when she toured South-East Asia. She arrived on a 12-month working holiday visa, but obtained a second 12-month visa before the first one expired. She qualified for the second visa by working on a farm in Western Australia for two months in 2016.

In the 2016-17 income year, Ms Addy worked as a waitress in Sydney. The issue in the case was whether she had to pay tax on her income at the working holiday rate (15% on the first $37,000 of taxable income) — the "backpacker tax".

The first question to be decided was whether Ms Addy was a resident of Australia for tax purposes. Logan J held that she was. For most of her time in Australia, Ms Addy lived with a friend in share house accommodation in Earlwood in Sydney, having arranged it before leaving the UK. It was also her postal address here. She also had two bank accounts and a pre-paid mobile phone account in Australia.

Logan J concluded that Ms Addy was a resident according to the ordinary meaning of that term. She was settled in Sydney at the Earlwood house. It was her home base for employment, living and social purposes. There was nothing itinerant about her life. Logan J also held that Ms Addy was a resident on the basis of the "183-day test" as, by 2016-17, the Earlwood house had become her usual place of abode.

Logan J also held that Ms Addy's residency ceased when she left Australia on 1 May 2017. This meant that she had a part-year residency period which commenced on 1 July 2016 and concluded on 30 April 2017.

Operation of DTA

The test case issue of the case was whether art 25 of the Australia–UK DTA applied so that Ms Addy should pay tax at the same rates that apply to Australian nationals who are tax residents.

Article 25 is a "non-discrimination clause" which provides that nationals of the one country (in this case the UK) should not be subject to tax in the other country (in this case Australia) that is "more burdensome" than the tax to which nationals of the latter country (Australia) "in the same circumstances" are or may be subjected.

Logan J said that art 25 is intended to prevent discrimination based solely on a difference that is prohibited by the article, one of which is nationality. The "backpacker tax" discriminates on the basis of nationality as it can never apply to an Australian national — it only applies to working holiday-makers. Accordingly, Logan J held that art 25 protected Ms Addy and she was entitled to pay tax at the same rates as Australian nationals in the same circumstances as her (including the benefit of the tax-free threshold).

Another recent residence case

It may be noted that, in another recent case (*Stockton v FCT*[3]), Logan J held that an individual who was a United States national and who was in Australia for 10 months was an itinerant while here. She worked in two cities, moved from house to house within those cities and travelled quite extensively in Australia. Logan J concluded that the individual was not a tax resident of Australia.

10. Capital or revenue expenditure

The High Court (Keifel CJ, Bell, Gagelar, Nettle and Gordon JJ) has unanimously reversed a majority decision of the Full Federal Court and held that certain expenditure incurred by a taxpayer in acquiring gaming machine entitlements under statutory provisions was properly to be regarded as on capital account and so was not allowable as a general deduction (*FCT v Sharpcan Pty Ltd*[4]).

Spazor Pty Ltd (Spazor) was the trustee for the Daylesford Royal Hotel Trust (the trust), and on 8 August 2005, in its capacity as trustee, acquired the business undertaking of the Royal Hotel located in in the Hepburn Shire of Victoria, for $1,025,000. The trustee conducted that business until it sold the business on 9 November 2015.

At the date of the acquisition by the trustee, the business undertaking of the Royal Hotel involved deriving revenue from a number of integrated activities including: providing accommodation in its 11 guest rooms; sales of food and drink at its restaurant, café and public bar; gaming on 18 electronic gaming machines onsite; and wagering (on racing and keno).

As to the gaming activities, from 2005 until 15 August 2012, the trustee engaged in gaming activities onsite, consistent with the *Gambling Regulation Act 2003* (Vic) (the Act), on the footing that Spazor had been granted a "venue operator's licence" as the operator of the venue on which gaming occurred on 18 machines, and Tattersalls Gaming Pty Ltd (Tattersalls) had been granted a "gaming operator's licence", enabling it to conduct gaming at the Royal Hotel by and through the 18 machines at the venue, taken together with a venue operator's agreement made between Tattersalls and the trustee for that purpose.

Under these arrangements, Tattersalls was the gaming operator of 18 gaming machines which it owned and operated at the Royal Hotel as an approved venue. The venue was operated by the trustee as an approved venue operator. Revenue derived from conducting gaming was derived by Tattersalls as the gaming operator. The trustee, however, derived income in respect of gaming conducted on the site of the Royal Hotel (by Tattersalls) in the form of a percentage of the net revenue from gaming.

All of these structural arrangements changed, however, by reason of amendments made to the Act in 2009. The "main purpose" of the amendments was to "substantially restructure the gaming industry", with effect from 16 August 2012, by providing for the creation and allocation of "gaming machine entitlements under which gaming by means of gaming machines will be authorised" and by "providing for a new licence for the monitoring of the conduct of gaming" and by "imposing certain ownership and related person restrictions in relation to licensees and persons registered on the relevant Roll".

As a result of these amendments, gaming on the 18 machines onsite became gaming conducted by the trustee rather than Tattersalls. In order to conduct gaming in respect of the 18 machines, the trustee had to acquire a gaming machine entitlement (a GME) in respect of each machine. In the absence of such an entitlement, the trustee could not conduct gaming and, as a result, could not generate income from gaming as part of the business of the Royal Hotel.

The mechanism by which the state of Victoria proposed to allocate GMEs to hotels and clubs was by means of an auction process. In the final round auction conducted on 10 May 2010, the trustee was successful in its bid for 18 GMEs. The total cost of the 18 GMEs was $600,300 (including a $10,000 non-refundable bond) or $33,350 per GME. Mr Canny, for the trustee, took up the option of paying the acquisition price by quarterly payments under a deferred payment arrangement over six years.

In a joint judgment, the High Court said that authority was clear that the test of whether an outgoing is incurred on revenue account or capital account primarily depends on what the outgoing is calculated to effect from a practical and business point of view. Identification of the advantage sought to be obtained ordinarily involves consideration of the manner in which it is to be used and whether the means of

acquisition is a once-and-for-all outgoing for the acquisition of something of enduring advantage or a periodical outlay to cover the use and enjoyment of something for periods commensurate with those payments. Once identified, the advantage was to be characterised by reference to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organisation and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; and between an enterprise itself and the sustained effort of those engaged in it. Thus, an indicator that an outgoing is incurred on capital account is that what it secures is necessary for the structure of the business.

The GMEs were assets of enduring value authorising the holder to conduct gaming activities. When the trustee's arrangements with Tattersalls expired, the trustee purchased the GMEs as assets of enduring value to replace the extinguished arrangements and thereby provide itself with the means of continuing to operate the gaming aspect of the hotel business for the next ten years. The GMEs were necessary for the structure of the business because the conduct of gaming in an approved venue is only lawful if the venue operator holds a GME. The GMEs were a barrier to entry. The purchase price was paid in several instalments, but it was in the nature of a once-and-for-all outgoing for the acquisition of an enduring asset. This was not a case of regular and recurrent payments for the use of an asset.

11. Discount capital gain concession

The Full Federal Court (Kenny, Kerr and Moshinsky JJ) has unanimously dismissed appeals brought by taxpayers from a decision of Thawley J in which his Honour held that the special rules that can extend the period of ownership of a CGT asset for the purposes of applying the CGT discount capital gain concession where certain CGT roll-over relief has operated were not satisfied in the particular circumstances of the case before the court (*Hart v FCT*[5]).

The case involved amended assessments issued to five taxpayers for the 2007-08 income year on the basis that the CGT discount capital gain concession was not applicable to capital gains that arose on the disposal of certain shares that had been acquired in a transaction that qualified for roll-over relief.

The decision serves as a reminder that, when seeking to utilise CGT roll-over relief, great care must be taken to ensure that the transaction is a qualifying transaction, and that there are no unexpected consequences. It appeared that if the series of roll-overs had not included a roll-over covered by s 115-34(1)(c) ITAA97, the gain would have been a discount capital gain.

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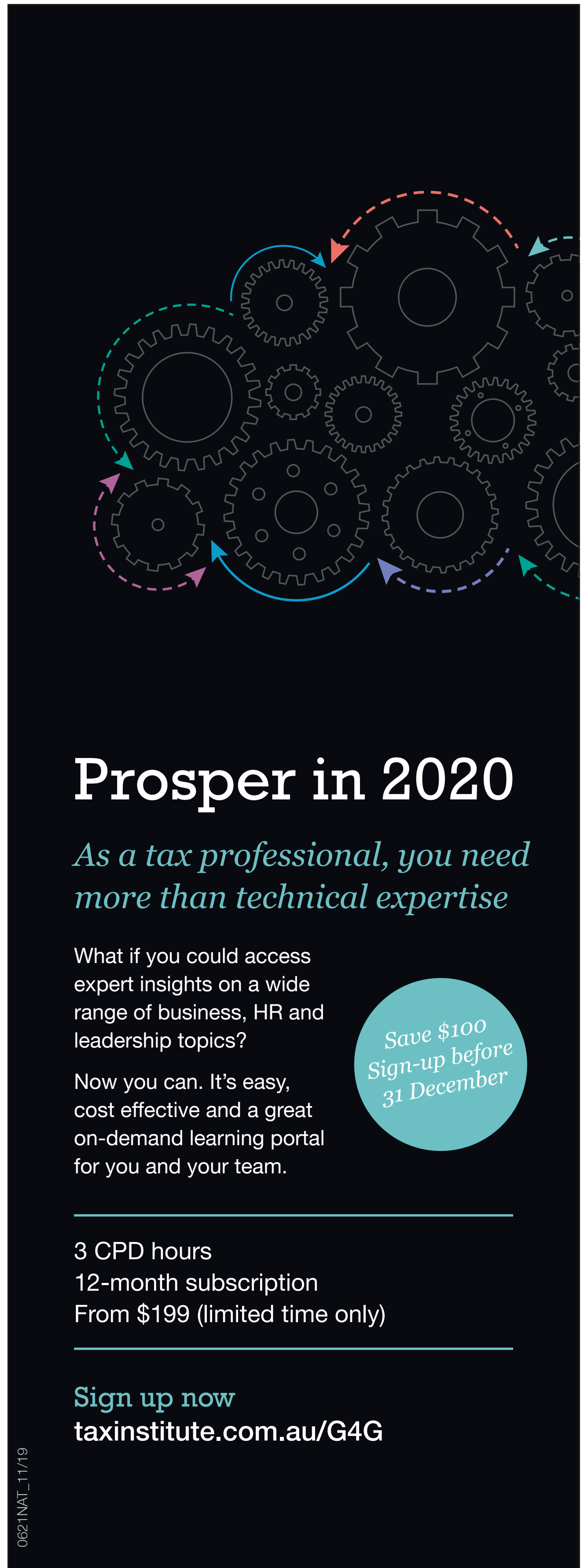
1 [1989] HCA 5.
2 [2019] FCA 1768.
3 [2019] FCA 1679.
4 [2019] HCA 36.
5 [2019] FCAFC 179.



Tax Tips

by TaxCounsel Pty Ltd

Vacant land deductions

During its passage through parliament, changes were made to the amendments that in certain circumstances operate to deny deductions that relate to the holding of vacant land.

Background

The amending legislation to enact a prohibition on certain taxpayers claiming deductions for losses and outgoings that relate to the holding of what may be called vacant land received the royal assent and became law on 28 October 2019. The amending Act is the *Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Act 2019*.

Importantly, amendments were made to the amending Bill in the Senate that relax the operation of the deduction prohibition in several significant respects. A supplementary explanatory memorandum was issued in relation to these amendments.

The Tax Tips column in the September issue of the journal considered the terms of the amendments as they were originally introduced into parliament. This column considers the amendments that were made to the amending Bill in the Senate (called, for convenience, "the Senate amendments").

The vacant land deduction provisions are contained in a new s 26-102 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and apply in relation to losses or outgoings incurred on or after 1 July 2019. It is immaterial when the land was acquired, that is, whether the land was acquired before, on or after 1 July 2019 (item 4, Sch 3 amending Act).

The rationale for the amendments

The vacant land deduction amendments had their genesis in an announcement in the 2018-19 Budget that, from 1 July 2019, the integrity of the tax system would be improved by denying certain deductions for expenses associated with holding vacant land.

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

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

The Senate amendments in brief

The Senate amendments to the vacant land deduction provision are intended to make clear that deductions may be available for potentially affected entities that incur losses and outgoings relating to the holding of land:

- that becomes (or is treated as being) vacant due to significant and unusual events or occurrences outside the reasonable control of the entity, such as fire, flood, or substantial building defects (see "Exceptional circumstances exclusion" below);
- while a business of primary production is carried on on the land (see "Primary production exclusion" below); or
- that is used by another entity under arm's length arrangements in carrying on a business (see "Carrying on a business exclusion" below).

Entities that are affected

When considering the potential for the operation of the vacant land deduction provision, it is important to always keep in mind that the kinds of entity that may be potentially affected is restricted.

All kinds of entity are potentially affected with the exception of:

- corporate tax entities;[1]
- superannuation plans (other than self-managed superannuation funds);
- managed investment trusts;
- public unit trusts; or
- unit trusts or partnerships of which each member is an entity that falls within any of the above (s 26-102(5)).

Thus, any entity that is not covered by the above items is potentially affected by the new rules. For example, a trust, even if it is a unit trust that does not fall within the last item in the above list, will be potentially affected, even if it has a corporate trustee.

Exceptional circumstances exclusion

One of the exclusions introduced by the Senate amendments is that the prohibition on the deductibility of losses and outgoings relating to holding vacant land does not apply where a substantial and permanent structure that was on the land (which would have meant that the holding costs could have been deductible by an entity) ceased to ensure deductibility because of the occurrence of a circumstance affecting the structure that was exceptional and outside of the reasonable control of the entity (or of any relevant associated or connected entity) (s 26-102(6)).

It may be noted that residential premises are treated as not being a substantial and permanent structure if they have been constructed or substantially renovated while the entity held the land and the premises are not able to be occupied under the law or are not either rented or available for rent (s 26-102(4)). If an exceptional circumstance affects residential premises and, as a result, the premises are treated as not

being a substantial and permanent structure, this would satisfy the requirement that the circumstances have resulted in there being no usable substantial and permanent structure (see further below).

The supplementary explanatory memorandum states that relevant exceptional circumstances could involve the structure being destroyed or damaged to the point where it cannot be used (for example, by a fire).

Relevant exceptional circumstances could also involve something that affects the property when first held or which is discovered later to be affecting the property that prevents it being used.

In the case of residential premises of the sort identified above, relevant exceptional circumstances could involve the premises being rendered unable to be made available for rent or lawfully occupied. This could, for example, include the discovery of asbestos or a substantial building defect that renders the building unsafe for occupation.

If the substantial and permanent structure was residential premises, then the residence must have, prior to the time of the circumstance, been treated as being a substantial and permanent structure. That is, if the residential premises was constructed or substantially renovated while the entity held the land, it must have been able to be occupied under the law and have been either rented out or have been available to be rented prior to the circumstance occurring.

In effect, the entity must have satisfied the general requirements (under s 26-102) for the cost of holding the relevant land to be deductible despite the restriction before the exceptional circumstance occurred.

Exceptional circumstances

For the exclusion under consideration to apply, there must have been an exceptional circumstance outside the control of the entity or related entities (s 26-102(6)(b) and (c)).

In addition to the points noted above, the supplementary explanatory memorandum states that, in this context, exceptional circumstances mean significant and unusual events or occurrences such as natural disasters, major building fires and substantial building defects. A circumstance will be outside the reasonable control of the entity if the entity did not cause the circumstances and there was nothing a reasonable person in the position of the entity should have reasonably done to prevent the circumstance.

The exclusion applies if the circumstance has the effect of wholly or mainly affecting an existing structure so that it is no longer a substantial and permanent structure that is in use or available for use, or, if it is residential premises, is no longer treated as a substantial and permanent structure.

The exclusion does not apply to circumstances that do not affect the structure, for example, if the taxpayer is an individual and suffers financial hardship that delays the completion of renovations.

In some cases, the absence of a structure may arise both from exceptional circumstances beyond the control of the entity and other circumstances. In this kind of case, the exclusion will apply if the exceptional and uncontrollable circumstance is the main cause of the absence.

By way of example, the supplementary explanatory memorandum states that the absence of a substantial and permanent structure on land may result from two circumstances, the destruction of a prior structure by fire and delays in the construction of a replacement structure. In general, the exceptional circumstance of the fire would be expected to be the main circumstance resulting in the absence of a substantial and permanent structure. While the building delays are also a circumstance contributing to the absence of a structure, their effect would usually be considered to be incidental to the effect of the fire.

Three-year limit

Where the exceptional circumstances requirements are met, deductions can be claimed for three years from the date the exceptional circumstance first resulted in there being no relevant substantial and permanent structure on the land (s 26-102(6)(d)). This is intended to ensure that this exception does not provide indefinite access to deductions for vacant land even after the effect of the circumstances are likely to have passed.

This period can be extended by the Commissioner. The supplementary explanatory memorandum states that it is expected that the Commissioner would allow an extension where the reasons for the failure to replace the structure are beyond the control of the individual, or due to the size of the structure, it is unable to realistically be completed in that time.

Record-keeping

The amendments require the entity that relies on the exemption to keep written records of the circumstance and its effect on the affected structure for the entity for five years after the end of the income year in which the cost was incurred (s 26-102(7)).[2]

Primary production exclusion

The Senate amendments also provide that the restriction on deducting the costs of holding vacant land does not apply if, at the critical time:

- the land was leased, hired or licensed to another entity;
- the entity holding the land or (broadly) an affiliate or a connected entity, is carrying on a business of primary production;
- the land does not contain residential premises; and
- residential premises are not being constructed on the land (s 26-102(8)).

It was explained that this exclusion is intended to address concerns that primary production activities may be inappropriately affected by the denial of losses or outgoings as such activities often involve the use and management of significant areas of vacant land, not all of which is held by the entity carrying on the primary production business.

Lease, hire or license

For the primary production exclusion to apply, the land must be leased, hired or licensed to another entity. Effectively this means that the land must be being used to generate rent etc. The other entity can be related to the entity that holds the land.

Carrying on a primary production business

For the primary production exclusion to apply, either the entity that holds the land or a related entity must carry on a primary production business. Primary production business is broadly defined (in s 995-1(1) ITAA97) and includes all forms of plant or animal cultivation and many related activities.

The supplementary explanatory memorandum explains that primary production is often closely tied to land and many entities involved in primary production will often have significant landholdings associated with the primary production activities. Often this land will not contain any substantial and permanent structures because of its link to primary production activities and may be held under different arrangements to reflect business needs and personal circumstances.

The primary production exclusion ensures that arrangements undertaken by entities linked to a primary production business do not result in deductions being denied for the cost of holding this land if it is rented etc to produce income.

Where there are residential premises

The primary production exclusion does not apply to land that contains residential premises or on which residential premises are being constructed (s 26-102(8)(c) and (d)). Residential premises has the same meaning as it does for GST purposes.

When construction commences is determined based on the facts and circumstances, consistent with the rules for determining the deductibility of the capital costs under Div 43 ITAA97.

It was explained that land being used for residential purposes is distinct from land that is usually held in connection with a primary production business and that this presents particular integrity risks as residential premises can be readily used for private purposes in addition to being available for rent. Excluding such land from the primary production exclusion means that it addresses any potential consequences for landholdings relating to primary production without giving rise to these integrity risks.

Carrying on a business exclusion

The Senate amendments also provide that the restriction on deducting the costs of holding vacant land does not apply if, at the critical time:

– the land is leased, hired or licensed to another entity on an arm's length basis;

– the land is in use or available for use, in carrying on a business;

– the land does not contain residential premises; and

– residential premises are not being constructed on the land (s 26-102(9)).

It was explained in the supplementary explanatory memorandum that this exclusion is intended to address concerns that certain income producing activities involving making land available for business use may not have constituted carrying on a business by the holder of the land.

Lease, hire or license

For this exclusion to apply, the land must be leased, hired or licensed to another entity. Effectively this means that the land must be being used to generate income from rent etc. The other entity can be related to the entity that holds the land.

However, while the parties to the rental arrangement may be related, the arrangement must be entered into on an arm's length basis. This means that, even if the parties are related, the arrangement must be consistent with what independent parties in the same situation might agree to. This ensures that the exclusion only applies to genuine commercial arrangements.

Use in carrying on a business

For the carrying on business exclusion to apply, the land must be used or available for use in carrying on a business.

While there was already an exception for land being used by the entity or certain related entities in carrying on a business (s 26-102(2)), the new exclusion applies if land is used by another entity in carrying on a business.

The supplementary memorandum states that land is not in use or available for use by a business if the land is being used or is available for use by a business solely for the purpose of providing services or other supplies to the entity that holds the land.

Residential premises

The carrying on a business exclusion does not apply to land that contains residential premises or on which residential premises are being constructed. This is consistent with the exclusion for land held by an entity linked to a primary production business.

An observation

The vacant land deduction provision is a further illustration of the way substantial complexity can be added to an already over complex legislative regime. It is suggested that attention needs to be paid to what can be done to reduce the problems for taxpayers and their advisers seeking to navigate the provisions of the income tax law.

One point that may be noted is that, at present, taxpayers and their advisers seeking to gain some certainty on a point and to avoid costly penalties are in many instances confined to utilising the private ruling regime which gives effect to ATO's views. Is it possible that an appropriate body that is independent of the ATO could issue private rulings in appropriate circumstances?

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References

1 An entity will be a corporate tax entity if it is a company, a corporate limited partnership or a public trading trust (s 960-115 ITAA97). The other categories of excluded entities are also defined in the ITAA97.

2 If the entity fails to keep the written records, the administrative penalty for failure to keep or retain records in s 288-25 of Sch 1 to the *Taxation Administration Act 1953* (Cth) would apply. Presumably, an entity which does not keep the required records may discharge the onus of proving an assessment to be excessive by other evidence: see *Coshott v FCT* [2015] FCAFC 71.

Mid Market Focus

by Daryl Jones, CTA, HLB Mann Judd Brisbane

Testamentary trusts: reforms at a trickle

With the taxation of testamentary trusts under increased scrutiny, this article provides a timely reminder when planning for the use of testamentary trusts.

Introduction

While the focus of this article is on the recent changes for testamentary trusts, it is worth noting that the broader debate with the reform of discretionary trusts resurfaced on 30 July 2017 with the release of the Labor party's policy "discretionary trusts reform", with a targeted standard minimum rate of tax (30%) for discretionary trust distributions to commence from 1 July 2019.

In the 2018-19 Budget handed down on 8 May 2018, the government announced that:

– from 1 July 2019, the concessional tax rates for minors receiving income from testamentary trusts is to be limited to income derived from assets that are transferred from the deceased estate or the disposal of investments of those assets; and

– the extension to family trusts of a specific anti-avoidance rule that applies to other closely held trusts that engage in circular trust distributions.

In relation to the latter measure, the government released for consultation draft legislation on 12 October 2018 to impose trustee beneficiary non-disclosure tax (at the top marginal rate) on circular trust distributions made by a family trust where that family trust becomes presently entitled to the income it had previously distributed to a trustee beneficiary.

Complex distributions continue to remain a focus of investigation of the Tax Avoidance TaskForce — Trusts.[1]

Testamentary trusts

We, as advisers to our clients, make them aware of the use of testamentary trusts as part of their estate and tax planning needs and to provide for their families in terms of:

– protecting estate assets for the future generations; and

– the potential tax benefits with effective tax planning.

Tax integrity measure – testamentary trusts

Overview

When announcing this Budget measure, the government stated:[2]

> "Currently, income received by minors from testamentary trusts is taxed at normal adult rates rather than higher tax rates that generally apply to minors. However, some taxpayers are able to in appropriately obtain the benefit of this lower tax rate by injecting assets unrelated to the deceased estate into the testamentary trust. This measure will clarify that minors will be taxed at adult marginal rates only in respect of income a testamentary trust generates from assets of the deceased estate (or the proceeds of disposal or investment of these assets)."

On 3 October 2019, the government released exposure draft legislation[3] to give effect to this measure, to commence from 1 July 2019.

The Bill primarily amends Div 6AA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) to ensure that the tax concessions available to minors in relation to income from a testamentary trust only apply in respect of income generated from assets of the deceased estate that are transferred to the testamentary trust (or the proceeds of the disposal or investment of those assets).

Application of Div 6AA

Division 6AA primarily contains a set of anti-avoidance rules to tax unearned income of minors at penalty rates of tax (66% applying above the tax-free threshold of $416 and the top marginal rate to amounts over $1,307).[4]

Pursuant to s 102AG(1) ITAA36, where a beneficiary of a trust estate is a prescribed person in relation to a year of income, Div 6AA applies to so much of the share of the beneficiary of the net income of the trust estate of the year of income as, in the opinion of the Commissioner, is attributable to assessable income of the trust estate that is not, in relation to the beneficiary, "excepted trust income".

Excepted trust income

As currently drafted, income from a testamentary trust is "excepted trust income" under s 102AG(2)(a) where the assessable income of the trust estate resulted from:

– a will, codicil or an order of a court that varied or modified the provisions of a will or codicil; or

– an intestacy or an order of a court that varied or modified the application, in relation to the estate of a deceased person, of the provisions of the law relating to the distribution of the estates of persons who die intestate.

The Bill amends s 102AG(2)(a) by inserting new subs (2AA) to provide the conditions for income from a testamentary trust to qualify as excepted trust income. Relevantly, the conditions are as follows:

1. the assessable income must be derived by the trustee of the trust estate from property (defined in s 102AA(1) ITAA36 to mean real or personal property, including money); and
2. the property must satisfy any of the following (all to ensure that assets unrelated to the deceased estate are injected into the testamentary trust):

a. the property was transferred to the trustee of the trust estate to benefit the beneficiary from the estate of the deceased in accordance with s 102AG(2)(a);
b. the property, in the opinion of the Commissioner, represents accumulations of income or capital that satisfies requirement (a) above; or
c. the property, in the opinion of the Commissioner, represents accumulations of income or capital from either property that satisfies requirement (b) above or property that has already satisfied this requirement.

The exposure draft explanatory materials provide some basic examples to illustrate the effect on excepted trust income where assets are injected into a testamentary trust from sources outside the deceased estate.

Conclusion

The proposed amendments clarifying the law are unlikely to impact taxpayers using testamentary trusts in their estate and succession planning. Being a targeted integrity measure, it should ensure that the tax concessions available using testamentary trusts can apply as intended without relying on the general anti-avoidance rules in Pt IVA ITAA36.

With ongoing reforms, including reductions in personal income tax rates, testamentary trusts will maintain a significant role in the estate and succession planning of our clients.

Daryl Jones, CTA
Director – Tax Consulting
HLB Mann Judd Brisbane

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1 ATO, *Current issues with trusts and the tax system*, 25 January 2019.

2 Australian Government, Budget 2018-19, *Budget measures, Budget paper no. 2, part 1: revenue measures*, p 44.

3 Treasury Laws Amendment (Measures for Consultation) Bill 2019: testamentary trusts.

4 S 13 of the *Income Tax Rates Act 1986* (Cth).

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Uphar Chhabra, Manager Accountant, Butler Pty Ltd – Chartered Accountants

Can you provide a brief background of your career in tax?

With eight years' experience, I work as a senior accountant in a Ballarat-based public practice. As part of my role, I look after business clients and assist them with their annual tax compliance and other tax issues. My client base is from various industries such as retail, manufacturing, construction, wholesale and medical.

What is the most valuable aspect of studying with the Institute?

I valued the in-depth discussion on the fundamentals of GST and international tax, along with other topics covered in CTA2B. The study material flow is in a logical order and easy to follow.

What are your areas of new confidence?

GST, corporate and international tax.

What was the reason for undertaking study with the Institute?

To strengthen my tax knowledge in order to move out of compliance and into tax advisory.

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

I would like to complete CTA3 Advisory and achieve the CTA designation.

What are the challenges of juggling study and work?

Time management. It is always a challenge to manage time between work, a young family, study and other commitments. My tip is to draft a plan, stick to it, and know your material. I always aim to stay a week ahead of my recommended study plan.

What advice do you have for other tax professionals considering the CTA Program?

Study hard, it is worth it!

Chris Harris, Senior Tax Analyst, Pitcher Partners

Can you provide a brief background of your career in tax?

I moved into an accounting career with a Master of Professional Accounting, finishing in 2013. I spent three years in business services at a small firm and then a year at a Big 4 firm, before moving into my current role in tax consulting at Pitcher Partners. My current role mainly consists of drafting tax advice for restructures, capital gains tax and general SME tax issues, as well as tax-effect accounting, significant transactions and income tax consolidation for larger corporate groups.

What is the most valuable aspect of studying with the Institute?

The Corporate Tax course was a good refresher about some aspects of corporate transactions, such as capital reductions, buy-backs and tax consolidation. The case study was a substantial piece of advice as well, so the research and writing process for that was useful practice of an everyday skill.

What are your areas of new confidence?

The course had a good discussion about some of the technical issues involved in calculating various aspects of the R&D tax incentive. I've never had to deal with determining feedstock adjustments in practice, or some of the complications regarding balancing adjustments on depreciating assets used wholly or partly for R&D activities, so it was good to get some theoretical grounding.

What was the reason for undertaking study with the Institute?

My previous work experience was light on practical corporate tax work before my current role, hence I thought it best to undertake some training to get some background. It was a good way to reinforce my understanding of some of the technical issues involved. It's also an interesting area of tax.

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

I haven't decided yet, but I think I might do CTA3 Advisory in 2020.

What are some challenges of juggling study and work?

For me, it's key to be flexible when combining study and work. It's important to keep on top of study but it's also important to live your life. I tried to spend time after work each night getting through the readings and writing the case study to make sure I still had time to relax on weekends. There comes a point where overworking just becomes counterproductive.

What advice do you have for other tax professionals considering the Tax Agent Program?

I think there's a lot of value in spending a bit of time studying aspects of taxation that you don't encounter every day, so you have the toolkit to identify client issues, if and when, they come up. It's also useful to get some reinforcement of the legislation, case law and ATO pronouncements involved in your day-to-day work to make sure you have a good grip on the fundamentals.

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Senior Manager
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Member Profile

This month's column features Kyriacos Savvas, CTA, from Kostkas Accountants and Advisors, Northern Territory.

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2015

Areas of specialty

My time at Kostkas has enabled me to develop a strong knowledge base in various areas of taxation, including CGT, GST and small business entities. I have been able to apply this knowledge to clients operating in the construction, retail, agricultural and hospitality industries.

Why are you a member of The Tax Institute?

I originally joined The Tax Institute as it was a requirement of undertaking the study to obtain the Chartered Tax Adviser (CTA) designation. I will continue to hold my membership with The Tax Institute as, through the CTA program and the CPD events it provides, I have developed a strong awareness in many areas of tax which I have found extremely useful in public practice.

How is your membership beneficial to your practice and clients?

As a firm, Kostkas has found that The Tax Institute not only provides great sources of ongoing CPD, but also an excellent arena for discussion in areas of tax that we always find relevant to our practice and clients. We have also been able to develop strong relationships with various tax professionals through The Tax Institute and this has been very useful in servicing our clients.

How did you end up in tax?

While in my second year of university, Kostkas had put out a job offer for trainee accountants. I applied and got the job. Admittedly, at that time, I was never really sure it was the right move, but it has since proven to be a great choice.

What are the challenges for tax practitioners this year?

Understanding technology and how to adapt to the changes it brings is definitely something that is relevant to all members of the tax profession. In my opinion, this currently is, and will continue to be, one of the biggest challenges for tax practitioners. Another rising challenge is the approach that the ATO takes towards the administration of tax law and how it impacts taxpayers (two examples being the one-size-fits-all mantra used in relation to travel expenses and rental properties, and the implementation of the GST and CGT withholding regimes that have impacted many Australians).

Most memorable career moment to date

Completing the CTA course through The Tax Institute was a significant achievement for me, as well as taking up an equity share in Kostkas.

How do you relax?

I enjoy sports and spending time with family and friends, but I am most relaxed when I am out at one of the hunting reserves here in the Northern Territory.

Advice to those entering the profession

The best advice I have is to maintain active business and social interests outside of your chosen area of the tax profession. I believe maintaining a balanced lifestyle plays a significant role in staying motivated and ensuring longevity in your chosen career.

Residence tests for individuals: impact of the Harding decision

by Michael Blissenden, Professor of Law, University of Western Sydney, Sylvia Villios, Senior Lecturer, University of Adelaide, and Paul Kenny, Associate Professor of Law, Flinders University

The High Court has refused the ATO special leave to appeal from the Full Federal Court decision in *FCT v Harding*. This case has particular importance for individual taxpayers attempting to determine whether they are Australian residents or non-residents for income tax purposes. The two tests directly affected by the *Harding* case are the domicile test and the 183-day test as per s 6(1) of the *Income Tax Assessment Act 1936*. This article analyses the Full Federal Court decision in Harding and provides an insight as to how the two tests should be applied according to law. In so doing, the article dissects IT 2650 and TR 98/17, and suggestions are made that those rulings need to be withdrawn or substantially revised.

Overview

The recent refusal by the High Court to grant special leave to the Commissioner in *FCT v Harding*[1] means that the unanimous Full Federal Court decision now stands.[2] The Full Federal Court decision has major implications for the long-established views of the ATO as outlined in IT 2650 and TR 98/17 concerning the domicile and the 183-day tests for an individual to be treated as a resident of Australia. This article explores the impact of the Full Federal Court decision in *Harding* and concludes that the relevant rulings are in fact now incorrect. The rulings will require withdrawal and new public rulings need to be issued by the ATO.

Special leave application in Harding

The first thing to note in the special leave application in *Harding* is that counsel for the Commissioner argued, in their submissions, that there are a dozen Federal Court and Administrative Appeals Tribunal cases awaiting the outcome of the application. On that basis, the refusal by the High Court to hear the appeal has far-reaching consequences for those cases that could be currently being examined through audits and through the channels of litigation. The High Court stated that "the proposed appeal does not enjoy sufficient prospects of success to warrant the grant of special leave to appeal".[3]

On that basis, the Full Federal Court decision stands. More importantly, the views expressed by the Full Federal Court on the meaning of "place of abode" within the permanent place of abode phrase of the domicile test should be taken to include country of abode. The mistake made by the Commissioner, in his special leave application, was the attempt to link the phrase "place of abode" in the domicile test for those persons abandoning their residence in Australia and going overseas to the phrase "place of abode" in the 183-day test for those persons coming to Australia. In short, the Commissioner argued that, if you look at country of abode, this destroys the 183-day test because the person has to have been in Australia for at least 183 days and the place of abode must be Australia.

A close examination of the Full Federal Court decision in *Harding* shows that this is not the case. The phrase "place of abode" is different between the two tests. In the domicile test, the phrase is prefaced by the word "permanent", while in the 183-day test, the phrase is prefaced by the word "usual". The *Harding* case makes it clear that there is a difference between the two tests.[4]

The Harding decision

The Full Federal Court in *FCT v Harding*[2] is a watershed decision dealing with both the permanent place of abode test and the 183-day usual place of abode test in the definition of "resident" in s 6(1) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36).

Facts

Mr Harding was an Australian domiciled individual born in Australia in 1965. He held both Australian and British passports. Mr Harding left Australia at an early age and he and his subsequent wife lived and worked in the Middle East for a number of years. After the 2001 terrorist attacks in New York, Mrs Harding, an English national, returned to the United Kingdom with their two sons. Mr and Mrs Harding then decided to move back to Australia. A property was built near other family members around 2004. Mrs Harding returned first to Australia and subsequently Mr Harding moved back around 2006. Mr Harding worked in Australia, but on lower wages than in the Middle East. In 2009, he was offered employment in Saudi Arabia. He decided to live in Bahrain and travel each day to Dannan in Saudi Arabia. Mr Harding stated that, when he left in March 2009, he was going to live and work in the Middle East indefinitely.

He sold all of his significant personal possessions in Australia, including his boat and car. Mr Harding returned to Australia each year when it was convenient to his working conditions. During the five or six years living in Bahrain, he resided in an apartment building. He moved from unit to unit as circumstances required, but remained in the same unit block. He moved from a two-bedroom unit to a one-bedroom unit when his marriage broke down, and then back to a two-bedroom unit when he established another relationship.

Mr Harding claimed that his units became his home and, when he went on holidays, he would leave his personal belongings. Subsequently, Mr Harding changed work and in 2014, moved to Oman for work.

The ATO considered that Mr Harding was a resident, for tax purposes, in the 2011 income tax year. Mr Harding accepted that he was domiciled in Australia for the 2011 tax year but claimed that he had a permanent place of abode outside Australia. On that basis, Mr Harding claimed that he was a non-resident. Mr Harding appealed to the Federal Court, where it was held, at first instance, that rented accommodation for a temporary purpose did not constitute a permanent place of abode. Mr Harding appealed to the Full Federal Court.

Preliminary point: practical aspect for practitioners

Before the primary judge in the Federal Court,[5] the parties proceeded on the basis that the question for the court was whether, in fact, Mr Harding had a permanent place of abode outside Australia. The Full Federal Court considered that this was not the proper question to be answered when the matter in dispute had been appealed, in first instance, to the court for determination. In fact, the proper question was whether the Commissioner had erred in law in not being satisfied that he did have such a permanent place of abode outside Australia. For practitioners, there is an important matter to keep in mind when considering which review body a disallowed objection decision should be referred to. In the situation when referring a matter to the AAT, that body exercises administrative and not judicial power. The AAT is able to re-examine, for itself, the evidence before it when determining whether it can be satisfied that a taxpayer has a permanent place of abode outside Australia. On the other hand, the court, being a judicial body, is only concerned with whether the Commissioner has erred in law when turning his/her mind to the state of satisfaction that the taxpayer had a permanent place outside Australia.

Practitioners should be continually aware of the distinction between administrative and judicial review. In the situation where the matter is referrable to a question of fact, such as the carrying on of a business, the AAT is able to avail itself of all available facts and step into the shoes of the Commissioner and decide for itself on that question. Where there is a need for the Commissioner to be convinced of a matter, such as whether a taxpayer had a permanent place of abode outside Australia, the court cannot substitute its own view for the views of the Commissioner. Instead, it is important for any taxpayer seeking review in the court to point out the error in law that the Commissioner has made in coming to this conclusion.

Full Federal Court decision

The Full Federal Court was in general agreement with the learned primary judge. Their Honours agreed with the primary judge that Mr Harding was not a resident within the ordinary concepts of the meaning of "resident" within s 6(1). Their Honours disagreed with the primary judge with respect to the application of a permanent place of abode outside Australia. In particular,[6] in a joint judgment, Davies and Steward JJ were of the view that the use of the phrase "place of abode" is not only to a specific house or flat. Otherwise, parliament would have used permanent abode rather than permanent place of abode. In so doing, their Honours stated that:

> "… drawing a distinction between someone who buys a singular flat in a foreign country as against someone who lives in a series of temporary flats in that country does not promote the rationale of the exception."

On that basis, the word "place" should accordingly be read as a reference to a country or state. When considering this conclusion with the word "permanent", it would mean that the words "permanent place" require the identification of a country in which the taxpayer is living permanently.[6] Accordingly, a person who has an Australian domicile is not a resident of Australia when they have abandoned, in a permanent way, their Australian residence. This view accords with the view expressed by Northrop J in *FCT v Applegate*.[7] Their Honours re-examined *Applegate's* case, both at first instance and on appeal, very carefully. It would seem that this has been overlooked for many years. Their Honours examined the decision, at first instance, of Sheppard J[8] that "place of abode" may mean the house in which the person lives or the country, city or town in which he is for the time being to be found. Thus, a person might be correctly said to have a permanent place of abode in, say, Vila, notwithstanding that, during a given period, he lived in a number of different establishments, occupying each for a relatively short period. His case is no different from one where a person, such as the appellant here, lives, for a substantial period, in the same house.

So, it seems that there has been a misunderstanding of the initial views in *Applegate's* case, at first instance. The appeal to the Full Federal Court did not focus on this aspect, but rather on the permanency aspect of the test. It has been assumed, up until now, that the specific circumstances of *Applegate's* case where he lived in the same house was the only way to consider the notion of permanent place of abode. The decision in *Harding* makes it quite clear that this is not the situation. There is no difference between a person living in the same house as compared to a number of different establishments of the town, city or country. The key is that the word "permanent" is referrable to a period of time to live outside Australia, but not indefinitely. Their Honours did express the view, though, that:[6]

> "… we do not favour the proposition that it does not matter if the taxpayer is not permanently in one country, but moves between foreign countries. In our view, the words 'permanent place' require the identification of a country in which the taxpayer is living permanently."

The Commissioner argued that the phrase "place of abode" must refer to a dwelling where a person lives. Their Honours[9] generally agreed that the phrase was capable of referring to a dwelling. But it has to be seen in the context of the statute. The Commissioner attempted to link the second test to the third test, with respect to the "usual place of abode". Their Honours noted[10] that the third test (the 183-day test) and a person's usual place of abode is a different context to a permanent place of abode outside Australia, that is directed to those who are purely visitors. In short, the two tests are different.[11]

The Stockton decision

The impact and effect of the *Harding* decision has been swift. In *Stockton v FCT*,[12] Logan J (who had been one of the judges in the Full Federal Court decision in *Harding* and had agreed with the joint judgment) was considering the residency of a taxpayer where the taxpayer was a citizen of the United States and came to Australia for a working holiday. The court had to determine whether the taxpayer was a resident, where the taxpayer had continuous presence in Australia for more than 183 days, and whether the Commissioner erred in law in being satisfied that the taxpayer's usual place of abode was outside Australia, and hence a non-resident.

Ms Stockton was a US citizen and had lived with her parents in Florida. At the time she left Florida for Australia, Ms Stockton had her own room in the family home and this was retained while she visited Australia. It was where she returned after her visit to Australia. She flew to Australia in September 2016 and obtained a 12-month work and holiday visa. She worked and travelled within Australia, until leaving Australia in June 2017. Ms Stockton claimed that she was a resident during the relevant income tax year, while the Commissioner claimed that, although she was in Australia for more than 183 days, she had her usual place of abode outside Australia (her family home). In such a submission, the Commissioner asserted that the meaning of "place of abode" should be assimilated with meaning "home".[13] Arguments in the case were heard before the final determination in *Harding*, so this view cannot now be supported after the ruling in *Harding*.

On the particular facts in *Stockton,* Logan J did determine that her usual place of abode was in the US, before, during and after her visit to Australia, and it happened to be the family home in Florida.[14] She was a welcome guest to Australia but, as she moved around Australia, during her time there was no usual place of abode in Australia, but, as it happened, the usual place of abode was the US. The conclusion reached by Logan J was the same as the Commissioner but not on the same basis, as the Commissioner had taken a narrow meaning of the place of abode. The taxpayer was therefore a non-resident during the relevant tax year.

> *"... the meaning of 'place of abode' should be assimilated with meaning 'home' ... cannot now be supported after the ruling in Harding."*

The Addy decision

An indicator of the importance of understanding the true meaning of "place of abode" has surfaced again in the most recent decision of *Addy v FCT.*[15] Ms Addy was a British citizen; she came to Australia on 3 July 2015 and applied and obtained a working holiday visa. In the period August 2015 to May 2017, Ms Addy remained in Australia, except for a period of two months which she spent on holiday. For most of the period she spent in Australia, she lived in a share-house accommodation at Earlwood in Sydney. During the 2017 income year, Ms Addy engaged in casual employment as a food and beverage waitress. The ATO, after a number of attempts at assessment and further assessment, determined that Ms Addy had been deemed to be a resident for tax purposes, with respect to the working holiday tax rate. That is, as a temporary resident for Subdiv 768-R of the *Income Tax Assessment Act 1997* (Cth). The taxpayer claimed that the Australia–UK double tax agreement applied to her and, for reasons not necessary for our purposes, won her appeal.

With respect to the question of residency for s 6(1) purposes, Logan J was at pains to outline the position of usual place of abode. His Honour determined[16] that the Commissioner had acted on the erroneous belief of what constituted a place of abode. His Honour then determined that Ms Addy, during the 2017 income year, had a usual place of abode in Australia and that she did intend to take residence. His Honour made the following observation:[17]

> "For reasons already given, not only had *Australia* and more particularly the *Earlwood house* become her usual place of abode during that income year but also that is where she intended to take up residence." (emphasis added)

ATO views on residency

The ATO has two major rulings dealing with residency for s 6(1) purposes: IT 2650 and TR 98/17. IT 2650 deals with the permanent place of abode outside Australia aspect for test 2, while TR 98/17 mainly deals with the residency status of individuals entering Australia for test 3 of the meaning of "resident".

IT 2650

IT 2650 provides guidelines for determining whether individuals who leave Australia temporarily to live overseas cease to be Australian residents for tax purposes. At para 5 of the ruling, there are a number of factors that the ATO says need to be taken into account. Factor 3 refers to the establishment (of) a home outside Australia, while factor 5 refers to the duration and continuity of the individual's presence in the overseas country. As has been pointed out by Fickling:[18]

> "… the third factor set out by the Commissioner, quoted almost verbatim from Northrop J in *Applegate* was taken arguably out of context by the Commissioner, and as a factor was given too much relevance."

This observation has proven to be accurate as the Full Federal Court in *Harding* emphasised not on the establishment of a home outside Australia (although that may be the case) but on the fact that the taxpayer is living outside Australia in an overseas country. In short, the word "place" should be read as including as reference to a country or state. This was actually mentioned by Sheppard J at first instance in *Applegate*.[19] Interestingly, the Commissioner does refer, in factor 5 of IT 2650, to the presence in the overseas country, but it would appear that this is cross-referenced

to the presence by the taxpayer in the fixed residence of the person, a family or a household outside Australia.[20] It now seems that the views expressed by the Commissioner at paras 5, 23 and 28 are now incorrect. In short, the Commissioner must now review IT 2650 and, at the very least, amend the ruling in accordance with the law. It may even be necessary for the Commissioner to withdraw the ruling entirely and reissue another consolidated public ruling on this test of residency in s 6(1).

Paragraph 28 of IT 2650 is worth examining in more detail. The first sentence states:

> "… the fact that an individual has established his or her home (in the sense of a dwelling place, a house or other shelter that is the *fixed residence* of a person, family or household in an overseas country would tend to show that the place of abode in the overseas country is permanent." (emphasis added)

It would seem, after the *Harding* decision, that this sentence would now need adjusting. Furthermore, the final sentence must now be seen to be incorrect. That sentence states:

> "… on the other hand, individuals or a family group also make do in temporary accommodation with limited resources and facilities such as in barracks, singles' quarters, aboard ships, oil rigs, will be less likely to be considered to have established a permanent place of abode overseas."

It should be noted that the whole emphasis in para 28 is to indicate an establishment, a home or a fixed residence of a person, family or household, and that the reference to a place does not envisage a reference to a country or a state. In short, IT 2650 needs to be withdrawn and the inclusion of the concept that it is unnecessary for the taxpayer to live outside of Australia in a particular way is needed.

TR 98/17

TR 98/17 deals with the residency status of individuals entering Australia. It is usually referred to as the 183-day test whereby, where an individual is actually present in Australia for more than half of the tax year, the individual may be a resident unless the Commissioner considers that their usual place of abode is outside Australia and there is no intention to take up residence in Australia. Throughout TR 98/17, the Commissioner refers to the notion of place of abode as their home. In para 44, the Commissioner states:

> "… many individuals work in a number of countries during their career … they often maintain a house in their country of domicile."

In para 57, it is stated:

> "… an individual may have a home and other assets outside Australia and still be residing here for the duration of the stay."

It is quite clear that the ATO is associating usual place of abode as being the home of the individual. This was the argument run by counsel for the Commissioner in *Stockton*. In that case, Logan J noted that the Commissioner in his objection decision had proceeded to reach his conclusion about the taxpayer on the basis of a conception of the meaning of "place of abode" with meaning home. After *Harding*, the notion of place of abode also refers to a town or a country. On this basis, it would now be expected that the Commissioner will need to either withdraw TR 98/17 or make substantial changes.

ATO decision impact statements

The ATO has issued two decision impact statements in relation to adverse decisions pertaining to the residency of an individual under s 6(1). The decision impact statement on the decision *The Engineering Manager and FCT*[21] outlines the ATO's response to the case of Mr M being a non-resident in the 2011 year of income. Mr M, an engineer, gave evidence that he decided to work overseas from 2004. His wife and children stayed in Australia. In January 2010, Mr M commenced work as an engineering manager in Oman. The contract was a one-year term and was renewable annually. His contract entitled him to paid travel to Perth regularly.

In Oman, Mr M lived alone in a privately leased house. He had a bank account in Oman. The AAT determined, following *Applegate*, that he had a permanent place of abode outside Australia in the relevant year and was a non-resident. The ATO, in its impact statement, states that the AAT's decision created no new law in this area. Again, the overarching emphasis by the ATO is on facts and circumstances of each case. Unfortunately, the ATO again focuses on the view by Fischer J in *Applegate* that the term "permanent place of abode" is the taxpayer's fixed and habitual place of abode. This narrow view is a misunderstanding of the actual decision in *Applegate* and the potential for the phrase to include a town, city or country.

The decision impact statement on the case of *Dempsey and FCT*[22] also illustrates a misunderstanding of the notion of place of abode by the Commissioner. Mr Dempsey owned a house at the Gold Coast where he had lived prior to leaving for Saudi Arabia. He chose not to sell or rent out this house while in Saudi Arabia. Mr Dempsey lived in two furnished studio apartments supplied by his employer, in one for nine months and the other for the remainder of his stay. He spent most of the relevant year in Saudi Arabia and when on leave, travelled to Bahrain, Thailand and Australia. The AAT concluded that, in the 2009 and 2010 years, Mr Dempsey had made a settled employment, lifestyle residence choice and made his home in Saudi Arabia.

The ATO again refused to acknowledge that the decision shed new light on the meaning of "permanent place of abode" and stated that the outcome of the case was confined to its facts. There is no appreciation of the fact that Mr Dempsey had a place of abode in Saudi Arabia — different apartments but still a permanent place of abode in Saudi Arabia.

Practical implications for practitioners and their clients

It would appear from the Commissioner's arguments in the special leave application in *Harding* that the ATO considers that the phrase "place of abode" is the same for both the domicile test and the 183-day test. Looking carefully at the special leave transcript, it seems evident that the High Court considers that the Full Federal Court in *Harding* has identified that the phrase "place of abode" does indeed have a different meaning between the two tests. It would seem that the key is to note that in the domicile test, "permanent" is before the phrase "place of abode", while in the 183-day test, "usual" is before the phrase "place of abode". The key difference relates

to the fact that the tests are, in fact, dealing with different and conceptually different scenarios.

In the domicile test, a permanent place of abode is not necessarily referring to a fixed place of abode outside Australia, with a context of permanency about such a situation. Rather, the focus should be on the words "permanent place" which could require, in the circumstances, the identification of a country. It does not mean that the taxpayer has to live in any particular way.

Practitioners need to look at the domicile test differently to the 183-day test. The context has to be taken into account. The domicile test is focused on where a taxpayer abandons, in the income year, in a permanent manner their Australian residence and lives outside Australia, whether in a fixed home, or in various forms of accommodation in a town or a city. With respect to the 183-day test, the focus is on the usual place of abode during the income year, and that could be in Australia or overseas. That will depend on the particular facts of the case, as was evidenced in the *Stockton* and *Addy* cases.

Practitioners should note that the process of identifying the usual place of abode for the relevant year is not a box-ticking exercise. The whole of the circumstances need to be explored to determine whether the living arrangements can be said to be of a settled nature for the taxpayer for the relevant year. It may be that the usual place of abode is in Australia or overseas in another location to be determined on all of the circumstances. It may be that the usual place of abode is the family home in the overseas country. Once viewed in this light, practitioners will be better placed to advise their clients.

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Deceased estates, real property and real issues

by Ben Wilson, CTA, Partner, and Caitlin Ashworth, Lawyer, CCK Lawyers

Notwithstanding that death is generally not a taxing event, there are a number of complex legal and tax issues which need to be considered, particularly in relation to real property. An executor who sells real property will need to understand how the capital gains tax cost base and main residence rules apply. It is also relevant to beneficiaries who inherit property. Further, the manner in which an interest in property is passed to a beneficiary (for example, directly or via a testamentary trust or life interest) will affect the tax treatment of that interest. Finally, estate administration is rarely straightforward, and if a dispute or other complication arises over the distribution of assets, the parties may wish to resolve the issue by entering into a deed of family arrangement. This has its own set of tax risks and considerations.

Introduction

According to the McCrindle 2016 wealth transfer report, it is estimated that, over the next 20 years, Australian "baby boomers" over the age of 60 will transfer $3.5tr in wealth, growing at 7% per year, to generations X and Y (gen X & Y).

An estimated 7.5 million people in gen X & Y are set to be the recipients of that wealth. On their retirement, the baby boomers are expected to spend only a small portion of their wealth in maintaining their lifestyle in retirement. The Grattan Institute 2014 *The Wealth of Generations* report suggests that, on current trends, the majority of wealth of older households will be saved and passed on. Assuming that 30% or so will be spent, if 70% of the "baby boomers" wealth were to be transferred to gen X & Y, an average of $320,000 would be passed on to each beneficiary.

Wealth in this context refers to a combination of assets, including superannuation, shares, business ownership and other assets. However, for many people, a large part of their wealth is Australian real property, such as the family home, rental properties and commercial properties.

We can expect that there will be a growing demand among gen X and Y for high-quality estate administration and tax advice due to the exponential growth in this area. It is therefore essential as tax practitioners, advisers or potential estate administrators to understand and plan for it.

The effective transition of wealth comes with a range of challenges and opportunities, particularly when dealing with property. The deceased estate administration process has a range of legal issues and tax issues that need to be considered carefully. This article focuses on those issues relevant to real property.

This article:

- reviews the key legal considerations, including mode of property holding, and the relevant probate and land transfer processes;
- addresses the key income tax, capital gains tax and stamp duty issues for deceased estates;
- explains the main residence exemption;
- considers life and remainder interests; and
- explores the use of deeds of arrangement to vary a will after death.

Other issues that are of interest in this area, but are not covered in this article, are:

- pre-death planning and restructuring;
- property held through superannuation funds;
- property held through companies; and
- dealing with property where the owner loses legal capacity and exercising powers of attorney.

Legal considerations

Mode of holding

Determining the correct position

One of the first steps when dealing with real property on the death of an owner is identifying the deceased's mode of holding of that property.

The legal consequences and processes that apply are very different depending on the mode of holding, and so it is important for this to be dealt with up-front.

The property may be:

- wholly owned by the deceased;
- owned by the deceased and their spouse or another person as joint tenants;
- owned by the deceased as tenants in common with a spouse or another person; or
- owned alone or together with another person as trustee for a trust.

Each of these is addressed in more detail later in this section of the article.

To determine which of the above is applicable, the deceased's legal personal representative (LPR), that is, the executor or administrator of the estate, will need to gather some information.

Initially, the LPR will typically use their own knowledge of the property or ask for information from family members of the deceased. However, it is important not to make assumptions or move forward on that basis alone.

The LPR should undertake a certificate of title search through the relevant Land Titles Office (LTO), or similar entity,

depending on the state or territory the deceased held assets in. This will give an indication of how the mode of holding has been legally recorded.

In some instances, there is doubt about whether the mode of holding is correctly recorded on the title or the title is not determinative. For example, the deceased's family may hold a belief about how a property is owned which does not reflect what is on the title (for example, the family may believe that farm land is co-owned with a child who worked on the farm with their deceased parent, but the title was never updated to reflect this understanding or arrangement).

Further, LTOs in some states do not record the existence of trusts on its titles (this is certainly the case in South Australia). That said, a title may indicate that the deceased and another person are the legal owner, but with "no right of survivorship". A fiduciary relationship also may be recorded by a caveat lodged on the title on behalf of the relevant beneficiaries. Either of those scenarios are a strong indication that the deceased held the property on trust rather than for their own benefit.

In circumstances where the position is not clear, it is necessary to undertake further investigations. This may involve locating and reviewing the original contract for purchase of the property, the original memorandum of transfer, original bank documentation, past documentation regarding restructures, divorces or inheritances, and relevant historic correspondence from lawyers, conveyancers and accountants.

While this may give rise to additional work and cost, it is necessary because the LPR needs to be certain whether the property forms part of the estate or whether it is owned by someone else or perhaps held on trust for the benefit of another person. It is better that these issues be identified early, rather than part way through the estate administration process, or worse, when the estate has been distributed or a dispute has arisen.

Once the LPR has determined the correct mode of holding, it is necessary to look at the legal consequences and processes that follow.

Wholly owned by deceased

If the property is wholly owned by the deceased, the LPR will need a grant of probate to deal with that property. Once the grant has been obtained, there will also be a process to work through with the LTO.

The probate and LTO process is discussed further below.

Joint tenants

Property is held as joint tenants when the co-owners of that property do not have discreet shares in that property that they are able to deal with separately from the other owner. In other words, they do not have a percentage ownership interest in the property but rather a full ownership of the whole property together with another person or persons.

If the property is held as joint tenants, the deceased's interest in the property will automatically revert to the surviving joint owner on the death of the deceased. In this case, the LPR will not need to apply for a grant of probate in order to deal with the property. Instead, an application to register death by survivor will need to be lodged with the LTO.

This means that the property can be dealt with relatively quickly and simply and does not need to get caught up in the probate and estate administration process.

Tenants in common

Property is held as tenants in common when the co-owners have discreet shares or percentages in that property that they are able to deal with separately from the other owner. This will often be expressed on the title as an owner having a particular percentage, a particular fraction, "one undivided second part" (50%), "one undivided third" part (33.33%), and so on.

When a co-owner of a property held as tenants in common dies, the deceased's interest in the property will form part of their estate and the surviving co-owner will not receive control of that interest unless it is gifted to them under the deceased's will or purchased by them from the deceased's estate.

Where there is an interest in real property held as tenants in common in an estate, the LPR will need to apply for a grant of probate in order to deal with the deceased's interest, and will need to move through the LTO process similar to if the deceased owned the property wholly by themselves.

Trust

If a property was owned by the deceased as trustee for a trust, the property will not form part of the deceased's estate. Instead, it will be necessary to review the relevant trust deed, the will and the relevant trustee legislation to determine what will happen with the deceased's role as trustee.

"It is better that these issues be identified early, rather than part way through the estate administration process."

Probate application process

For the above scenarios where probate is required (that is, where the property is wholly owned by the deceased or the deceased had an interest as tenants in common), it is necessary to work through the relevant formal process.

If there is a will, the LPR applies for probate. If there is no will (that is, the deceased has died intestate), the LPR applies for letters of administration.

Obtaining a grant of probate requires the LPR to gather detailed information about the deceased and all of the assets and liabilities of the deceased (not just the property assets) and prepare and submit that information to the Probate Registry of the relevant Supreme Court in the form required by that court. The deceased's last original will must be submitted to the Probate Registry for examination as well.

The Probate Registry will assess the application and, if they require further information or evidence to support the application, they may ask for affidavits to be prepared or other documents to be provided.

Probate is usually applied for in the state in which the deceased lived at the date of their death. Probate will also need to be applied for in other states (or a re-seal obtained) if property is held interstate.

Once granted, probate gives the LPR the formal authority to deal with the assets of the deceased in accordance with the will. Except as mentioned above with respect to registering an application to register death by survivor of a joint property, the LTO requires the LPR to obtain a grant of probate in order to deal with real property in the estate.

LTO process and estate administration considerations

Once probate has been obtained, the LPR ordinarily takes steps to call in all of the assets of the estate. This involves closing bank accounts, having shares transmitted into the LPR's name and, in the case of real property, having the property transmitted into the LPR's name with the LTO.

The LTO process for transmitting real property into the name of the LPR is relatively straightforward. It is necessary to submit with the LTO a transmission application or similar, usually along with the grant of probate and a certificate confirming that the property was disclosed to the Probate Registry as part of the probate application process. There are also identification verification processes to be attended to.

Once the property is in the name of the LPR, the LPR needs to determine what will happen with the property. It will be necessary to check the will to determine whether the property has been left to a particular beneficiary, whether a trust or life interest is applicable to the property or whether it simply forms part of the residuary estate. If the property forms part of the residuary estate, the LPR needs to decide whether the property will be sold (on the open market or to a family member), or whether the property will be transferred to the beneficiaries.

If the property is sold, the LTO process is the same as a normal sale or conveyance.

If the property is to be transferred to the beneficiaries, a transfer is prepared between the LPR and the beneficiaries. The consideration is recorded as "pursuant to the will" or similar.

Alongside dealing with the property, the LPR will need to work through the myriad of issues and steps required in administering the estate. It will be necessary to pay off all of the liabilities, lodge date of death and estate tax returns, deal with any disputes in relation to the estate (including claims brought against the estate under relevant family inheritance legislation), take steps to protect the executors (including possibly placing a notice in the public notices), distributing gifts under the will, and then dividing and distributing the residuary estate.

Other considerations

In conjunction with all of the above, the LPR also needs to make sure that they work closely with banks, insurance companies, tenants, service providers and other people that are involved with properties affected by the deceased's death and the probate and LTO process.

The process of gathering information, lodging an application for probate, calling in the assets of the estate, administering the estate and distributing the estate can take months and even years, depending on the complexity of the estate. Beneficiaries are often anxious to receive their inheritances. Their expectations in this regard should be managed. Also, decisions need to be made about ensuring properties are used, secured and protected properly in the intervening period.

Key tax issues for deceased estates

General comments

Whenever assets move from one person to another, it is necessary to consider the possible income tax, CGT and stamp duty implications.

Death is generally not a taxing event.

Various exemptions apply for transmission of property from the deceased to the LPR, and for transfers from the LPR to the beneficiaries. However, it is necessary to understand the extent of those exemptions, and the effect of their application. Also, as is often the case in tax law, there are exceptions to the exemptions.

Income tax

In the context of property and deceased estates, income tax is less relevant. However, it is still worth raising.

Income tax is a relevant consideration if the deceased was a property developer that was holding property as trading stock.

If the LPR continues carrying on the property development business and makes an appropriate election, the trading stock is treated as if there was no death and the closing value of the trading stock in the date of death return will be the opening value of the stock in the estate's first tax return (s 70-105(6) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)). In these circumstances, the death essentially does not trigger a taxing event.

However, if the LPR will not be carrying on the property development business, the stock will be attributed with its market value as at date of death (s 70-105). In other words, if the property development business comes to an end on death, there is a taxing event.

Income tax is also relevant to the transfer of depreciating assets. Depreciating assets are often transferred in conjunction with a property (for example, hot water systems, tanks, curtains and other fixtures and fittings).

On the death of the deceased, a "balancing adjustment event" occurs in respect of any depreciating assets that they held. However, to avoid the transfer to an LPR triggering a taxing event, the termination value or sale price will be its adjustable value/written down value as at date of death. However, when depreciating assets are distributed to a beneficiary, they are deemed to be disposed of at market value, and therefore potentially trigger a taxing event. These rules are set out in the table in s 40-180 ITAA97.

CGT

Where property was held by the deceased on capital account, which is ordinarily the case, Div 128 ITAA97 applies.

Division 128 sets out how capital gains and losses are dealt with, and how this affects a person's LPR and beneficiaries of their estate.

A deceased person's assets are taken to have been acquired by their LPR on the day they passed away (s 128-15(2) ITAA97).

Any capital gain or loss on death is disregarded (s 128-10 ITAA97).

Similarly, when an asset of the deceased is transferred from the LPR to a beneficiary, any capital gain or loss made by the LPR is disregarded (s 128-15(3)). A CGT event technically occurs but it is does not give rise to tax.

It is worth mentioning the key limitations on this exemption.

First, the asset being transferred must be an asset of the deceased. It cannot be an asset that the LPR has acquired after death. Therefore, the LPR cannot acquire an asset during the estate administration process and then subsequently transfer the asset to a beneficiary without triggering CGT. This can unintentionally become an issue if the LPR takes up shares through a dividend reinvestment plan, takes up rights issues, or similar. In the context of property, it can unintentionally become an issue if property is strata titled, subdivided, or improved during the estate administration process. The position needs to be looked at carefully if those circumstances arise.

Second, the asset must pass to the beneficiary in their capacity as a beneficiary. If the beneficiary buys an asset from the estate (which is a common occurrence), CGT applies.

Calculating the new cost base

While the capital gains or losses of a property passed through an estate are generally disregarded, there is still a very important CGT task to be attended to on death. That is the calculation of the new cost base in the hands of the LPR or the beneficiaries.

The cost base is critical because it will determine the CGT payable by the LPR if they sell the property. If the LPR does not sell the property, but instead distributes it to a beneficiary, the beneficiary will have the same cost base. When the beneficiary sells the property (which may be shortly after inheriting the property, or many years later), a capital gain or loss may arise on that sale, and they will need to know the cost base.

The LPR is in the best position to obtain this information as the LPR is the legal owner of the deceased's tax and financial records. The LPR should therefore either calculate the cost base on death or at least pass on records to the relevant beneficiary on distribution.

The new cost base will depend on whether the deceased purchased the property before CGT legislation came into effect on 20 September 1985 (pre-CGT) or on or after that date (post-CGT).

The cost base of the property in the hands of the LPR or the beneficiary will be in accordance with the table of "modifications to cost base and reduced cost base" found in s 128-15(4), as follows:

"**Modifications to cost base and reduced cost base**

Item	For this kind of CGT asset:	The first element of the asset's cost base is:	The first element of the asset's reduced cost base is:
1	One you acquired on or after 20 September 1985, except one covered by item 2, 3, 3A or 3B	the cost base of the asset on the day you died	the reduced cost base of the asset on the day you died
2	One that was trading stock in your hands just before you died	the amount worked out under section 70-105	the amount worked out under section 70-105
3	A dwelling that was your main residence just before you died, and was not then being used for the purpose of producing assessable income	the market value of the dwelling on the day you died	the market value of the dwelling on the day you died
3A	If you were a foreign resident just before you died — an asset that was not taxable Australian property just before you died, except one covered by item 2	the market value of the asset on the day you died	the market value of the asset on the day you died
3B	One that passes to a trustee of a special disability trust	the market value of the asset on the day you died	the market value of the asset on the day you died
4	One you acquired before 20 September 1985	the market value of the asset on the day you died	the market value of the asset on the day you died

Note 1: Section 70-105 has a general rule that the person on whom the trading stock devolves is taken to have bought it for its market value. There are some exceptions though.

Note 2: Subdivision 118-B contains other rules about dwellings acquired through deceased estates.

Note 3: The rule in item 3 in the table does not apply to a dwelling that devolved to your legal personal representative, or passed to a beneficiary in your estate, on or before 7.30 pm on 20 August 1996: see section 128-15 of the *Income Tax (Transitional Provisions) Act 1997*."

The most likely scenarios for real property in a typical deceased estate will fall under items 1, 3 or 4 of the table in s 128-15(4) (being a post-CGT, main residence or pre-CGT asset).

In short, the rules are:

- if the property was pre-CGT in the hands of the deceased, the cost base will be the market value of the property as at the date of the deceased's death;
- if the property was post-CGT in the hands of the deceased, the cost base will be the deceased's historic cost base; and
- if the property was a main residence (whether pre-CGT or post-CGT), the cost base will be the market value as at date of death.

Where it is necessary to determine the market value of a property as at date of death, it is important to arrange a valuation as soon as possible after death through a licensed valuer.

Example 1

The deceased, Frank, died on 1 September 2018 leaving a rental property with a market value at his date of death of $500,000, which Frank had purchased in 1990 for $200,000. The rental property was not Frank's residence.

Raymond has inherited Frank's rental property. As we know, the rental property is a post-CGT asset with a cost base of $200,000. Raymond takes that same cost base. Raymond decides to sell the house soon after inheriting at a time when the market value is still $500,000.

If Raymond sells the house, he will make an assessable capital gain of $300,000.

Example 2

If Frank's rental property was purchased by Frank before 20 September 1985, the rental property would be a pre-CGT asset.

When Raymond on-sells the rental property, Raymond's cost base for the rental property will be the market value on Frank's date of death ($500,000). Assuming Raymond achieves market value for the rental property (as at Frank's date of death) and obtains $500,000 in the sale, Raymond's capital gain or loss will be zero.

Special considerations in relation to pre-CGT assets

There are obviously benefits in treating an asset as pre-CGT. It gives the asset a higher cost base and therefore a lower capital gain.

It should also be noted that, when determining whether a property is pre-CGT or post-CGT, it is relevant to consider carefully the ownership history of the property and other events that may have affected the property. It cannot be assumed, simply because a property was initially purchased by a family pre-CGT, that the whole of the property continues to be a pre-CGT asset.

Below are some examples of where a property that has been in the family since before 20 September 1985 will not be pre-CGT or will not fully be pre-CGT:

- an improvement has been made to the property that becomes a separate post-CGT asset pursuant to s 108-70 ITAA97;
- the property has previously been inherited after 20 September 1985 — all assets lose their pre-CGT status on death;
- the property has been the subject of a family group restructure and was transferred out of a company or trust or from another family member after 20 September 1985; and
- the property was initially held by husband and wife as joint tenants and the first of them passed away after 20 September 1985.

Special rules for joint tenants

In addition to dealing with CGT issues in relation to deceased estates, Div 128 also sets out rules about what happens when a joint owner of a property dies.

Notwithstanding that joint tenants do not have a distinct percentage interest in a property, the legislation deems that to be the case. In other words, if there are two joint tenants, each is deemed to have a 50% interest.

Section 128-50(2) ITAA97 states that the survivor is taken to have acquired the deceased's share on the day the deceased died. This means that the survivor ends up with two assets with different acquisition dates and different cost bases.

If the property was purchased pre-CGT, the deceased's share in the property will pass to the surviving joint tenant, with a cost base equal to market value of that share (s 128-50(4)). Therefore, the original 50% of the property owned by the survivor will not attract CGT when a capital gains event occurs with respect to the property. However, the 50% share the survivor inherited will have a cost base equal to the market value of 50% of the property on the deceased's date of death.

If the property was purchased post-CGT, the deceased's share of the property will pass to the survivor, with the deceased's cost base for that share (s 128-50(3)).

Where a property was purchased by a couple as joint tenants pre-CGT, but the first member of the couple passed away on or after 20 September 1985, the surviving member of the couple will inherit a share of the property which has become post-CGT. The following example sets out how this would operate in practice.

Example 3

We will continue with the fact scenario from examples 1 and 2 above. However, in this example, Frank is married to Marie and the property is owned by them jointly. In addition, the property was purchased pre-CGT.

On Frank's death, Frank's share automatically reverts to Marie. Frank's 50% share passes to Marie, with a cost base equal to market value on the day he died.

Example 3 (cont)

You will recall that the property has a market value of $500,000 on Frank's date of death. Therefore, the cost base of Frank's share is 50% * $500,000 = $250,000.

After a few years, Marie decides to sell that property. When calculating Marie's tax for the year in which she sold the property, her accountant will disregard any CGT attributable to the share Marie originally held (which will continue to be treated as a pre-CGT asset). However, Frank's share is no longer pre-CGT but post-CGT. CGT will have to be paid on Frank's share and the cost base will be market value of that share from a few years earlier.

If Marie sells the property for $600,000, the CGT calculations will be as follows:

– as to Marie's original 50% share of the property sale ($300,000), there is no capital gain as that share is still a pre-CGT asset; and
– as to the share Marie received on Frank's death, CGT applies as that share is now a post-CGT asset. Therefore, Marie makes a capital gain of $50,000 with respect to Frank's share ($300,000 – $250,000).

Accordingly, Marie's tax return will need to reflect a capital gain of $50,000 in respect of the sale of the property.

Subdivision 115-A: discount capital gains

Individuals (and trusts) can access a 50% discount on any capital gain they generate on an asset they have held for at least 12 months (s 115-25(1) ITAA97).

In the context of deceased estates, the 12-month period is not reset on death (except for pre-CGT assets). The LPR, and ultimately the beneficiary, gets the benefit of the asset holding period of the deceased (items 3 and 4 of s 115-30(1) ITAA97). The same applies for the survivor of a joint tenant property (item 7 of s 115-30(1)). That means that an asset can be disposed of within 12 months of date of death (if it has been at least 12 months since the deceased purchased the asset), and can still obtain the benefit of the 50% discount.

Example 4

Going back to example 1, assume that Frank bought the rental property on 1 September 1990, Frank died on 4 July 2019, the property was distributed to Raymond on 6 September 2019, and Raymond sold the property the next day. Accordingly, Raymond has held Frank's share for less than 12 months.

Notwithstanding this, Raymond is deemed to have held the property since 1 September 1990 and is entitled to the 50% discount. This means that Raymond will need to pay tax at the applicable marginal income tax rate on $150,000 of the capital gain (50% discount × $300,000).

Small business concessions

There are a range of small business CGT concessions available, which are well known to most tax practitioners. If the deceased owned a property that was used in a small business, there might be some opportunity to access those concessions.

The LPR or beneficiary can access the small business concessions if they dispose of the property within two years of the deceased's date of death and the property would have qualified for the CGT small business concessions if the deceased had disposed of it immediately before their death (s 152-80(1) ITAA97).

Treatment of testamentary trusts

All of the rules above apply to trustees of testamentary trusts, as well as to LPRs. This is because it is commonly accepted that the transfer of a property to the trustee of a testamentary trust established pursuant to the will of the deceased is not a distribution of that property to the beneficiary in accordance with the will. For the purposes of Div 128, the ATO treats the trustee of a testamentary trust in the same way as the LPR (PS LA 2003/12).

This means that property in an estate can pass from the deceased to the LPR, from the LPR to the trustee of a testamentary trust, and then finally from a trustee to a beneficiary of the testamentary trust, and any capital gain or capital loss will be disregarded.

The ATO has issued a number of publications relating to this particular practice of treating trustees of testamentary trusts in the same way as they treat the LPR. These publications have changed in form over the years, but have remained the same in substance and practice.

Stamp duty

Stamp duty is generally not payable in relation to transmission of property from the deceased to the LPR. Similarly, stamp duty is typically not payable where property is transferred to a beneficiary pursuant to the terms of a will.

You will need to consider carefully the applicable stamp duty legislation in the state or territory where the real property is located to ensure that the property is in fact exempt when transferred pursuant to a will.

If a property is sold by the LPR to a beneficiary, rather than distributed to the beneficiary pursuant to a will, stamp duty will likely apply. Depending on where the property is located, there may be other exemptions available. In South Australia, if the property is a commercial property, the transfer of that property since 1 July 2018 has been fully exempt from stamp duty.

Main residence exemption

Legislation

A property which is used as a person's main residence is generally exempt from CGT. There are special rules that apply in relation to deceased estates.

The relevant legislation is s 118-195 ITAA97, which states as follows:

> "**118–195 Dwelling acquired from a deceased estate**
>
> (1) A capital gain or capital loss you make from a CGT event that happens in relation to a dwelling or your ownership interest in it is disregarded if:

(a) you are an individual and the interest passed to you as a beneficiary in a deceased estate, or you owned it as the trustee of a deceased estate; and

(b) at least one of the items in column 2 and at least one of the items in column 3 of the table are satisfied.

Beneficiary or trustee of deceased estate acquiring interest

Item	One of these items is satisfied	And also one of these items
1	the deceased acquired the ownership interest *on or after* 20 September 1985 and the dwelling was the deceased's main residence just before the deceased's death and was not then being used for the purpose of producing assessable income	your ownership interest ends within 2 years of the deceased's death, or within a longer period allowed by the Commissioner
2	the deceased acquired the ownership interest before 20 September 1985	the dwelling was, from the deceased's death until your ownership interest ends, the main residence of one or more of: (a) the spouse of the deceased immediately before the death (except a spouse who was living permanently separately and apart from the deceased); or (b) an individual who had a right to occupy the dwelling under the deceased's will; or (c) if the CGT event was brought about by the individual to whom the ownership interest passed as a beneficiary — that individual

Note 1: You may make a capital gain or capital loss if the dwelling was used for the purpose of producing assessable income: see section 118-190.

Note 2: In some cases the use of a dwelling to produce assessable income can be disregarded: see sections 118-145 and 118-190.

Note 3: There are special rules for dwellings acquired before 7.30 pm on 20 August 1996. These rules also affect the operation of section 118-192 and subsections 118-190(4) and 118-200(4): see section 118-195 of the *Income Tax (Transitional Provisions) Act 1997*."

Different treatment for pre-CGT and post-CGT properties

To apply s 118-195, you must first determine whether the property in question is a pre-CGT asset or a post-CGT asset.

If the property is pre-CGT, the property does not even need to have been the main residence of the deceased to obtain the exemption. It can be any dwelling of the deceased (for example, a rental property). In other words, pre-CGT properties are rewarded with the main residence exemption even though the property might not even be a main residence.

If the property is post-CGT, it is necessary for the property to be the deceased's main residence immediately before death, and it cannot at the date of death be being used for income-producing purposes (for example, renting out part of the property, conducting a business from the property, and so on).

Two-year period and extensions

To access the exemption, the property must generally be sold within two years. That said, the period can be extended. An automatic extension occurs if one of the following persons occupies the property from the date of death until the property is ultimately sold:

- the spouse of the deceased;
- a person granted a right to occupy the property under the deceased's will; or
- the beneficiary which the property was passed to under the will.

Where a married or de facto couple are not both owners of their main residence and the owner of the property is the first to pass away, the property will pass to the LPR and then a beneficiary. If the deceased's spouse continues to occupy the property until it is sold, the main residence exemption will not be lost or will not "expire" during that period. This is the case even if the spouse is not the beneficiary of the property (for example, if the house is left to a child but the spouse lives there). Also, the spouse simply needs to live in the property. There does not need to be any formal right to occupy.

Where it is someone other than the spouse that occupies the property, that person either needs to be the beneficiary that will inherit the property or a person who is expressly granted a right to occupy the property under the will.

This gives rise to planning opportunities. By drafting a will carefully, and granting rights of occupancy, the main residence exemption can be extended for lengthy periods of time. In fact, as testamentary trusts are treated by the ATO as a continuation of the estate, it is possible to set up discretionary testamentary trust wills with rights of occupancy such that the main residence exemption is preserved even though the property is held in a trust.

Example 5

Frank has passed away and his will leaves his residuary estate equally between Marie and Raymond. One of the assets owned by Frank was the family home.

The family home has been transmitted to the LPR.

Marie continues to live at the family home during the administration of the estate.

Three years following Frank's death, the LPR sells the property and distributes the proceeds to the beneficiaries.

Notwithstanding that it has been more than two years since Frank died, the main residence exemption is still available to the LPR.

Example 5 (cont)

An extension to the two-year period can also be obtained by the Commissioner exercising his discretion to allow the period to be longer. There are safe harbour scenarios in which the LPR or beneficiary can self-assess that the discretion should be exercised (PCG 2019/5).

Absences and using property to produce income

Rules about absences

There are certain scenarios in which a person may cease living in their property and still qualify for the main residence exemption. This is provided another residence is not claimed as a main residence during that time (s 118-145 ITAA97).

An example used in the ITAA97 is where a person is posted overseas for a number of years for work. A similar scenario would be if an elderly person moves out of their home to obtain some long-term specialist care or to move into a nursing home.

If the property is not used to produce income after they cease living in the property (such as being rented out), that person can continue to claim that property as their main residence indefinitely and there is no limitation on the length of the absence.

If the property is used to produce income after the person ceased living in the property, they can only claim the main residence for a maximum period of six years while they are absent from the property. If they return to the property and then leave again, the property can again be rented out for a further six years.

These rules can assist in an LPR or a beneficiary accessing the main residence exemption when the deceased was not living at their home at the time of death.

Using main residence for income-producing purposes

If a main residence is used for income-producing purposes, an LPR or a beneficiary can still often claim the main residence exemption. This is the case whether that income-producing purpose occurred before or after death.

If the income-producing purpose occurred prior to death, it can be ignored by the LPR or beneficiary provided the purpose did not occur while the deceased also lived in the property (s 118-190(3) ITAA97). If the deceased lived in the property while the income-producing purpose occurred, a partial exemption from CGT may be available. This is discussed further below.

If the income-producing purpose occurred after the deceased's death, provided the property is on-sold within two years of the deceased's date of death, the income-producing purpose can be ignored. This is because the main residence exemption does not require the property to be the main residence for that two-year period (see the example in s 118-190(1)).

Partial exemption

Where the deceased used part of the property for income-producing purposes while they lived in the property (for example, used their garage to run their mechanics business), the LPR or beneficiary may be able to access a partial exemption.

Section 118-190(3) provides a formula for calculating a partial exemption from CGT under certain circumstances.

Life and remainder interests

What is a "life interest" and what are they for?

A life interest is a right granted in a property which will continue for the life of the person who holds that right and gives the person the right to have possession of the property and to receive the income of the property. That person is known as a life tenant or life interest beneficiary. When the life interest beneficiary passes away, the property passes to another person (known as the remainderman or remainder beneficiary). The property does not form part of the life interest beneficiary's estate when they die, but automatically reverts to the remainder beneficiary.

Life interests can be granted inter vivos (during the grantor's lifetime) or on death via the grantor's will. This article focuses on life interests granted via the will of the deceased.

Life interests can be "legal" or "equitable".

A legal life interest is one which is no longer in the hands of the LPR or trustee of the estate. The property has been distributed to the remainder beneficiary but subject to the life interest beneficiaries' right to the possession and use of the property. The life interest arrangement is recorded on the certificate of title.

An equitable life interest is one where the LPR or other trustee holds the property for the benefit of the life tenant and remainder beneficiaries under the terms of the will. This is the more common arrangement. This article deals only with equitable life interests.

In an environment where families are more complicated than ever and blended families are becoming the norm, life interests can be an important tool to address the competing interests of beneficiaries. For example, a testator on their second marriage can leave a life interest in the family home to their spouse while preserving the capital for their children from their first marriage.

There are many planning opportunities in the use and structure of life interests. However, care should be taken to ensure that a life interest clause in a will properly sets out in detail the various rights and obligations of the life interest beneficiary to occupy and maintain the property. If this is not set out clearly, it can give rise to disputes.

Other similar interests

In addition to life interests, there are other similar arrangements which commonly arise in the context of deceased estates:

- rights to occupy for life which grant a beneficiary a right of possession only (but no right to income); and
- a mere licence to occupy the property.

While these are often referred to as life interests, they are not, strictly speaking, life interests. They have a different tax treatment.

Rights to occupy are formal rights which are enforceable by the occupant. Conditions can be imposed on the

period of the occupation such that the right may be for the beneficiary's lifetime, for so long as the beneficiary chooses to reside at the property or for a specific period (for example, until the beneficiary remarries).

A licence to occupy can sometimes simply be at the discretion of the LPR or as a result of informal family arrangements. In those circumstances, it is not a "right", but a mere licence and may not have the same tax consequences as life interests or rights to occupy.[1]

Creation of life interests

When an equitable life interest is created under a will, CGT event E1 technically occurs. However, any capital gain or loss is ignored pursuant to s 128-10.

The life interest beneficiary and the remainder beneficiary do not pay for their interest and so they are deemed to have a market value cost base for their interest (s 112-20 ITAA97).

The transfer of property is typically exempt from stamp duty if the transfer is to or by the LPR or trustee of an estate and pursuant to the will. Therefore, the transfer of the property to the LPR or trustee to hold on trust for the life interest and remainder beneficiary will likely be exempt from stamp duty.

Expiry/ending of a life interest

When a life interest expires because the holder of that interest has died, there will be a transfer of that life interest to the remainder beneficiary. That expiration would ordinarily be CGT event C2 (which is the expiry of a CGT asset, but any capital gain or loss made by the life tenant is disregarded under s 128-10).

The remainder beneficiary becoming entitled would ordinarily trigger CGT event E5. However, provided the life interest was granted pursuant to a will and not brought to an end earlier than the death of the beneficiary (or such other period of time granted under the will), CGT event E5 does not apply. This is because the ITAA97 provides that CGT event E5 does not apply to a trust (being a deceased estate) to which Div 128 applies.

Stamp duty will also not typically apply to the expiry of a life interest which occurs in accordance with the will. The ending of a life interest is not a conveyance of property. The remainder beneficiary becoming entitled and the transfer of the remainder interest to that beneficiary is a conveyance pursuant to the will and therefore ought to be exempt from stamp duty.

Early surrender or disposal of life or remainder interests

A beneficiary may wish to surrender or dispose of an interest for a number of reasons.

Sometimes beneficiaries may wish to surrender their life interest or remainder interest, dispose of it, or otherwise bring it to an end prior to the life interest beneficiary's death (for example, in order to avoid further legal, accounting and other compliance costs in relation to the life interest, or to pass the property to the next generation).

Where this occurs, it is treated as the disposal of an asset just like any other. Where the life or remainder interest is surrendered or disposed of for no consideration (which is ordinarily the case), it will be deemed to have been disposed of for market value. The capital gain or loss in relation to that will be the market value of the interest at the time of surrender less the cost base.

Because the surrender or disposal of the interest is not pursuant to the will, any capital gain or loss will *not* be disregarded pursuant to Div 128. Similarly, the surrender or disposal may also be dutiable under the relevant stamp duty legislation.

Disclaimer of interest versus surrender

Reason for disclaimer. Because a surrender or disposal of a life or remainder interest triggers CGT and stamp duty, beneficiaries will sometimes consider a disclaimer of the interest upfront rather than receiving the interest and then subsequently dealing with it.

Timing of disclaimer. If a beneficiary disclaims an interest prior to receiving it, there is no CGT event because the beneficiary never acquired the property interest.[2]

An asset "passes" to a beneficiary of an estate when that asset is transferred to that beneficiary or the beneficiary becomes absolutely entitled to it. A beneficiary is absolutely entitled to an asset of an estate when that beneficiary has a vested, indefeasible and absolute interest in that asset. It is the view of the Commissioner in TD 2004/3 that, provided a beneficiary is absolutely entitled, the actual transfer of the asset does not have to have legally occurred for it to have "passed" for the purposes of s 128-20(1) ITAA97.

Therefore, if a beneficiary wishes to disclaim an interest in an asset of the estate, that beneficiary ought to do so before becoming absolutely entitled. Otherwise, in the eyes of the Commissioner, if the beneficiary is absolutely entitled to the asset, then notwithstanding that there has been no actual transfer, the asset has passed to the beneficiary and any subsequent attempt to disclaim that asset could give rise to a CGT event.

A beneficiary is also taken to have accepted an interest where the beneficiary is made aware of it and does not take steps to disclaim it within a reasonable time frame.[3]

Stamp duty on disclaimer. Notwithstanding that an effective disclaimer is not subject to CGT, it may still trigger stamp duty. The relevant stamp duty legislation will need to be examined closely.

Valuation of life interests and remainder interests

As you can see from above, the market value of life interests and remainder interests becomes relevant for the purposes of calculating the cost base on creation and also the deemed proceeds on surrender. It is also relevant for stamp duty purposes.

Due to the nature of life interests and remainder interests, they are difficult to value. They largely depend on the age of the life tenant, but also on the terms and conditions of the arrangements.

Some state revenue offices have published a table of life tenant factors calculated by the Australian Government Actuary. This can also be a helpful guide for CGT purposes.

Example 6

In this example, under his will, Frank grants Marie an equitable right to possession and the income of the property for her lifetime. On Marie's death, the remainder in fee simple is to be divided equally between Raymond and his brother, Robert.

Marie initially lives in the property. However, after some years, Marie is unable to manage the property and moves into a retirement village. Marie rents the property out and uses the rental income to supplement her pension.

When Marie dies, the remainder reverts to Raymond and Robert.

There is no taxing event on Marie's interest expiring. As set out above, this would be a CGT event C2, but any capital gain/loss is disregarded under s 128-10.

There is also no taxing event on Raymond and Robert becoming entitled to the property because CGT event E5 does not apply to Div 128 trusts.

Deeds of arrangement

Using deeds in deceased estates

What is a "deed of arrangement" and when might they be used?

A deed of arrangement is a deed entered into to settle a dispute between the beneficiaries or potential beneficiaries of an estate.

Depending on the jurisdiction in which probate is applied for, there are time frames in which a person may challenge a will or an estate. A challenge can typically only be made by certain persons (being close family members or other dependants).

The parties to that dispute can settle by entering into a "deed of arrangement". The document may be called something else like a "settlement deed" or '"deed of family arrangement". As a result of the settlement, the assets of the estate may ultimately be distributed differently to the manner set out in the will.

CGT position of deeds

As discussed throughout this article, CGT arising from assets of the deceased passing to a beneficiary of the estate is disregarded under ss 128-10 and 128-15(3).

An asset can pass to a beneficiary not only pursuant to a will, but also in other ways, including the will as varied by a court order or pursuant to a deed of arrangement (s 128-20(1)(a) to (d)).

In the case where the estate parties enter into a deed of arrangement, the assets of the estate are not being distributed in accordance with the will or pursuant to a court order. Notwithstanding this, any CGT will be disregarded under the following circumstances.

The deed must have been entered into by the beneficiary to settle a claim to "participate in the distribution" of the estate. The deed must settle a claim made by a person eligible to bring proceedings, but the Commissioner does not require that person to actually commence proceedings. This allows for claims to be resolved between "friendly parties".

The Commissioner is of the view that the parties to the deed must have entered into it within the time frames available under the relevant family inheritance legislation to make an application to vary the will.[4] An extension to this time frame may be considered by the Commissioner if the beneficiary can demonstrate that the court would have entertained their application for family provision or would have granted an extension in order to file such an application.[5]

Under the deed of arrangement, the only consideration given for the asset must be the satisfaction or waiver of a claim to the estate assets. In other words, the beneficiaries cannot exchange non-estate cash or assets as part of the settlement. This is so a full or part sale of assets cannot be disguised through a deed of arrangement.

For the purposes of disregarding CGT under Div 128, when drawing such a deed, it will be important to ensure that the background to the deed clearly sets out the dispute which is being settled and the relevant beneficiary's right to bring a claim under the relevant family inheritance legislation. The operative clauses of the deed will need to clearly set out those parts of the will being altered by the deed and how the assets of the estate will ultimately be distributed and when.

Stamp duty and deeds

Stamp duty legislation may be stricter in application than the ITAA97 and may not recognise a deed of arrangement as altering the will. Accordingly, while a deed can resolve the issue of triggering a capital gain when trying to settle a dispute, it may not allow you to avoid stamp duty triggered by a beneficiary receiving an interest or disposing of an interest in dutiable property.

However, if the relevant stamp duty legislation does not recognise a deed of arrangement as varying the will, an order of the court under family inheritance legislation will usually operate and take effect as though it was a codicil executed by the deceased immediately before they died. If the court makes such an order, the distribution of property will be a transfer in pursuance with the will and will likely be exempt from stamp duty. Court orders can be obtained by consent if all parties agree.

Again, this issue will need to be carefully considered and the relevant stamp duty legislation closely examined before proceeding with the preparation and execution of a deed of arrangement.

Example 7

Both Frank and Marie have died leaving the house and some cash in equal shares to Raymond and Robert.

The house was purchased pre-CGT.

A dispute arises between the brothers. Robert has indicated that he intends to bring a claim against the estate under the relevant family inheritance legislation for further provision from the estate. Specifically, Robert believes he should receive a transfer of the house in specie and that Raymond should receive the balance of

Example 7 (cont)

the estate, which is a lesser value than the market value of the house.

Robert states that this is fair given that:

- he has been living in the house with Frank and Marie for some years now and providing them with physical and emotional support which Raymond did not need to provide;
- he has invested significant funds into the upkeep of the house and even made some major capital improvements; and
- Raymond already owns a house and is in a better financial position overall compared with Robert.

To minimise costs to the estate and to Raymond of litigating Robert's contentions, the LPR and Raymond consider Raymond's ongoing relationship with Robert and decide to settle the dispute by way of deed of arrangement.

The LPR's lawyer drafts the deed which captures the nature of Robert's claim against the estate and the manner in which the estate will now be distributed.

The agreed arrangements do not trigger CGT. They may trigger stamp duty unless the parties obtain a court order.

Appropriation powers

It is not uncommon for beneficiaries to work out between them that they would prefer to distribute the assets of the estate differently to the manner set out in the will.

A deed of arrangement can be used in this situation as well. However, without a genuine dispute, s 128-20(1)(d) may not operate to disregard any CGT triggered by the distributions.

Some wills contain an appropriation power, which enables the LPR discretion to appropriate particular assets to be distributed to particular beneficiaries.

In that case, the parties can enter into a "deed of appropriation" in which they agree to the distribution of the assets in a particular way. Provided the distribution is still in pursuance of the will (for example, to the beneficiaries named in the will and in the percentages contemplated in the will), the distribution is in accordance with the will and any CGT and stamp duty will be disregarded.

Final remarks

As practitioners, we often deal with LPRs who find the cost of professional advice to be prohibitive. However, as you can see from this article, there are a number of complex tax and other legal issues which arise in the course of an estate administration. Sometimes mistakes made in relation to tax and the duties of administering an estate, even when innocently made, are costly to the estate and others.

Unless the LPR is a relevantly qualified professional, it is unlikely that they will be in a position to recognise and attend to those issues as they arise. It is therefore important that LPRs seek and obtain advice on estate administration and practitioners give high-quality and relevant advice.

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An earlier version of this article was presented at The Tax Institute's 2019 SA Property Day held in Adelaide on 6 September 2019.

References

1 Para 105 of TR 2006/14.

2 Paras 29 and 30 of TR 2006/14.

3 *Ramsden v FCT* [2004] FCA 632 at [80]; *Hodge v Griffiths* [1940] Ch 260.

4 Paras 210 and 212 of TR 2006/14.

5 Para 36 of TR 2006/14.

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Reliability of evidence in tax disputes

by William Calokerinos, CTA, Barrister, Wentworth Chambers

Taxpayers and their advisers face constant crossroads in disputes with the ATO. These crossroads include, inter alia, the making of ongoing assessment of the probative value of contemporaneous documentation in support of the client taxpayer's position. The recent cases of *Mingos v FCT* and *SDRQ and FCT* serve as a timely reminder of the importance of having access to contemporaneous records to support factual propositions in tax positions being adopted. Taxpayers and their advisers should prudently make value judgements regarding the probative value of documentary evidence held in support of the taxpayer's position with the contextualisation of the documents against the uncontroversial facts of the dispute.

Introduction

During the lifecycle of an ATO investigation, taxpayers prudently need to gauge the precise nature of the information being sought in order to prevent escalation of the dispute.

The ATO is well resourced in the event of litigation and frequently uses statutory notices[1] as a pre-litigation strategy. This is especially important as the ATO has increased the use of evidence-gathering processes to gather evidence prior to litigation.

The consequences of failing to respond to the ATO's use of statutory notices in the pre-litigation phase of a dispute are:

- significant, as there are penalties for non-compliance with statutory notices;[2] and
- critical, as statutory notices are appropriately drafted and have identified and addressed the risk hypothesis for the tax dispute.

Taxpayers will need to assess the reliability of their evidence collected in support of the position adopted within their tax affairs. As a general proposition, the following will hold true for taxpayers' records:

- the more contemporaneous the documents to the alleged set of facts, the more likely the asserted facts will be persuasive;
- taxpayers need to be aware of their obligations, particularly their burden of proof; and
- in the absence of contemporaneous records, the support and the representations of tax agents and lay witnesses will be subject to the court's assessment and rigour.

The above may sound obvious. Case law suggests that it is not obvious to all and this article argues that it is prudent for taxpayers to demonstrate to their advisers as early as possible that one can prove the asserted tax position with reliable, contemporaneous documentary evidence. This evidence will hopefully ultimately minimise the risk of adverse amended assessments.

The process of collecting relevant documents will require taxpayers and their advisers to engage proactively and meaningfully with the ATO so that the taxpayers and advisers understand what risks the ATO has identified.

In order to assess the veracity of the evidence collected to support the tax position of a taxpayer, an objective assessment is needed in identifying the tax risk.

This objective assessment will include:

- characterising documents by contemporality to clearly demonstrate the asserted facts, which is critical in marshalling evidence to support the tax position; and
- applying an understanding of relevant judicial considerations.

Taxpayers and their advisers also need to be mindful of relevant judicial considerations. Courts will apply judicial considerations to the taxpayers' evidence that include:

- hearsay consideration of the evidence; and
- in the event of an appeal, the difficulties in attacking (or overturning) the credit findings for witnesses.

Judicial considerations

There is judicial support for the proposition that the more contemporaneous the document and the statements are, the better. The closer the document is to the timing of the asserted fact, the more reliable the evidence will be viewed.

This proposition has been adopted from the relevant legal principles from the High Court case in *Pollitt v R*,[3] citing with approval the passage from *Walton v R*[4] and the remarks of Deane J.

The High Court in *Walton v R*[4] opined that, in the context of a phone conversation, the existence of a contemporaneous document will support the asserted words within the conversation (notwithstanding considerations of hearsay), as the contemporaneous document will have the flavor of reliability:

> "There is plainly something to be said for the view that, at least in some circumstances, the hearsay rule should be qualified so as not to preclude the receipt of evidence of *contemporaneous statements* made by one party to a telephone conversation (either in the course of the actual conversation or immediately before or after it) which disclose that the other party to the conversation was the person against whom it is sought to lead otherwise relevant and admissible evidence of that part of the conversation which was overheard." (emphasis added)

Ultimately, taxpayers need to be mindful of the fact that, should a tax dispute matter proceed to hearing, it will be difficult on an appeal to challenge an adverse credibility

finding for a particular witness. An example is the appeal case of *Lemongrove Services Pty Ltd v Rilroll Pty Ltd*.[5]

In the *Lemongrove* case*,* the appellant sought to challenge the factual findings of a lower court by attempting to demonstrate that a primary judge's finding about a critical issue was "glaringly improbable" or "contrary to compelling inferences".

In effect, the taxpayer was attempting to challenge the factual findings of a court by diminishing the relevance of particular credit findings. The appeal in the *Lemongrove* case was dismissed with costs, but the lessons from that case are:

- Payne J reasoned[6] that, for an appellant to be successful in attacking credit findings of a lower court, it will be "necessary to point to evidence having a quality which seriously calls into question the integrity of the primary judge's critical finding of fact";
- the attack on credit findings involves a determination of the reliability of the documentary evidence when put in the context of the dispute and the differing versions of witness testimony; and
- Payne J provided a useful factual matrix that applied to testing the probative value of evidence:[7]

  > "[45] Returning then to the critical question, the primary judge gave close consideration to the conflicting accounts and saw all three participants at the meeting cross-examined. His Honour had the advantage of seeing each witness respond to cross-examination about the critical conversation here in issue. His Honour took into account the contemporaneous documents. This is not a case where the conclusion of the primary judge is shown by uncontroversial facts or uncontested testimony to be erroneous. The contemporaneous and apparently reliable documentary evidence supports the Hanshaws' account [the respondents' account of events]. The primary judge did not fail to deal in a satisfactory way with a substantial amount of evidence.
  >
  > [46] I would reject the challenge to his Honour's finding that at the 27 November meeting the Hanshaws were not told of that the vendors had rejected a 'subject to finance' clause. It follows that ground 1-4 of the notice of appeal must be dismissed."

The genesis of this article is that taxpayers should support tax positions with contemporaneous representations captured within documentary evidence. Taxpayers are best advised to use best endeavour to capture contemporaneous representations.

Case law has consistently illustrated the importance of utilising "contemporaneous documents" to capture representations in the event of a tax dispute. The alternative to this approach would be summarised as follows:

- missteps in the tax dispute could easily result in the Commissioner utilising compulsive powers or moving straight to amended assessment;
- the ATO does not have to be correct in the tax imposed in the assessment;
- the burden of proof imposed on taxpayers is onerous; and
- while very few disputes result in litigation, the ATO is well resourced and aware that it is a taxpayer's job to convince a court that an assessment is excessive.

Recent case law

The case of *Mingos v FCT*[8] involved an appeal by the taxpayer pursuant to Pt IVC of the *Taxation Administration Act 1953* (Cth) (TAA) against the disallowance of his objection to the inclusion of the capital gain in his assessable income for the 2014 income year.

The capital gain related to a gain made by a discretionary trust (and distributed to the taxpayer) from the disposal of a dwelling (the property being a residential house) that was asserted by the taxpayer to be exempt from CGT due to the main residence exemption in CGT.[9]

Although the subject property in this dispute was recorded as a trust asset, the taxpayer's case, in short breadth, was that the property was not an asset of the trust but was owned by him beneficially.

The material facts of the case were as follows:

- the property was originally acquired in 1992 by a company (Unique Planning Pty Ltd) on trust for the benefit of the taxpayer absolutely. The taxpayer and his wife and their two children took up occupation of the property as the family's main residence;
- on 16 November 2006, the company transferred the property to the taxpayer, the consideration expressed in the transfer being "entitlement in equity";
- by another transfer of land on 16 November 2006, the taxpayer also transferred the estate in the property to his then wife, the consideration being "natural love and affection". The wife held the interest in the property;
- shortly thereafter in 2006, the marriage started to fail, and the taxpayer moved out of the property into temporary accommodation;
- in November 2010, the taxpayer and his wife entered into a property settlement as a result of the divorce proceedings in the Federal Magistrates Court;
- on 23 December 2010, final orders in the Federal Magistrates Court were entered into by consent in relation to the settlement of property that included, inter alia, the following:
  - the wife was to do all such acts and things and sign such documents at the expense of the taxpayer to transfer to him, or his nominated entity, all her right title and interest in the property; and
  - the taxpayer was obligated to discharge mortgages secured over the property;
- on 27 May 2011, the wife, at the taxpayer's direction, transferred the property to the Lemnian Investment Trust and not to the taxpayer;
- the property was sold by the trust in May 2014; and
- it is the sale of the said property that the taxpayer claimed the main residence exemption under taxation law.[9]

The substantive tax issues in the proceedings were as follows:

- whether or not the taxpayer had an "ownership interest" in the property at the time it was sold in 2014. The court's answer to that question was "no". Davies J reasoned that the taxpayer had failed to discharge the onus of proving

that he had an ownership interest in the property in 2014;[10]

- if so, whether the taxpayer was entitled to the main residence exemption in Subdiv 118-B of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). The court's answer to that question was "no";[11] and
- if not, whether the amount of the capital gain on which the taxpayer was assessed was excessive. It was the taxpayer's burden[12] of proof, and the court's answer to that question was "no", the assessment was not excessive.[13]

> *"However aside from that loan agreement, there is no evidence whatsoever to substantiate either the amount of interest, the land tax or any selling costs."*

Evidence before the court

The taxpayer (Mr Mingos) and his tax agent (Mr Munro) gave evidence in the proceedings. The oral testimony evidence of both witnesses was unsatisfactory in terms of substance and was self-serving.[14] The court made this assessment in contrast to the objective circumstances of the tax dispute and the contemporaneous records that were before the court.

Relevantly, the taxpayer asserted in his affidavit and deposed to the difficulties he had in raising the funds necessary to comply with the orders and to the arrangement for the Lemnian Investment Trust to borrow the funds.

The taxpayer also deposed that to enable the Lemnian Investment Trust to borrow from the mortgagee (the Bank of Queensland), the said property was needed as security, and so he arranged to have the residence transferred to Lemnian Investment Trust.

The taxpayer deposed that he never intended to give "the benefit of" the property to the Lemnian Investment Trust and only transferred the property to the Lemnian Investment Trust because the Bank of Queensland required it that way in order to proceed with the loan.

With respect to the reliability of the taxpayer's evidence (Mr Mingos' evidence), the court opined the following:

> "24. In view of the emails, I reject the taxpayer's evidence that the property was transferred to Lemnian as a requirement of the Bank. His evidence is not supported by the *contemporaneous email correspondence* and no other documentary evidence was adduced which demonstrates that it was a requirement of the Bank that the property be transferred to Lemnian.
>
> …
>
> 27. Mr Mingos' evidence was far from satisfactory. His evidence was vague, lacking in specifics and highly generalised and his subjective view about what he said he understood was contradicted by the objective circumstances that, as a director of Lemnian, he signed the transfer of land form placing title to the property in the name of the company. He also signed, as fairly presenting the Trust's financial position, the Trust accounts for each of the 2011 and 2012 income years in which the property was recorded as an asset of the Trust and the Trust accounts for the 2014 income year in which the sale proceeds were recorded as a receivable of the Trust." (emphasis added)

With respect to the reliability of the tax agent's oral testimony (the tax agent was named Mr Munro), the person who prepared the relevant accounts, the court opined the following:

> "40. Faced with that email, Mr Munro then gave the self-serving evidence that:
>
> MR MUNRO: On reflection, I meant Lemnian Investment Proprietary Limited.
>
> COUNSEL: No, you didn't. You just made the distinction between the trust and the company?
>
> MR MUNRO: I'm saying to you that in my email there it's an error. It's not what I intended to say and it's not consistent with the manner in which we've — we've – we've treated it in the books.
>
> 41. I reject as untruthful his evidence that what he said in the email to the Bank was in error. Against that evidence is the clear email instructing the Bank that the property title was to be in the name of the Trust, which I accept on its face was accurate and shows Mr Munro's evidence to be demonstrably wrong in this respect. Later in his cross-examination Mr Munro gave evidence that he 'never recorded anything as showing that [the] property belonged to the [Trust]' as an asset of the Trust in the financial statements. I reject that evidence also as untruthful as the property plainly was accounted for in the financial statements as an asset of the Trust.
>
> 42. For the reasons given above, I have not accepted the evidence of these witnesses where their testimony was contradicted by contemporaneous documents which I consider to be more reliable. Given the contradictory documentary evidence, I was left with the clear impression that there was a great deal of reconstruction in their evidence, rather than evidence based upon clear recollection."

The court in the *Mingos* case rejected the evidence of these witnesses where their testimony was contradicted by contemporaneous documents.

For completeness, it is noted that the present status of the *Mingos* case is that the taxpayer has lodged an appeal to the Full Federal Court.

In *SDRQ and FCT*,[15] the AAT allowed the taxpayer company to claim a capital loss on the sale of shares in one related company (Company B[16]), but disallowed the capital loss on the sale of shares in another related company (Company A[17]), having regard to the market values of the related companies' shares at the time of acquisition and disposal.

The AAT reduced administrative penalties in the sum of $656,806.30 to the sum of $448,948.75.

The tribunal reasoned:

> "178. The Commissioner also submits, to which I accept, the Applicant *neglected to maintain contemporaneous records* required to substantiate the alleged cost base of the Company A shares and the alleged capital proceeds on the disposal of the Company A shares including the alleged 'formalised' agreements, financial information, and/or management accounts as at the valuation date.

> 179. There is no contemporaneous evidence of any valuation calculations carried out by Mr P or any other person either in 1989 or at any time up to and including when the capital losses were claimed in 2003, 2005 and, relevantly for this proceeding, in 2011.
>
> 180. There is no contemporaneous evidence of the use of valuation inputs or assumptions that are asserted to have been used in the calculation of the valuation of the Company A shares in 1989. Moreover, importantly, I have found that no particular methodology was employed by Mr P (or Mr R) in fixing the purchase price for the Company A shares in January 1989." (emphasis added)

Conclusion

Notwithstanding the many crossroads and challenges in the event of a tax dispute, there is value in conducting an assessment of the reliability of the documentary evidence in support of the taxpayer's position prior to advancing a matter to litigation.

The recent cases of *Mingos v FCT* and *SDRQ and FCT* serve as a timely reminder of the importance of having access to contemporaneous records to support factual propositions in tax positions being adopted.

William Calokerinos, CTA
Barrister
Wentworth Chambers

References

1 Statutory notices include the following: s 353-10 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (TAA) (request for documents); s 353-15, Sch 1 TAA (ATO to enter premises and demand business records); and s 353-25, Sch 1 TAA (ATO power to seek information from outside Australia).

2 PS LA 2012/5; s 284-75(1), Sch 1 TAA.

3 [1992] HCA 35 at [11].

4 [1989] HCA 9.

5 *Lemongrove Services Pty Ltd v Rilroll Pty Ltd* [2019] NSWCA 174 (*Lemongrove Services*).

6 *Lemongrove Services* at [33].

7 *Lemongrove Services* at [45] and [46].

8 *Mingos v FCT* [2019] FCA 834 (*Mingos*).

9 Subdiv 118-B of the *Income Tax Assessment Act* 1997 (Cth) (ITAA97).

10 *Mingos* at [43].

11 *Mingos* at [65].

12 S 14ZZO TAA.

13 *Mingos* at [70].

14 *Mingos* at [25].

15 *SDRQ and FCT* [2019] AATA 2003 (*SDRQ*).

16 *SDRQ* at [197].

17 *SDRQ* at [198].

A Matter of Trusts

by Sam Campbell, ATI, Sladen Legal

TD 2019/D6 and TD 2019/D7: (further) unintended consequences?

While consistent with recent ATO views, TD 2019/D6 and TD 2019/D7 provide minimal clarification on the taxation of Australian discretionary trusts distributing capital gains to foreign beneficiaries.

The ATO recently released TD 2019/D6 and TD 2019/D7 (together, "the determinations") that concern Australian discretionary trusts distributing capital gains to foreign beneficiaries.

The determinations in turn follow the ATO's 2016 discussion paper[1] and effectively "complete the circle" after TD 2017/23 and TD 2017/24 (which dealt with foreign trusts distributing capital gains to Australian beneficiaries) were finalised by the ATO on 13 December 2017.

As with TD 2017/23 and TD 2017/24, the determinations will cause significant and continuing angst for taxpayers and their advisers who are considering and seeking to understand the interaction of Australia's trust taxation rules and the cross-border distribution of capital gains, and this highlights the need for real reform in this area.

How did we get here?

> "The government is aware that due to the short timeframe involved in developing these amendments, there may be scope for unintended consequences. The operation of these amendments will therefore be closely monitored and if unintended consequences are identified, the government will act to remedy these consequences retrospectively where appropriate.
>
> The broader review of the trust income tax provisions remains the primary focus for the government. This will simplify the system, rewrite the rules and give more certainty to the many thousands of small businesses and farmers who use trusts."[2]

Section 95 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) provides that the net income of a trust is calculated on the assumption that the trustee is an Australian resident taxpayer. On this basis, the trustee includes income from all sources, whether in or outside Australia, when calculating its net income.

Following the 2010 High Court decision in *FCT v Bamford*,[3] in 2011, the *Tax Laws Amendment (2011 Measures No. 5) Act 2011* (interim measures) amended Subdiv 115-C (capital gains) and Subdiv 207-B (franked dividends) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) and introduced Div 6E into the ITAA36. In light of the perceived difficulties presented by *Bamford*, the interim measures (including the introduction of Div 6E) sought to allow for the streaming of franked dividends and capital gains.

Division 6E modified the calculation of the net income of the trust and the income of the trust to exclude franked dividends and capital gains which are taxed under Subdiv 115-C and Subdiv 207-B. Subdivision 115-C (when read with Div 6E) provides that capital gains can be streamed to beneficiaries, including foreign resident beneficiaries.

Section 855-10 ITAA97 states that foreign residents can disregard a capital gain or loss from a CGT event if the CGT event happens in relation to an asset that is non-taxable Australian property (non-TAP). Section 855-40 ITAA97 provides for a similar outcome in relation to foreign residents owning CGT assets through fixed trusts. Taxable Australian property (TAP) includes Australian real property and indirect interests in Australian real property. As a result, where a capital gain relates to TAP, the foreign resident beneficiary will be subject to Australian tax on the net capital gain. However, where the trust is a fixed trust, s 855-40 would apply to disregard the gain or loss if the asset is non-TAP.

Prior to the interim measures, the ATO had expressed views that the exemption under s 855-10 may have applied when foreign residents receive a distribution of a capital gain, not being TAP, from a discretionary trust.[4] The ATO has also expressed views that it may not apply.[5] However, since the introduction of the interim measures, the ATO view has been that s 855-10 does not operate to disregard a capital gain from not being TAP when the foreign resident distributed the gain from the discretionary trust. In the discussion paper, the ATO said:

> "9. It has been suggested that [the] 'general' exemption provision [in s 855-10 ITAA97] disregards a capital gain which a foreign beneficiary of a non-fixed trust is taken to have made as a result of a CGT event happening to non-TAP assets of the trust.
>
> 10. However, a capital gain that a foreign beneficiary makes because of the operation of subsection 115-215(3) is not a capital gain from a CGT event that happens to the beneficiary; rather, such an event happens to the trustee. While subsection 855-10(1) does not expressly provide that the relevant CGT event must happen 'to' the foreign resident, this is an inference reasonably drawn from the statutory context.
>
> 11. In particular, the presence of a specific rule in section 855-40 enabling beneficiaries of fixed trusts to disregard certain trust capital gains seems to us to be a strong indicator that beneficiaries of non-fixed trusts are not catered for by section 855-10.
>
> 12. If subsection 855-10(1) could disregard trust capital gains attributed to foreign beneficiaries, it presumably could do so without regard to whether or not the trust was a fixed trust, rendering that aspect of section 855-40 redundant. The statutory context strongly suggests to us that the intention is to disregard capital gains for foreign beneficiaries of fixed trusts, but not foreign beneficiaries of non-fixed trusts. Such an intention is consistent with the policy considerations set out above."

And further:

> "19. …The source concept in Division 6 appears to us not (or no longer since 2011) relevant in determining whether an amount of trust capital gain is assessable to the non-resident beneficiary or trustee. [The same view would apply in relation to a non-resident beneficiary's share of TAP gains of a non-resident trust and trustee's share of capital that are assessed under 115-222.]"

In the explanatory memorandum to the interim measures, the ATO said that "the capital gains and losses provisions bring to account gains and losses on the disposal of a 'taxable Australian asset' rather than on Australian-sourced capital gains and losses". However, it is less than clear that the "statutory context" (including the explanatory memorandum to the interim measures) does actually support a change in approach by the ATO to the application of Div 855 ITAA97 as it applies to discretionary trusts. On one view, the ATO's approach could arguably be counter to the objective of Div 855 (that foreign persons disregard capital gains from CGT assets that are not TAP) and the principle underpinning Div 6 ITAA36 (that non-residents should not be subject to Australian tax on trust income that does not have an Australian source).

TD 2019/D6 and TD 2019/D7

When it released TD 2017/23 and TD 2017/24, the ATO had indicated that it would produce further guidance on the interaction between Div 855, the source concept in Div 6, the CGT provisions and Subdiv 115-C. The ATO has now introduced the determinations.

In TD 2019/D6, the ATO says that a foreign beneficiary presently (or specifically) entitled to a capital gain made by an Australian discretionary trust on an asset that is non-TAP is assessable on the capital gain, even though that would not occur if the foreign resident made the gain directly, or through a fixed trust, rather than through a discretionary trust.

The ATO continues in TD 2019/D7 by saying that a foreign beneficiary of a discretionary trust is assessable on non-TAP capital gains, irrespective of whether the gain has an Australian source or not.

In TD 2019/D7, the ATO notes that "source" is relevant to the application of s 99D ITAA36. Section 99D could potentially apply to all or part of a foreign source capital gain. However, the ATO notes that any refund entitlement under s 99D is subject to the Commissioner's discretion where there was a purpose of enabling the beneficiary to obtain the refund of tax.

Section 99D ITAA36 provides that, broadly, where foreign sourced income that has been assessed to the trustee of a resident trust (pursuant to either s 99 or 99A ITAA36) is paid to a non-resident beneficiary who was a non-resident at the time that income was derived, that beneficiary (subject to the discretion of the Commissioner) is entitled to a refund of the tax paid by the trustee.

An example to which TD 2019/D6 applies would be a capital gain from Australian Stock Exchange listed shares distributed to a foreign beneficiary by an Australian discretionary trust. TD 2019/D7 takes this example even further to a scenario where an Australian discretionary trust distributed a capital gain from shares listed on (say) the New York Stock Exchange to the foreign beneficiary.

The determinations do not affect the taxation of capital gains that arise from TAP.

While the ATO views in TD 2019/D7 appear to be (yet another) unintended consequence of the interim measures and the changes to Div 6 and Subdiv 115-C, these views are similar to those previously voiced by the ATO. While the ATO views in the determinations are controversial, those views are not surprising and replicate its views from the discussion paper. However, as noted above, these views are controversial and unhelpful in seeking to clarify the application of the law in this area.

The ATO says that, when the determinations are finalised, TD 2019/D6 will apply before and after its date of issue, while TD 2019/D7 will apply for the income year ending 30 June 2020 and later income years. The determinations will not apply to the extent that they conflict with the terms of settlement of a dispute agreed to before the date of finalisation.

For the income year ending 30 June 2019 and earlier income years, the ATO says that it will not seek to disturb approaches taken for capital gains from non-TAP assets which are consistent with the source principles present in the pre-2011 streaming legislation (providing such approaches are not artificial or contrived, or otherwise have a dominant purpose of tax avoidance).

Where to now?

In TD 2019/D6, the Commissioner says that "when the provisions are read as a whole and in context, and having regard to the way the provisions have developed over time", then his views are supported. The position taken by the Commissioner in TD 2019/D7 may be foreshadowed by the discussion paper but it is not supported by any prior changes or amendments to the law, including the interim measures.

Division 6 has its origins in 1915, the CGT provisions are from 1985, Div 855 is from 2007, and the post-*Bamford* rewrite of Subdiv 115-C is from 2011, but the ATO's views from the discussion paper in 2016 and now the determinations are not comfortable bedfellows.

Continued tinkering and further "changes" in ATO views as to the application of the relevant laws without progressing proper legislative reform in the area only continues to bring out yet more "unintended consequences" in relation to trusts and the foreign beneficiaries of trusts and the assessment of tax to those trusts and beneficiaries (including capital gains tax). It remains to be seen whether the ATO has the willingness or appetite for the reforms required.

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1 ATO, *Capital gains and non-resident trust beneficiaries*, discussion paper, 22 December 2016.

2 Assistant Treasurer Bill Shorten, MP, Tax Laws Amendment (2011 Measures No. 5) Bill 2011, second reading speech, 2 June 2011.

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

4 See, for example, PBR 76868.

5 See ID 2007/60 (a very similar position is ultimately taken by the ATO in TD 2019/D6).

Superannuation

by Daniel Butler, CTA, and
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NALI warning: LCR 2019/D3

LCR 2019/D3 contains a very draconian application of the newly amended non-arm's length income and expenditure provisions for self-managed superannuation funds.

Overview

LCR 2019/D3 contains a very draconian application of the newly amended non-arm's length income (NALI) and expenditure (NALE) provisions in s 295-550(1)(b) and (c) of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Advisers must be aware of this application. However, it should be noted that there is considerable opposition to certain aspects of the draft ruling and hopefully this will be revised before being finalised.

The warning relates to situations where, say, an accounting firm provides discounted accounting services to a related party's self-managed superannuation fund (SMSF).

Background

For many years, provisions have existed that seek to prevent income from being unduly diverted into the concessionally taxed superannuation environment. Originally, such provisions were contained in the now repealed s 273 of the *Income Tax Assessment Act 1936* (Cth). The old s 273 used the term "special income". Section 273 was replaced with effect from 1 July 2007 with s 295-550 ITAA97. Similarly, the term "special income" was replaced with effect from 1 July 2007 with the term "non-arm's length income". However, the 2007 changes were a mere rewrite and did not substantially alter the scope of the operation of the provisions.

In FY2018, the Treasury Laws Amendment (2018 Superannuation Measures No. 1) Bill 2018 was introduced into parliament. The explanatory memorandum (EM) to this Bill expressed a concern that there may be a technical deficiency in the NALI provisions as they then stood. The concern was that NALE did not result in excessive income being NALI, despite the fact that this was what was intended.

The Bill proposed to amend the NALI provisions. At the risk of oversimplication, the proposed amendments were as follows: in gaining or producing the income, if there is any NALE that is less than what might have been expected if parties were dealing at arm's length, that income is also NALI. Non-arm's length expenditure includes not just an expenditure, but also a loss or an outgoing that is lower than an arm's length amount, and also includes where there is a nil amount (eg no expenditure).

This original Bill proposed to take effect from 1 July 2018.

The Bill lapsed when the 45th parliament was prorogued and the House of Representatives was dissolved on 11 April 2019.

However, the NALI and NALE provisions have since returned in the *Treasury Laws Amendment (2018 Superannuation Measures No. 1) Act 2019* (Cth). This Act received royal assent on 2 October 2019. Item 4 of Sch 2 of the Act provides that the NALI and NALE provisions have effect from 1 July 2018.

What the EM says

Paragraph 2.38 of the EM of the second Bill (ie the Bill that ultimately did become law) states that:

> "Where there is a scheme that produced non-arm's length income by applying non arm's length expenses, there must also be a sufficient nexus between the expense/s and the income, that is, the expenditure must have been incurred 'in' gaining or producing the relevant income."

In light of this, recall the situations that this article's key warning relates to. Namely, situations where, say, an accounting firm provides discounted accounting services to a partner's SMSF.

The comments in para 2.38 seem to suggest that discounted accounting fees will have no impact on the NALI situation. This is because, on first blush, accounting expenditure is not incurred "in" gaining or producing any income. For example, a tenant will pay the same quantum of rent and a company will pay the same quantum of dividends regardless of the identify of the SMSF's accountant and how much that accountant charges the SMSF.

However, the authors stress that this is only what one *might* think *on first blush* if one *only* reads the new provisions and the EM.

The draft ruling must also be considered

The draft ruling initially repeats para 2.38 of the EM in substance. Namely, the draft ruling states in para 16:

> "In identifying whether the complying superannuation fund has incurred non-arm's length income, there must be a sufficient nexus between the non-arm's length expenditure and the relevant ordinary or statutory income."

However, the draft ruling then goes further, stating in para 18:

> "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 (see Example 2 of this Ruling)."

Example 2 is as follows:

> "Example 2 — non-arm's length expenditure incurred has a nexus to all income of the fund — NALI
>
> 21. For the 2020–21 income year, Mikasa as trustee of her SMSF, engages an accounting firm, where she is a partner, to provide accounting services for the fund. The accounting firm does not charge the fund for those services.
>
> 22. For the purposes of subsection 295-550(1), the scheme involves the SMSF acquiring the accounting services under a non-arm's length arrangement. The non-arm's length expenditure (being the nil amount

> incurred for the services) has a sufficient nexus with all of the ordinary and statutory income derived by the SMSF for the 2020–21 income year. *As such, all of the SMSF's income for the 2020–21 income year is NALI.*" (emphasis added)

This is a draconian outcome. It is now considered in more detail.

Discounted accounting fees

The amount that the accounting firm might charge for accounting services on a purely arm's length basis might be, say, $2,000 to $8,000, depending on the complexity of the SMSF. In the draft ruling's example, the fees were reduced to nil.

Now consider the most recent ATO statistics (ie the *Self-managed super fund quarterly statistical report — June 2019*). These statistics indicate that the "average" size of an SMSF for FY2018 is $1,271,356. Assuming a net income yield of 4%, this means the "average" SMSF has income of $50,854.24.

It seems harsh that a saving of $2,000 to $8,000 could cause, on average, $50,854.24 of income to become NALI.

The situation is even more drastic if it is remembered that the saving could be far smaller than $2,000 to $8,000. Remember that the new provisions apply to not just nil expenditures, but also to reduced expenditures. Accordingly, consider an accounting bill that has a discount of, say, $200 to $800 because the SMSF belonged to a partner, a staff member, or friends or family of a staff member. On the ATO's approach in the draft ruling, such a modest act of benevolence would still cause the entire $50,854.24 of income to become NALI!

Mitigating factors

The ATO has also issued PCG 2019/D6 that mitigates this situation somewhat. Namely, it states that:

> "The ATO will not allocate compliance resources to determine whether the NALI provisions apply to a complying superannuation fund for the 2018-19 and 2019-20 income years where the fund incurred non-arm's length expenditure (as described in paragraphs 9 to 12 of LCR 2019/D3) of a general nature that has a sufficient nexus to all ordinary and/or statutory income derived by the fund in those respective income years (for example, non-arm's length expenditure on accounting services)."

The warning

Hopefully, the warning is already clear: SMSFs should no long accept any sort of discounts unless those discounts are entirely consistent with an arm's length dealing.

With the greatest of respect, the authors hope that the ATO abandons or alters its current view. This is because, as demonstrated above, the current view could cause disproportionate tax that seems to go far beyond what the legislature intended (as indicated by para 2.38 of the EM).

For example, extrapolating the current ATO view, if an SMSF was to receive a $100 discount on its accounting fees as a result of an SMSF member working at an accounting firm, not only is the fund's entire net income for that financial year subject to 45% tax, but any net capital gain realised on any asset held by that fund at that time is also likely to be subject to 45% tax.

While this example is an absurd outcome, it reflects the ATO's current view that a general expense has a nexus to the derivation of all of the fund's ordinary income and statutory income (which includes a net capital gain).

Conclusion

Due to LCR 2019/D3, SMSFs should no longer accept any sort of discounts unless those discounts are entirely consistent with an arm's length dealing. This is relevant for, say, fees for accounting services provided by an accounting firm to a related party's SMSF.

Arguably though, SMSFs can wait until 1 July 2020 before implementing this based on PCG 2019/D6. Also, practitioners should "watch this space" as the ultimate position might still change.

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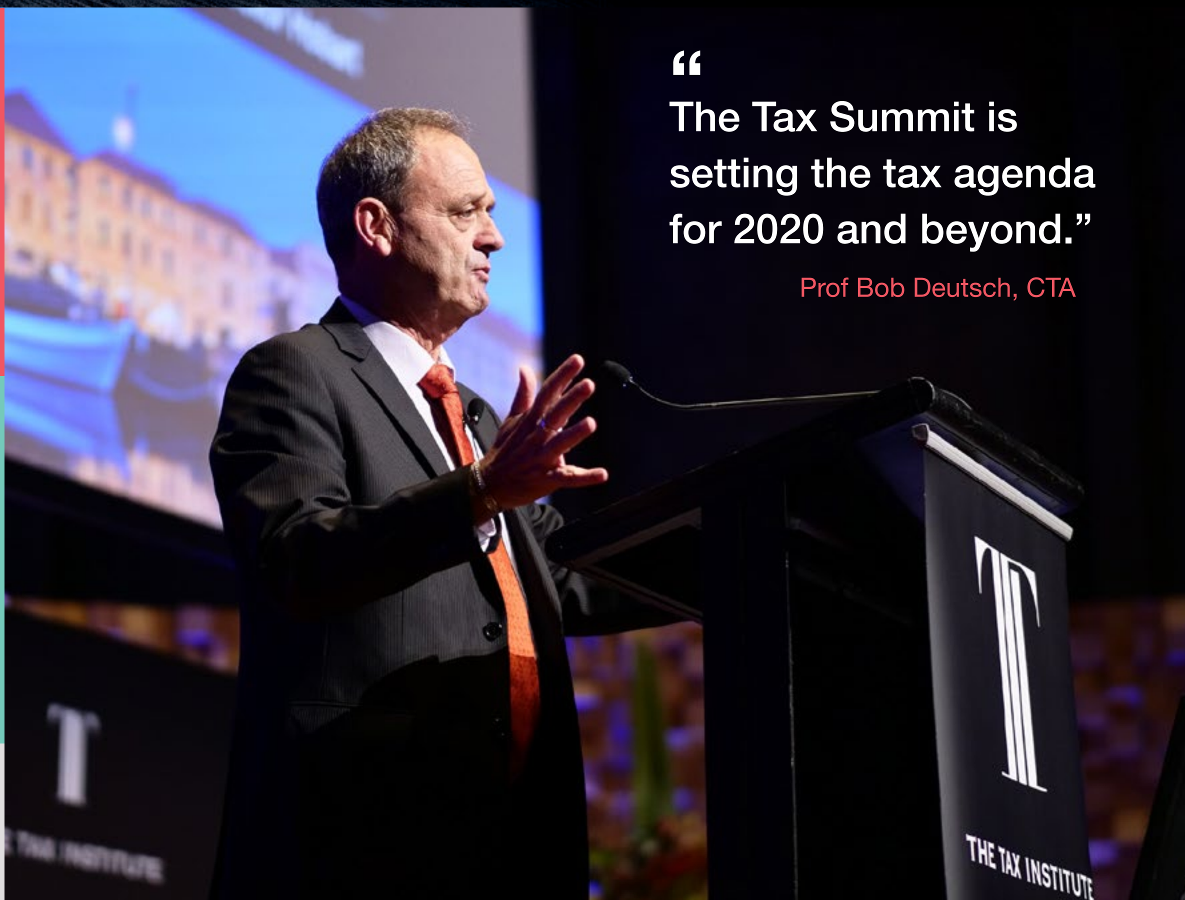

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Tax Cases

by Michael Norbury, CTA, Norbury Lawyers

Is it a capital or an income expense?

In *Sharpcan*, the High Court has considered longstanding principles relating to whether an outgoing was on revenue or capital account.

In *FCT v Sharpcan Pty Ltd*,[1] the High Court considered whether the purchase price, which was paid by instalments, of 18 gaming machines was an outgoing on revenue or capital account.

Facts

The taxpayer was the sole beneficiary of a trust. The trustee of the trust purchased the business of the Daylesford Royal Hotel from Tattersall's Ltd on 8 August 2005 for $1,025,000. At the time of purchase, the hotel premises were approved under the Victorian *Gambling Regulation Act 2003*. Tattersall's was the approved operator of 18 gaming machines, all owned by Tattersall's and used at the hotel.

As part of the sale of the hotel business, the trustee did not purchase any rights to the gaming machines. After the sale, Tattersall's continued to operate the 18 gaming machines, and paid a share of the gaming machine takings to the trustee.[2]

In 2008, the Victorian Government announced that the gaming operator licences issued to Tattersall's would not be renewed following their expiration in 2012, and that a new regulatory regime would be introduced in their place. Gaming machine entitlements would be allocated directly to gaming venue operators.

The Victorian Government put up the new gaming machine entitlements for auction, and the trustee bid $600,300 for 18 new entitlements. Each entitlement permitted the trustee to operate one gaming machine for 10 years at the hotel.[3]

In order to fund the purchase of the entitlements, the trustee entered into a deferred payment arrangement with the Victorian Minister for Gaming which provided for payment over the period May 2010 to August 2016. The arrangement provided that, if there was a default in payment, the number of entitlements proportional to the default would be forfeited. The trustee made all payments under the arrangement.[4]

The trustee entered into various contracts to ensure that its machines were "approved gaming machines" for the purposes of Victorian gaming regulations.

The trustee operated the 18 machines on the hotel site and derived income from them until it sold the hotel business in November 2015.[5]

In its income tax return for the year of income ended 30 June 2012, the trustee claimed the purchase price of the entitlements as a deduction under s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) or, alternatively, one-fifth of the purchase price as a deduction under s 40-880 ITAA97. The Commissioner disallowed both claims.[6]

Proceedings before the AAT

The taxpayer sought review of the Commissioner's decision in the AAT. Pagone J, sitting as Deputy President of the AAT, set aside the Commissioner's decision on the basis that the amount paid for the entitlements was allowable as a deduction in respect of the 2010 year of income under s 8-1 ITAA97. Pagone J reasoned that, although "[s]ome features of [the entitlements] may be thought to be of capital or of a capital nature", "[t]he character of the outgoing … must be answered by considering what the expenditure was effected to calculate for the business of the trustee from a practical and business point of view", and that "[t]he outgoing for the [entitlements] in the trustee's business is more like a fee paid for the regular conduct of a business than the acquisition of a permanent or enduring asset". In his Honour's view:[7]

> "The outgoings were for the statutory entitlement to conduct gaming at its premises on gaming machines over time, and the amount of the bid reflected the expected income stream from the use of those other assets which the [entitlements] permitted. An incident of acquiring the [entitlements] by the outgoing may have been to have preserved the trustee's income earning structure, but the purpose of the outgoing was to obtain the right to conduct gaming to enable the trustee to derive the future income which was expected from the gaming."

Proceedings before the Full Court

The Commissioner appealed to the Full Federal Court which, by majority, dismissed the appeal.[8]

The Commissioner appealed to the High Court

High Court decision

The five members of the High Court delivered one judgment.

The High Court found that the Full Court majority accepted that there were factors which suggested that the outgoing was in the nature of a capital outgoing. These factors were that:[8]

1. the entitlements were intangible assets created pursuant to statute;
2. the entitlements could be bought and sold;
3. the entitlements conferred on the trustee a statutory authority necessary lawfully to conduct gaming on gaming machines;
4. the entitlements were of 10 years' duration (subject to a liability to forfeiture for breach of the operating conditions);
5. the price which the trustee paid for the entitlements was set at auction and, despite the deferred payment agreement, was properly characterised as a lump sum;
6. the price was payable irrespective of the fortunes of the business;
7. the fundamental change in the arrangements involved the trustee conducting gaming and becoming entitled to the whole of the income generated from the gaming activities for the entire period of 10 years; and

8. the trustee became responsible for outgoings for the supply, maintenance and monitoring of gaming machines and the payment of taxes in respect of gaming.

The High Court found, however, that the Full Court majority considered there were, in effect, four factors which, taken together, led to the conclusion that the outgoing was on revenue account. They were that:[9]

1. the outgoing had "to be recouped out of, in effect, every day's trading across all facets of the integrated business and especially out of gaming revenues";
2. the outgoing reflected "the economic value of the income stream expected from putting other assets to use to derive income" from gaming;
3. the outgoing was "incurred in relation to a business properly understood as an integrated hotel business characterised by the various trading activities [being the sale of drinks, meals and accommodation], including gaming, conducted by the trustee", which "the Commissioner ha[d], quite artificially, looked *through* and *beyond*" to "*excise*[ ] … that part of it which relate[d] to gaming"; and
4. "[t]he trustee was confronted with the changed circumstances brought about by government intervention and had to respond to the possible loss of the right to derive revenue from gaming activities", and "[i]f the trustee [had] not bid for, and [won] the bidding for, 18 entitlements … it would not have any income from gaming from 16 August 2012" and "the business of the integrated hotel undertaking would have been significantly at risk".

The High Court noted that the majority in the Full Court equated the purchase price of the entitlements to amounts paid by BP Australia to service station proprietors to secure solo-site tying arrangements. In *BP Australia Ltd v FCT*,[10] the Privy Council held that these amounts were deductible under s 51(1) of the *Income Tax and Social Services Contributions Assessment Act 1936* (Cth) as amounts paid out of "circulating capital" which "had come back penny by penny with every order during the period in order to reimburse and justify the particular outlay".[11]

The majority found in the alternative that, if the purchase price were an outgoing on capital account, it would be deductible under s 40-880 ITAA97 because the purpose of the expenditure from a practical and business point of view was to preserve the goodwill of the hotel business, and the value to the trustee of the entitlements was solely attributable to the effect that they had on the goodwill of the business.[12]

The minority in the Full Court concluded that the entitlements were a capital asset of enduring value acquired as a "means of production", being "capital assets necessary for it to conduct gaming activities". The minority observed that it was "not to the point that changes in the law were the reason why the trustee formed a desire to acquire those assets, or formed the view that it was commercially necessary for those assets to be acquired". The minority did not accept that the outgoing reflected "the economic value of the income stream expected from putting other assets to use to derive income from gaming", and said, "even if it had, that would not have been a basis for concluding that the expenditure was on revenue account". Nor did the minority accept that the purchase price was analogous to the amounts paid by BP Australia to secure tying arrangements. As the minority explained:[13]

> "The practical commercial requirement to acquire the [entitlements] was a one-off expenditure which would secure for the trustee the ability to conduct gaming for a period of 10 years. This was a significant, one-off, structural change to the way the business operated. It was not expenditure which would need to be repeated over and again as a necessity of trade comparable to the need on the part of BP [Australia] to secure trade ties with numerous petrol retailers."

The minority also rejected the claim to deduct part of the purchase price of the entitlements under s 40-880 ITAA97. The minority denied that the entitlements were acquired "to preserve (but not enhance) the value of goodwill". The evidence demonstrated "that the purpose of the expenditure was to acquire [the entitlements] at the lowest possible price … to enable the trustee lawfully to commence conducting gaming activities and derive income (greater over the full term than had previously been derived) through the exercise of the rights … for 10 years absent a sale of the rights to an incoming purchaser", rather than "to preserve (but not enhance) the value of goodwill". The minority also denied that the value of the entitlements to the trustee was "solely attributable" to the effect that they had on "goodwill". The minority held that they "had a value distinct from any effect [they] had on goodwill", which inhered in the fact that they were "a valuable asset capable of transfer" which "resulted in a taxable income stream" different from, and likely to be significantly more profitable than, that which had previously been earned.[14]

The High Court considered the arguments in greater detail.

Assets of enduring advantage

The taxpayer submitted that, although the entitlements were of nominally 10 years' duration, the purchase price was incurred on revenue account because their acquisition did not amount to the acquisition of "permanent rights" or, alternatively, because the rights conferred by the entitlements were in the nature of statutory licences subject to forfeiture if there was failure to comply with their conditions and the possibility of statutory amendment. *FCT v Citylink Melbourne Ltd*[15] and *ICM Agriculture Pty Ltd v The Commonwealth* were cited in support.[16]

This was rejected by the High Court: *Citylink* provided no support for the idea that the acquisition of the entitlements was not the acquisition of an asset of enduring advantage. The High Court found that, in *Citylink*, the concession agreement in issue was essentially a licence agreement "to *use* capital assets for the limited period of the concession". It followed that concession fees under the agreement, which were payable semi-annually and calculated in part on the basis of revenue generated, were "periodic licence fees" for such use. They were not the purchase price for the *acquisition* of any enduring advantage, because the agreement did not confer any "permanent ownership rights" over the roads and lands which were the subject of the concession. Although the concession agreement was of 30 years' duration, that fact did not alter the character of the advantage sought by the fees payable under it.[17]

Purchase price funded out of revenue

The High Court found that the majority in the Full Court attributed significance to the fact that the trustee had purchased the entitlements with the intention that the purchase price should be funded out of receipts of gaming income derived from the operation of the entitlements. However, the evidence did not go so far and, even if it had, the existence of such an intention would only serve to confirm that the trustee expected the entitlements to generate income over a substantial period of time and thus be of enduring advantage to the business. The nature of a once-and-for-all outgoing for the acquisition of an asset is determined by the character of the advantage sought to be achieved by its acquisition, not by the source of funds with which it is purchased. The High Court drew the distinction between a once-and-for-all outgoing for the acquisition of something of enduring advantage and a periodical outlay to cover the use and enjoyment of something for periods commensurate with those payments. The intended source of funding did not imply that the purchase price of the entitlements was not a once-and-for-all outgoing for the acquisition of something of enduring advantage.[18]

Economic value of income stream

The High Court found that the majority in the Full Court considered it to be significant that the trustee calculated the maximum amount which it was prepared to bid for the entitlements on the basis of a projection of what the entitlements were likely to return over the course of their 10-year term. The evidence did not go so far and, even if it had, it would not have been significant. Proper analysis of what the acquisition of the entitlements was calculated to effect from a practical and business point of view required taking account the legal rights and obligations thereby created and their expected consequences for the trustee's business. Regardless of the considerations informing the amount that the trustee was willing to pay for the entitlements, the purchase price for the entitlements was a lump sum paid for the acquisition of the entitlements which was payable regardless of the amount of income that might be earned from them.[19]

The High Court accepted that most rational business operators would not contemplate the acquisition of a capital asset unless the present discounted value of the stream of income which it is expected to generate over its lifetime was at least as much as its purchase price. But there was nothing in principle or authority which supported the idea that that was a basis to treat the acquisition of a capital asset as if it were acquired on revenue account.[20]

Obstacle to integrated business

The majority in the Full Court considered it to be significant that the purchase price of the entitlements was "incurred in relation to a business properly understood as an integrated hotel business" and referred to the Commissioner as having artificially looked "*through* and *beyond* the integrated undertaking of the hotel business and *excised* from it that part of it which relate[d] to gaming". Similarly before the High Court, the taxpayer emphasised that the trustee's purchase of the entitlements was not the purchase of a new business, or the addition of a new and distinct aspect of business, but rather a means of dealing with an obstacle to continued trade as a result of the change in legislation.[21]

This was rejected by the High Court. The determination of whether an outgoing was incurred on capital account or revenue account depended on the nature and purpose of the outgoing: specifically, whether the outgoing was calculated to effect the acquisition of an enduring advantage to the business. And the identification of what (if anything) was to be acquired by an outgoing ultimately required a counterfactual, not a historical, analysis: specifically, a comparison of the expected structure of the business after the outgoing with the expected structure *but for* the outgoing, not with the structure *before* the outgoing. Other things being equal, it made no difference whether the outlay had the effect of expanding the business or simply maintaining it at its present level. If a once-and-for-all payment was made for the acquisition of an asset of enduring advantage which, once acquired, formed part of the profit-earning structure of the business, the payment was incurred on capital account.[22]

The High Court illustrated the point: if a tradesperson's delivery van reaches the end of its working life, it may be necessary for the tradesperson to purchase a new delivery van in order to continue to carry on business as he or she has done up to that point. But the purchase price of the new van is not a revenue outgoing. It is the acquisition of an asset of enduring advantage which is incurred on capital account. The same applied to the trustee's purchase of the entitlements. It was necessary for the trustee to purchase the entitlements in order to continue to carry on its business as it had done up to that point. But the purchase price was a once-and-for-all payment for the acquisition of an asset of enduring advantage (the 18 entitlements) which, once acquired, formed part of the profit-earning structure of the trustee's business. It was incurred on capital account.[23]

No commercial choice

Finally, the High Court analysed the last of the majority's reasons, that is, that the impending statutory regime presented a major threat to the revenues, profitability and goodwill of the hotel unless the entitlements were acquired, thereby depriving the trustee of any commercial choice other than to bid successfully for the entitlements. The majority equated that to the circumstance in *BP Australia Ltd* that BP Australia's entry into the solo-site agreements under which it made payments to petrol retailers was in effect foisted on it by the actions of its competitors entering into similar agreements with other retailers and thus leaving it with no choice but to do likewise. The majority in the Full Court reasoned that the fact that the purchase of the entitlements was foisted on the trustee meant, or contributed to the conclusion, that the purchase price of the entitlements was incurred on revenue account.[24]

The High Court found that reasoning misplaced. The determination of whether a taxpayer acquired an asset on capital account or revenue account was not affected by whether the taxpayer's assessment of the need to acquire the asset was foisted on the taxpayer. Nor was it the case that the determination of whether expenditure is incurred on capital account or revenue account depended on whether,

but for acquisition of the asset, the taxpayer might have suffered a substantial reduction in income or be unable to continue in business. It depended on whether the asset was acquired as part of fixed capital (as part of the profit-earning structure of the business) or as part of working capital to be used up in the course of the regular and recurrent operation of the profit-earning structure of the business. The High Court approved the minority's conclusion that the entitlements were a capital asset of enduring value acquired as a "means of production" to put the trustee in a position where it owned the capital assets necessary for it to conduct gaming activities.[25]

Section 40-880

The High Court also considered the application of s 40-880 ITAA97. At the relevant time, it provided:

> "(1) The object of this section is to make certain business capital expenditure deductible over 5 years if:
>
> (a) the expenditure is not otherwise taken into account; and
>
> (b) a deduction is not denied by some other provision; and
>
> (c) the business is, was or is proposed to be carried on for a taxable purpose.
>
> …
>
> (2) You can deduct, in equal proportions over a period of 5 income years starting in the year in which you incur it, capital expenditure you incur:
>
> (a) in relation to your business …
>
> (5) You cannot deduct anything under this section for an amount of expenditure you incur to the extent that:
>
> …
>
> (d) it is in relation to a lease or other legal or equitable right; or
>
> …
>
> (f) it could, apart from this section, be taken into account in working out the amount of a capital gain or capital loss from a *CGT event …
>
> (6) The exceptions in paragraphs (5)(d) and (f) do not apply to expenditure you incur to preserve (but not enhance) the value of goodwill if the expenditure you incur is in relation to a legal or equitable right and the value to you of the right is solely attributable to the effect that the right has on goodwill."

The High Court found that the purpose of that section was to allow a deduction for capital expenditure which was incurred to preserve goodwill by acquiring a legal or equitable right that has no value to the taxpayer independent of its effect on goodwill, and which could not otherwise be brought to account under the ITAA97.[26]

The amending Act which introduced s 40-880(2) abolished the ability to include expenditure in relation to goodwill in the fourth element of the CGT cost base. It created a new deduction under s 40-880(2) in effect to preserve the deductibility of such expenditure.[27]

The High Court found that the purpose of s 40-880(6) was to confine deductibility under s 40-880(2) for expenditure in relation to goodwill to expenditure in relation to goodwill that could not otherwise be brought to account under the ITAA97. Because the entitlements were a kind of property and thus CGT assets, the purchase price of the entitlements could be brought to account under the Act in the first element of the CGT cost base of the entitlements.[28]

Conclusion and comment

On the capital–income dichotomy, the High Court has upheld principles enunciated by the Privy Council more than 50 years ago. The High Court has clearly, and relatively succinctly, restated those principles.

The High Court has also given us an explanation of the "black hole" expenditure provisions.

Both aspects are welcome.

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Alternative Assets Insights

by Peter Collins, FTI, PwC

Glencore v FCT: transfer pricing decision

The *Glencore* case is expected to have a significant impact on a broad range of outstanding transfer pricing disputes.

On 3 September 2019, the Federal Court (Davies J) handed down its decision in *Glencore Investment Pty Ltd v FCT*[1] in favour of the taxpayer. This judgment is important because it provides clarity in relation to Australia's transfer pricing rules and, in particular, aspects of the Full Federal Court's 2017 decision in the *Chevron* case.[2] Subject to the outcome of any appeal, this latest transfer pricing decision is expected to have a significant impact on a broad range of outstanding transfer pricing disputes.

Background to recent transfer pricing disputes in Australia

The Australian Taxation Office has recently explained that transfer pricing is a key area given its importance to the Australian taxation system. Its main areas of focus are related party loans, marketing "hubs" and inbound "distributor" supply chains. In addition, the ATO has described a range of "transfer mis-pricing traps".

In an endeavour to provide greater levels of certainty, the ATO has provided, in recent years, a number of practical compliance guidelines (PCGs). In broad terms, these PCGs set the ATO perspective on what it considers are safe "green zone" arrangements in relation to transfer pricing issues, as well as risky "red zone" arrangements. While these PCGs are designed as risk assessment tools only, in some circumstances, a practical difficulty with these safe harbours is that, when individual transactions are assessed, they do not align with international transfer pricing guidelines. Ultimately, this lack of alignment could lead to double taxation that will need to be resolved through bilateral dispute resolution mechanisms, which is a costly, uncertain and time-consuming exercise.

The ATO's focus on transfer pricing follows the Full Federal Court decision in the *Chevron* case, which involved the application of Australia's transfer pricing rules to a related party loan. A confidential settlement was reached in 2018 before the High Court heard the taxpayer's special leave application.

Glencore decision

The Federal Court's decision in the *Glencore* matter concerned transfer pricing aspects of the acquisition of copper concentrate under an offtake agreement (the contract) by Glencore International AG (buyer) (GIAG) from its subsidiary, Cobar Management Pty Ltd (the seller) (CMPL), an Australian company which owned and operated the mine in Australia. The evidence heard by the court was that, in 2007, there was uncertainty in future copper prices and higher costs associated with the mine, and in that context, the pricing arrangement in the contract was changed.

The case considered whether the Commissioner was able to take a "flexible" approach to identifying the substitute hypothesis for arm's length purposes, including inserting additional clauses and changing the structure of the pricing arrangement between the parties. In particular, the Commissioner sought to replace the pricing mechanism, agreed in 2007 to be set at 23% of the copper reference price on the London Metals Exchange, with the historical benchmark previously used by the parties. In effect, the Commissioner's approach sought to reconstruct the arrangement to what the Commissioner considered independent parties would have agreed, rather than re-price the actual arrangement entered into. The Commissioner issued amended assessments to reflect the mechanism previously used and increased consideration paid under the contract by AU$241m over the 2007 and 2009 years.

Davies J allowed the taxpayer's appeal in full (with costs). The 127-page judgment sets out a number of key principles regarding the Australian transfer pricing provisions (former Div 13 of the *Income Tax Assessment Act 1936* (Cth) and Subdiv 815-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)) and the *Chevron* decision, which are summarised below.

The threshold for reconstruction — flexible does not mean unconstrained. The transfer pricing analysis "should be based on the form of the actual transaction entered into" and the Commissioner is unable to simply "recast" the transaction "as a different transaction". Davies J rejected the Commissioner's reliance on the term "flexible comparative analysis" by Allsop CJ in the *Chevron* decision. Instead, any reconstruction is limited to the exceptional circumstances referred to in the Organisation for Economic Co-operation and Development (OECD) guidelines. The Commissioner cannot "flexibly" reconstruct the terms of an agreement for the purposes of conducting the comparative analysis and must generally respect the actual transaction entered into between the parties.

It is important to highlight that the Commissioner has endeavoured to rely on this reconstruction approach in numerous taxpayer disputes and the decision may significantly impact these disputes. The OECD's "exceptional circumstances" are limited to arrangements where the substance and form of the transaction are not aligned, or where the form and substance of the transaction are the same, however the arrangements viewed in their totality differ from those which would have been adopted by independent enterprises behaving in a commercially rational

manner, and the actual structure practically impedes the tax administration from determining an appropriate transfer price.

The two-step process of the arm's length principle. Her Honour established that neither Div 13 nor Subdiv 815-A directs an inquiry into the commercial prudence of the non-arm's length contract or transaction entered into. The inquiry directed is a comparative analysis of the consideration given under the actual agreement with a comparable "real world" arm's length consideration. That is, the task at hand is not for the Commissioner to determine the transaction that "might reasonably be expected" to have been entered into and then use this as the benchmark, rather the actual transaction is to be respected (other than in exceptional circumstances) (step 1), and then comparables to this actual transaction should be identified to test the arm's length outcome (step 2).

It must be analysed through the lens of the parties (absent non-arm's length conditions). Her Honour indicated that the analysis should not occur between "abstract independent parties" and that "the actual characteristics of the taxpayer must, therefore, ordinarily serve as the basis in the comparable agreement".

It is a "but for" analysis for Subdiv 815-A purposes. It is not enough for the Commissioner to identify the non-arm's length conditions (eg no evidence of negotiations between the parties), there must be a "causal relationship" between the identified conditions and the profit that would otherwise be expected to accrue. Her Honour confirmed the reasoning of Pagone J in *Chevron* that the analysis is an objective determination.

Subjective motivations are not relevant. Her Honour reinforced the findings in *WR Carpenter Holdings*[3] that the analysis under Div 13 and Subdiv 815-A does not "introduce, or involve, any investigation or consideration of purpose or motive" because these concepts are more appropriately found in other provisions, such as the general anti-avoidance rules. She rejected the Commissioner's argument that CMPL would not have agreed to renegotiate the terms in 2007 given the group's motivation to maximise profitability.

Hindsight reasoning is not relevant. Her Honour applied the reasoning in a Canadian judgment[4] to reject the relevance of hindsight that CMPL would have been more profitable if the alternative benchmarks were used instead of a 23% price sharing contract.

Comparability standards and satisfying the onus of proof within the arm's length range. A taxpayer will discharge its burden of proof if the actual price was within an arm's length range, reinforcing the decision in the *SNF* case[5] that the relevant comparable does not need to be identical and variations in comparables, producing variations in price, are acceptable. In *SNF*, the court concluded that the proposed ATO approach would mean that a taxpayer could never succeed in a transfer pricing case because "the bar would be set at an unattainable height" and be "deeply impractical".

The comparables put forward by the taxpayer in Glencore were based on contracts it had negotiated with third parties, which, while not identical, provided a reference point of between 20% and 27.5% for price sharing percentages. The Commissioner's own expert had supported a range of between 21% and 26% as the normal range of price sharing.

International arm's length standard to be applied. Her Honour found it necessary to highlight the international context in which the internationally accepted arm's length principle has been adopted as the measure by which countries may bring to tax within their jurisdiction an appropriate share of tax revenue from the international dealings of multinational enterprises. She further warned that a construction and application of the Australian rules by applying some different measure for determining the arm's length price, other than one based on the arm's length equivalent of the transaction actually entered into, would not give effect to the policy objective. This supports an approach to Australia's transfer pricing rules which accords with the OECD's transfer pricing guidelines.

The references to the OECD commentary, including those made in the Chevron case which were recast again by her Honour in the judgment, will touch many issues that are currently in dispute or under review with the ATO. This includes the OECD approach to guarantee fees, recognition in the OECD guidance that multinational groups can enter into transactions that are arm's length despite these transactions not being found between true independent parties, as well as the two exceptional circumstances in which transactions should be reconstructed.

Expert evidence. Although the decision did not ultimately turn on differences of opinions between the experts, Davies J reinforced that the factual inquiry in transfer pricing must be based on the probative evidence which will include, where appropriate, the use of expert evidence to find a reliable substitute for the actual considerations.

Lay witness evidence. Her Honour accepted the evidence of the mine's asset manager (who subsequently was a director of CMPL) at various parts of the judgment. This evidence appeared to be highly influential in her Honour's findings by providing context around the relevant facts and contemporaneous documents filed in the proceedings.

In its press release, the ATO identified that "aspects of the Commissioner's interpretation of the relevant transfer pricing rules" were rejected, and it is understood that the ATO plans to appeal the decision.

The case involved the application of Australia's former transfer pricing rules. However, the principles established by the *Glencore* decision should also be applicable to the current transfer pricing rules (Subdiv 815-B ITAA97 applicable from 29 June 2013), which require the arm's length conditions to be identified in a way that is consistent with guidelines on arm's length principles developed by the OECD.

The takeaway

The *Glencore* decision provides helpful clarity in relation to the operation of Australia's transfer pricing rules and, in particular, reinforces their alignment with international standards, which reduces uncertainty and the risk of double taxation and assists in minimising compliance and administration costs.

Taxpayers who are setting, reviewing or defending their Australian transfer pricing arrangements at the risk review or audit stage will need to carefully assess their circumstances in light of the *Glencore* decision and consider the precedential impact of this seminal decision.

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