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The Tax Institute

Taxation in Australia

PepsiCo falls flat for the ATO
Cameron Blackwood, ATI, Eugenia Kolivos, Luke Imbriano, Craig Boyle, Michael Carroll and Julia Bolodurina

Revisiting the ESIC measures
Jackson Jury and Joshua Pascale

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Invitation to write

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

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Tax News – at a glance

by TaxCounsel Pty Ltd

August – what happened in tax?

The following points highlight important federal tax developments that occurred during August 2024. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 88 (at the item number indicated).

Foreign resident CGT regime

A consultation paper has been released by the Treasury in relation to the government's proposal (announced in the 2024–25 Budget) to strengthen the foreign resident capital gains tax regime. **See item 1.**

Foreign resident: capital gains withholding

Exposure draft legislation and explanatory materials have been released by the Treasury that would give effect to the 2023–24 Mid-Year Economic and Fiscal Outlook proposal to increase the integrity of the foreign resident capital gains withholding regime. **See item 2.**

Small and medium businesses: amendment period

The Treasury has released draft legislation and explanatory materials that would allow small and medium businesses up to four years to request amendments to their tax assessments. **See item 3.**

Tax practitioners: registration requirements

The Treasury has released a consultation paper relating to the Tax Practitioners Board (TPB) registration requirements for tax practitioners, with a particular focus on the education, qualification and experience requirements for new entrants and existing practitioners. **See item 4.**

TPB: new code of conduct obligations

A legislative instrument (the Tax Agent Services (Code of Professional Conduct) Determination 2024) has been made which expands the *Tax Agent Services Act 2009* (Cth) Code of Professional Conduct obligations in a number of important respects. **See item 5.**

TPB Register: regulation changes

The *Tax Agent Services Regulations 2022* (Cth) have been amended by the *Tax Agent Services Amendment (Register Information) Regulations 2024* to further implement the government's response to the *Independent review of the Tax Practitioners Board*. **See item 6.**

Philanthropy inquiry: final report

The final report of the Productivity Commission's inquiry into philanthropy in Australia (*Future foundations for giving*) was released by the government on 18 July 2024. **See item 7.**

Administrative Review Tribunal: start date

The Administrative Review Tribunal, which is replacing the Administrative Appeals Tribunal, is to commence operations on 14 October 2024. **See item 8.**

Division 7A: benchmark interest rate

For the 2024–25 income year, the Div 7A benchmark interest rate for private companies with a regular 30 June accounting period is 8.77%. **See item 9.**

Previously untaxed trust income

The Commissioner has released a draft determination and a draft practical compliance guideline in relation to the operation of two of the exclusions from the operation of s 99B of the *Income Tax Assessment Act 1936* (Cth) (receipt of trust income not previously subject to tax) (TD 2024/D2; PCG 2024/D1). **See item 10.**

AAT to rehear residence case

The Federal Court (Logan J) has upheld an appeal by an individual taxpayer from a decision of the AAT in which the tribunal held that the taxpayer was a resident of Australia for income tax purposes (*Quy v FCT (No. 3)* [2024] FCA 726). **See item 11.**

Default assessments: taxpayers' appeals dismissed

The Federal Court (Downes J) has dismissed an appeal by two taxpayers (a husband and wife) from a decision of the AAT which rejected challenges by the taxpayers to default assessments (*Rusanov v FCT* [2024] FCA 777). **See item 12.**

Global minimum tax legislation

On 4 July 2024, the government introduced into parliament a package of Bills that will fully implement the "Implementation of a global minimum tax and a domestic minimum tax" measure that was announced in the 2023–24 Budget. When enacted, the new laws will set a 15% global minimum tax and domestic minimum tax for all multinational enterprise groups with an annual global revenue of at least €750m (approximately A$1.2b), effective from 1 January 2024.

President's Report

by Todd Want, CTA

Advocacy and learning for the future

President Todd Want on recent advocacy efforts and upcoming opportunities for learning and development.

Advocacy in action

All eyes have been on changes to the tax practitioner obligations under the Code of Professional Conduct in the *Tax Agent Services Act 2009* (Cth), the topic of conversation for just about every tax practitioner I know.

Along with the Joint Bodies, we have advocated for the withdrawal and deferral of the Tax Agent Services (Code of Professional Conduct) Determination 2024 to allow for the development of TPB guidance and a sensible implementation period for practitioners. We have also requested on multiple occasions further consultation to ensure that the new obligations are properly designed, fair and practically implementable.

This is an ongoing situation. The start date was first deferred, followed by the Opposition announcing its intention to disallow the changes. Our team at The Tax Institute continues to advocate and consult closely with government and regulator stakeholders to ensure that the outcome of the situation is good for our economy, tax system and the tax practitioners who work with it.

I encourage you to continue to engage with the Institute on this and other advocacy topics, and to follow our updates closely to stay up to date with further developments.

The Tax Summit

The Tax Summit is just days away and we're excited to welcome delegates to the ICC in Sydney. As always, we are looking forward to the excellent tax technical program, delivered by wonderful speakers from across the tax industry. We are also looking forward to the opportunity to connect with our members and hear directly from you about the challenges, triumphs and changes affecting your career in tax.

Be sure to drop by The Tax Institute stands during the event to chat with our team, collect your complimentary goodies, and find out what's new at the Institute.

Lifelong learning at the Institute

As you know, learning is at the heart of what we do at the Institute. Continuing education is such an important part of a successful career in tax as our industry evolves and grows over time. Tax guidance and legislation are continually changing in order to better serve our economy, community and goals as a nation.

Education is also one of the best pathways to growing your career in new and interesting directions. Whether you're looking to move up the ranks, specialise in a certain area of tax or improve your performance in your current space, education can help you to reach your career goals.

We at the Institute are dedicated to helping you secure the kind of education that not only helps you to meet your career goals, but also works with your busy schedule and makes fulfilling, genuinely meaningful use of your time. Practical outcomes and actionable insights are the name of the game.

That's why I'm excited that, at this year's Tax Summit, we will be introducing delegates to our Tax Academy offering, now available to all tax practitioners (and future tax practitioners!).

Tax Academy has, to date, been available to ABN and CAN holders, purchasing corporate packages for learning at a company level. The response from those who engaged with the platform has been overwhelmingly positive, and appetite for this quick, flexible style of learning has been considerable.

It goes to show that you can improve your knowledge and grow your career, whether you have years to dedicate to structured learning, or just a few hours a week to dedicate to self-paced improvement. Education is a door-opener and we are thrilled and honoured to facilitate lifelong learning for our members and the wider tax community.

CEO's Report

by Scott Treatt, CTA

The new face of tax learning

CEO Scott Treatt discusses recent advocacy efforts and making Tax Academy units available to all practitioners.

As Todd said in his report this month, the advocacy efforts of our Tax Policy and Advocacy team, in conjunction with our colleagues in the Joint Bodies, have been in the spotlight in recent months.

While the changes to the tax practitioner obligations under the code of conduct are an ongoing situation, and not something to get into in depth in this forum, I would like to acknowledge the stress and uncertainty that this has created for our members and the wider tax community. Rest assured that the Institute shares your concerns and will continue to represent your voice on this and similar matters.

I'd like to give a shout out to our Tax Policy and Advocacy team and to the volunteers on our councils and committees who have been involved in our advocacy efforts, both surrounding this issue and in general this year. It has been a particularly busy year for advocacy, with so much changing in the profession and the tax system. I truly believe that we have the best people for the job representing our members.

It is gratifying when our advocacy pays off, as it has with this recent issue around the TASA obligations. But more importantly, I am grateful that we have the opportunity to make our members' voices heard, and to ensure that those who know our system best and who are passionate about tax, are consulted in decisions regarding its administration and design.

Learning at the speed of you

In his report, Todd also reflected on lifelong learning and our new Tax Academy units being made available to individuals. I'd like to expand on this topic.

Tax Academy has been designed as a modern, flexible style of tax learning, which allows you to upskill yourself and your team as and when it suits you. It means you can home in on topics and specialties to build a skillset that serves you, your clients and your career best.

With The Tax Summit coming up this month, we have been reflecting on what the future of the profession may look like. Education, and especially this kind of flexible, self-paced and self-driven education, is central to the future we envision for our community.

The next generation of tax practitioners will be working in a world of emerging technologies and shifting client needs. It is increasingly looking as though they will be doing so still encumbered by an out-of-date and clunky tax system – at least in the short to medium term. So, being able to keep up with changes in the industry through reliable, expertly delivered learning is set to become more and more important.

Tax Academy is our answer to these changing needs of the profession.

For those of you coming along to The Tax Summit (seemingly quite a lot of you – looking forward to a wonderful turnout at the ICC!), don't forget to stop by the Tax Academy booth to test your tax knowledge and find out more about the units currently on offer. If you aren't joining us at the Summit, sit tight. Tax Academy units will soon be available for purchase through our website.

Of course, though Tax Academy is our newest offering in the learning space, we are still dedicated to offering our structured education, both single subjects and programs. Study Period 3 is currently open for enrolments into all subjects, so if you've been thinking about picking up a textbook and commencing further study, consider this your sign to do so.

Associate's Report

by Sumitha Krishnan, FTI

Corporate tax residency

We examine and explore the growing necessity for legislative action regarding corporate tax residency.

The highly anticipated proposed reform to the corporate tax residency (CTR) rules announced some years ago remains unimplemented. Recent amendments to the *Corporations Act 2001* (Cth) (Corporations Act) and proposed amendments to the *Taxation Administration Act 1953* (Cth) (TAA) highlight the importance and urgency of reforming the CTR rules.

Overview

Under s 6 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36), a company is an Australian tax resident if it is either incorporated in Australia or, if not incorporated in Australia, it "carries on business" in Australia and has either: its "central management and control" in Australia (the CMAC test); or its "voting power" controlled by shareholders who are residents of Australia (the voting power test).

The interpretation of the CMAC test has sparked controversy in various court cases owing to the phrase's lack of clarity. In *Malayan Shipping Co Ltd v FCT*,[1] the High Court determined that a foreign company with its central management and control (CMAC) in Australia is deemed to be operating in Australia. In TR 2004/15, the Commissioner expressed the view that the exercise of CMAC in Australia cannot, by itself, constitute carrying on business in Australia for the CMAC test.

Subsequently, the High Court's endorsement of the *Malayan Shipping* case in *Bywater Investments Ltd v FCT*[2] in 2016 prompted the ATO to update its position on CMAC by releasing TR 2018/5 and PCG 2018/9. The Commissioner's view in TR 2018/5 is that the exercise of CMAC in Australia can, by itself, constitute carrying on business in Australia for the CMAC test. This caused uncertainty and increased the risk for foreign-incorporated subsidiaries of Australian companies that they may be considered a resident.

Board of Taxation's review

In response to a government request, the Board of Taxation reviewed Australia's CTR rule and submitted its final report in July 2020 proposing to replace the CMAC test with a "sufficient economic connection" test in Australia. This test requires the company's primary commercial activities and CMAC to occur within Australia for it to be considered an Australian resident.

On 6 October 2020, as part of the Federal Budget 2020–21, the government announced that it would implement the Board's recommendation. Industry welcomed this announcement, but this reform has not progressed.

Recent and proposed amendments

On 25 October 2022, as part of the updated Federal Budget 2022–23, the government announced new reporting obligations aimed at improving the transparency of tax information disclosed by relevant companies.

Consequently, the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024* amended the Corporations Act, requiring Australian public companies, listed and unlisted, to disclose information about their subsidiaries in their annual financial reports. This requirement applies to financial years starting on or after 1 July 2023, with the first disclosure due by 30 June 2024. Public companies that must prepare consolidated financial statements in line with accounting standards need to include a consolidated entity disclosure statement (CEDS). This includes identifying whether each entity within the consolidated group is classified as an Australian or foreign resident according to *the Income Tax Assessment Act 1997* (Cth), which in turn refers to s 6 ITAA36.

Given the existing ambiguities in this area, the new requirement heightens the risk of more foreign entities being classified as Australian residents for tax purposes. To mitigate this uncertainty, the Minister issued a media release clarifying that entities can ascertain their tax residency based on the ATO's established public guidance. While the Minister's clarification provides relief to public companies that must include a CEDS, it does not resolve the underlying issues and constitutes only a temporary solution.

Further, the Treasury Laws Amendment (Responsible Buy Now Pay Later and Other Measures) Bill 2024 proposes amendments to the TAA requiring certain large multinational enterprises to disclose selected tax information on a country-by-country (CbC) basis for specified jurisdictions, and either a CbC basis or an aggregated basis for the others. Even in this context, entities must ascertain the residency status of their subsidiaries and related parties.

Conclusion

Tax residency is a fundamental tax concept that should be easy to understand and apply. However, the existing CTR rules create uncertainty and may deter international businesses from expanding into Australia. This situation calls for reform, highlighting the growing demand for clarity in the law and the need to progress legislative changes.

References

1 (1946) 71 CLR 156.

2 [2016] HCA 45.

Tax Academy

Are your team’s tax skills falling behind?

In today’s rapidly evolving professional landscape, continuous learning is essential. A recent survey reveals that a staggering 92% of professionals say their role requires them to learn new skills. However, less than half of these professionals believe that the learning opportunities provided by their employers meet their needs.

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Tax News – the details

by TaxCounsel Pty Ltd

August – what happened in tax?

The following points highlight important federal tax developments that occurred during August 2024.

Government initiatives

1. Foreign resident CGT regime

A consultation paper has been released by the Treasury in relation to the government's proposal (announced in the 2024–25 Budget) to strengthen the foreign resident capital gains tax regime.[1]

The measure comprises three complementary elements to ensure that Australia can tax foreign residents on direct and indirect disposals of assets with a close economic connection to Australian land and natural resources.

It is also expected that the measure will improve certainty for foreign investors on their Australian tax outcomes by aligning Australia's tax law more closely with the Organisation for Economic Co-operation and Development's *Model Tax Convention on Income and on Capital*. The measure will also align the treatment for non-residents more closely with the tax treatment that already applies to Australian residents.

The amendments are to apply to CGT events that happen on or after 1 July 2025.

Following consideration of responses to the consultation paper, the government will issue and consult further on exposure draft legislation before introducing any legislation into parliament.

2. Foreign resident: capital gains withholding

Exposure draft legislation and explanatory materials have been released by the Treasury that would give effect to the 2023–24 Mid-Year Economic and Fiscal Outlook proposal to increase the integrity of the foreign resident capital gains withholding (FRCGW) regime.

This measure will increase the FRCGW rate for relevant CGT assets from 12.5% to 15% and remove the current $750,000 threshold before which withholding applies for transactions involving either taxable Australian real property or an indirect Australian real property interest that provides company title interests.

These changes are to apply to acquisitions of relevant CGT assets made on or after the later of 1 January 2025 and the commencement of the measure.

3. Small and medium businesses: amendment period

The Treasury has released draft legislation and explanatory materials that would allow small and medium businesses up to four years to request amendments to their tax assessments.

This change will reduce the administrative costs of amendments on small and medium businesses by delaying their engagement with the burdensome amendment process currently required when the existing two-year self-amendment period expires.

More particularly, the proposed amendment would allow the Commissioner to amend an assessment of a small or medium business entity if:

- the small or medium business entity requests the amendment in the approved form; and
- the request is given to the Commissioner within four years after the day on which the Commissioner gives notice of the assessment to the taxpayer.

The explanatory materials state that, while the draft amendment would allow the Commissioner to amend such assessments on application by the taxpayer, the provisions do not mandate the Commissioner to do so.

The Commissioner would only be able to amend such assessments to give effect to the decision on the taxpayer's application. The provisions would not permit the Commissioner to amend the assessment about other particulars that are not included in the taxpayer's application. This will ensure that sufficient certainty is still afforded to these taxpayers, as the four-year statutory limitation period only applies in respect of those particulars mentioned in the taxpayer's application.

The proposed amendments would give effect to one element of the 2023–24 Budget small business package "Driving collaboration with small business to reduce the time spent complying with tax obligations".

The proposed amendment is to apply in relation to assessments issued (after the commencement of the amendments) for income years starting on or after 1 July 2024.

4. Tax practitioners: registration requirements

The Treasury has released a consultation paper relating to the Tax Practitioners Board (TPB) registration requirements for tax practitioners, with a particular focus on the education, qualification and experience requirements for new entrants and existing practitioners.[2]

The consultation paper relates to the priority area identified for action in the government's response to the PwC matter and explores the following areas of improvement for registration pathways:

- strengthening company and partnership registration eligibility requirements;
- reviewing the professional association "recognition" and registration pathways; and
- broadening the TPB's ability to accept alternative forms of "relevant experience".

The primary objective is to reform the registration framework to realign it with the contemporary tax practitioner services landscape. Additionally, it aims to equip the TPB with the flexibility to appropriately respond to emerging industry trends and to bolster and modernise existing registration criteria. This will ensure that the community is able to access high-quality tax practitioner services as desired and is given greater assurance that tax practitioners have the right attributes and qualifications to deliver quality services in an ethical manner.

The proposed reforms will also remove inequitable barriers to registration, ensuring that appropriately qualified tax practitioners with diverse life experiences are able to register and provide their services for the benefit of the community.

5. TPB: new code of conduct obligations

A legislative instrument (the Tax Agent Services (Code of Professional Conduct) Determination 2024) has been made which expands the *Tax Agent Services Act 2009* (Cth) Code of Professional Conduct (the Code) obligations in a number of important respects.

The Code obligations created by the 2024 Determination relate to the following:

1. upholding and promoting the ethical standards of the tax profession (s 10);
2. false, incorrect or misleading statements (s 15):
3. conflicts of interest in dealings with government (s 20);
4. maintaining confidentiality in dealings with government (s 25);
5. keeping proper client records (s 30);
6. ensuring that tax agent services provided on an agent's behalf are provided competently (s 35);
7. quality management systems (s 40); and
8. keeping clients informed of all relevant matters (s 45).

These new obligations reinforce the necessity for registered tax practitioners to be proactive and, as necessary, have systems in place to ensure that they are compliant with the Code obligations. It would be expected that the TPB will issue guidance materials intended to support registered tax practitioners in complying with the new Code obligations.

In this regard, the TPB has indicated that draft guidance on the various new Code obligations is expected to be released for consultation as follows:

- for new Code obligations 2, 3 and 4 above – early August 2024;
- for new Code obligations 5, 6, 7 and 8 above – late August 2024;
- for new Code obligation 1 above – early September 2024.

Commencement

The legislative instrument as made was to commence on 1 August 2024. However, on 1 August 2024, the Assistant Treasurer announced that the government will insert a transitional rule into the legislative instrument that will provide firms with 100 employees or less until 1 July 2025, and larger firms with 101 employees or more until 1 January 2025, to bring themselves into compliance with the new obligations, so long as they continue to take genuine steps towards compliance during this period.

The Tax Tips column in this issue of the journal considers the operation of the new false, incorrect or misleading statement obligations (see page 94).

6. TPB Register: regulation changes

The *Tax Agent Services Regulations 2022* (Cth) have been amended by the *Tax Agent Services Amendment (Register Information) Regulations 2024* to further implement the government's response to the *Independent review of the Tax Practitioners Board*.

The amendments, which commenced on 5 July 2024, form one of a range of measures to give effect to the government's commitment to restore public trust and confidence in the regulation of the tax profession and, as their name implies, are concerned with the information that appears on the TPB Register.

The amendments updated the regulations in four main ways:

- requiring additional information to be published on the Register. This makes information about the conduct of registered and formerly registered tax professionals, or unregistered entities who have advertised or provided tax agent services, transparent to the public;
- requiring Register information to be updated to ensure that it is not false or misleading following a review of a TPB decision by the AAT or a court;
- extending the length of time that certain information must be kept on the Register, thereby securing the availability of that information to the public; and
- providing greater transparency of accountable individuals who form the sufficient number of tax practitioners within a registered company or partnership.

7. Philanthropy inquiry: final report

The final report of the Productivity Commission's inquiry into philanthropy in Australia was released by the government on 18 July 2024.[3]

From a tax perspective, the most significant issue considered in the final report is an overhaul of the deductible gift recipient (DGR) system, which determines the charities that are eligible to receive tax-deductible donations. Under the proposals in the final report, eligibility for DGR status would be extended to most classes of charitable activities, drawing on the charity subtype classification in the *Australian Charities and Not-for-profits Commission Act 2012* (Cth) to classify which charitable activities are eligible for DGR status and which are not.

However, under the recommendations, there would be a number of express exclusions from DGR status. These exclusions would include primary, secondary, religious and informal education activities, with an exception for activities that have a specific equity objective (such as activities undertaken by a public benevolent institution), the activities of early childhood education and care and aged care (other than activities undertaken by a public benevolent institution), and all activities in the subtype of advancing religion.

When releasing the report, the Assistant Minister for Competition, Charities and Treasury said that, while the government considers its response to the final report, the recommended changes to tax settings for donations to school building funds were not being considered. The Assistant Minister said that a world-class education system is essential to tackling inequality, driving economic growth and supporting well-paid, secure jobs, and that our school system is a key part of it.

8. Administrative Review Tribunal: start date

The Administrative Review Tribunal (ART), which is replacing the Administrative Appeals Tribunal (AAT), is to commence operations on 14 October 2024.

When announcing the commencement date, the Attorney-General said that an effective administrative review system is essential for the tens of thousands of people who seek independent review of government decisions each year – decisions that have a major and sometimes life-altering impact on their lives.

The ART's objective will be to provide administrative review that:

- is fair and just;
- resolves applications in a timely manner, with as little formality and expense as possible;
- is accessible and responsive to the diverse needs of parties;
- improves the transparency and quality of government decision-making; and
- promotes public trust and confidence in the tribunal.

All matters currently before the AAT will continue as usual and will automatically transition to the ART on its commencement. Anyone who has applied to the AAT for review of a decision does not need to submit a new application, and all AAT decisions that have already been finalised will not be considered again by the ART.

The Commissioner's perspective

9. Division 7A: benchmark interest rate

For the 2024–25 income year, the Div 7A benchmark interest rate for private companies with a regular 30 June accounting period is 8.77%.

This benchmark interest rate is relevant to:

- determine if a loan made in the 2023–24 income year is taken to be a dividend (s 109N(1)(b) of the *Income Tax Assessment Act 1936* (Cth) (ITAA36) and, as applicable, s 109D(1) or 109XB ITAA36); and
- calculate the amount of the minimum yearly repayment for the 2024–25 income year on an amalgamated loan taken to have been made prior to 1 July 2024 (s 109E(5) ITAA36).

10. Previously untaxed trust income

The Commissioner has released a draft determination and a draft practical compliance guideline in relation to the operation of two of the exclusions from the operation of s 99B ITAA36 (receipt of trust income not previously subject to tax) (TD 2024/D2 and PCG 2024/D1 (the draft ATO products)).

The general rule in s 99B ITAA36 is that where, at any time during an income year, an amount, being property of a trust estate, is paid to, or applied for the benefit of, a beneficiary of the trust estate who was a resident at any time during the income year, the assessable income of the beneficiary of the income year shall, subject to the exclusions in s 99B(2), include that amount.

As indicated, there are a number of exclusions to the operation of the general rule. Two of these (which are considered in the draft ATO products) are so much of the amount as represents:

1. corpus of the trust estate (except to the extent to which it is attributable to amounts derived by the trust estate that, if they had been derived by a taxpayer being a resident, would have been included in the assessable income of that taxpayer of an income year); and
2. an amount that, if it had been derived by a taxpayer being a resident, would not have been included in the assessable income of that taxpayer of an income year.

These exclusions are referred to in the draft ATO products as the "hypothetical resident taxpayer tests".

TD 2024/D2 makes these points:

- for the purposes of the hypothetical resident taxpayer tests, the only characteristic of the hypothetical taxpayer is that they are an Australian resident;
- further, when applying the hypothetical resident taxpayer tests to determine whether or not an amount would be assessed in the hands of the hypothetical taxpayer, it is necessary to consider the circumstances that gave rise to the relevant amount in the hands of the trustee; and
- the ultimate source of the amount paid or applied to the beneficiary is also taken into account when determining whether it is "attributable to" amounts which would be assessed in the hands of a hypothetical resident taxpayer for the purposes of (1) above, or whether an amount "represents" an amount that would not have been assessable if derived by the hypothetical resident taxpayer for the purposes of (2) above.

TD 2024/D2 then gives three examples: where a non-resident trust disposes of a CGT asset acquired pre-CGT; where there is a distribution from a non-resident deceased estate; and where a CGT discount is not available to hypothetical taxpayer.

PCG 2024/D1 provides guidance on the ATO's approach to s 99B in respect of arrangements where property of a non-resident trust (or trust property accumulated while the trust was a non-resident) is paid to or applied for the benefit of a resident beneficiary. PCG 2024/D1 aims to provide clarity on:

- common scenarios where s 99B may need to be considered;
- the practical aspects of record-keeping evidencing that an exception in s 99B(2) applies to reduce the amount that s 99B would otherwise include in assessable income; and
- the ATO's compliance approach to distributions and benefits which the ATO considers to be low risk, and the record-keeping expected to substantiate this.

Recent case decisions

11. AAT to rehear residence case

The Federal Court (Logan J) has upheld an appeal by an individual taxpayer from a decision of the AAT in which the tribunal held that the taxpayer was a resident of Australia for income tax purposes (*Quy v FCT (No. 3)*[4]).

The taxpayer was born in Vietnam and came to Australia in the 1970s, obtaining Australian citizenship in 1978. By profession, the taxpayer was a mechanical engineer and, in 1986, came to work for an Australian company, CBI Construction Pty Ltd (CBI).

On and from 1986, the taxpayer worked for CBI either in Australia or on a number of overseas assignments. One of those assignments saw him working and living in Dubai in the United Arab Emirates between 1998 and 2009. At the end of that assignment, the taxpayer relocated, along with his wife and daughters, to Perth. On 13 September 2015, the taxpayer was deployed to Dubai again. It was that deployment and the related deduction of PAYG instalments under the income tax legislation which gave rise to a controversy in respect of the income years ended 30 June 2016 to 30 June 2020.

The taxpayer's wife was also born in Vietnam. She came to Australia in 1982. They married in 1990 and had three daughters. In 2015, the eldest two daughters were studying at university and the youngest was then completing her final year at high school. The taxpayer's wife was employed as the primary caregiver for the couple's daughters, and did not pursue employment outside the family.

There was a family home at Beldon in Western Australia, purchased in 2010. The taxpayer had other properties in Australia – two in New South Wales and one in Western Australia, purchased in 2022 with one of his daughters. Prior to his more recent deployment to Dubai, the taxpayer had lived at the Beldon home. It was to there, in the main, that he returned during those periods in the income years in question when he was not in Dubai.

There was considerable variation in the length of time that the taxpayer spent in Australia in the income years in question – as little as 29 days in one instance, but in no instance longer than 183 days. The longest was 119 days. Over that same period, the taxpayer's wife was in Australia for between 183 and 343 days.

Throughout his time living and working in Dubai, the taxpayer held an employer-sponsored permit enabling his lawful presence in Dubai. The taxpayer's wife also held a permit, but this expired in November 2019.

The AAT was not satisfied that, for tax purposes, the taxpayer was not a "resident of Australia" in the relevant income years.

In allowing the taxpayer's appeal from the decision of the AAT, Logan J said that the AAT, when considering authorities concerning residents, such as *Levene v Inland Revenue Commissioners*[5] and *Hafza v Director-General of Social Security*,[6] also made this statement:

> "17. …
>
> While intention is relevant in determining residency (being '*the intention of remaining in a place permanently or indefinitely*'), it alone is neither sufficient nor decisive."

Logan J said that a difficulty about the parenthetical reference to intention was that it entailed a misreading of the Full Federal Court's judgment in *Comcare Australia (Defence) v O'Dea*.[7] After quoting from the Full Federal Court's judgment in that case, Logan J said:

> "19. The long and the short of it is, in this particular exposition of its understanding of residence under ordinary concepts, the Tribunal has erroneously incorporated a reference to intention for the purpose of determining a person's domicile …"

Logan J also held that, in relation to the domicile test, the AAT's reasons exhibited a misunderstanding of the word "permanent" ("whose domicile is in Australia, unless the Commissioner is satisfied that the person's permanent place of abode is outside Australia"), as explained by Northrop J in *FCT v Applegate*.[8]

The consequence was that, both as to the domicile test as well as the ordinary resident test, the taxpayer's appeal was allowed. Logan J considered that the matter should be remitted to the tribunal for determination according to law.

12. Default assessments: taxpayers' appeals dismissed

The Federal Court (Downes J) has dismissed an appeal by two taxpayers (a husband and wife) from a decision of the AAT which rejected challenges by the taxpayers to default assessments (*Rusanov v FCT*[9]).

The taxpayers did not lodge tax returns for a number of income years. On 10 August 2017, the Commissioner issued default assessments to the taxpayers for the relevant income years under s 167 ITAA36 on the basis of covert audits conducted in 2017. Those audits used a bank account analysis methodology to attribute taxable income to the taxpayers based on unexplained deposits and expenses in their bank statements.

The taxpayers objected to the assessments. They claimed that the majority of the particular deposits were gifts from Ms Rusanova's father, Mr Vladimir Rusanov (Mr V Rusanov), or were loans from their friend, Mr Boris Varvulev.

On review, the AAT affirmed the Commissioner's objection decisions.[10] The taxpayers then appealed to the Federal Court. On these appeals, the taxpayers relied on several grounds. One ground was made by reference to guidelines issued by the ATO concerning documenting gifts or loans from related overseas entities. The taxpayers submitted that the material they relied on before the AAT was consistent with these ATO guidelines and with the information available to the taxpayers.

In its decision, the AAT accepted that money was transferred by Mr V Rusanov, and that Mr V Rusanov said that the transfers were "truly gifts". The AAT stated that there were no contemporaneous records to substantiate the nature of the payments, such as emails or texts, and found it implausible that no communications of that sort existed. After considering other evidence, the AAT found that the "actual sources of the funds, whether from personal wealth or from a company, was not clear".

Downes J said that it was apparent from its decision that the AAT considered the evidence which the taxpayers claimed should have led it to conclude that the transfers from Mr V Rusanov were gifts, and found that it was insufficient. That the tribunal formed this view did not raise a question of law.

Her Honour also said that whether the evidence adduced by the taxpayers could be said to have complied with the ATO guidelines did not alter the conclusion. Those guidelines were not prescriptive, and they provided an inclusive list of the types of supporting documentation which could be used to support the characterisation of the transfer as a gift or loan. As the guidelines themselves made clear, however, the Commissioner could form a view based on all available evidence and may make further inquiries. Similarly, the guidelines did not fetter the AAT's ability to assess the evidence and form its own conclusions. No error of law had been shown.

The taxpayers also contended that, as a result of the decision of the Full Federal Court in *FCT v Cassaniti*,[11] the Commissioner did not make out his case merely by asserting that the evidence of the taxpayer, supported by the taxpayer's financial records, was not accepted. They submitted that, based on *Cassaniti*, if authenticity was not challenged, then, absent evidence to the contrary, authenticity should be assumed.

However, Downes J said that this contention was misconceived. In *Cassaniti*, there was a dispute as to whether certain amounts had been withheld from a taxpayer. Documents, including business records, were produced by the taxpayer to evidence the amounts which had been withheld, but the authenticity of those documents was challenged by the Commissioner. The Full Federal Court found that it could be inferred that those documents were authentic, and that the primary judge was correct to admit them into evidence.

That, Downes J said, was different to the circumstances of the present case in which the authenticity of the documents, and the transactions which they recorded (such as a transfer of funds), was not challenged by the Commissioner. Rather, it was the characterisation of the transactions recorded in the documents which was in dispute before the AAT, with the overarching question being whether the evidence adduced by the taxpayers was sufficient to discharge the burden imposed by s 14ZZK of the *Taxation Administration Act 1953* (Cth).

The bases on which the AAT determined that the burden had not been discharged by the taxpayers did not include a finding that any of the documents relied on by the taxpayers was not authentic. Rather, the AAT considered the evidence adduced by the taxpayers in relation to the characterisation of the deposits in the accounts, but did not accept that there was adequate evidence to support a conclusion that they were in fact loans or gifts, primarily because of the lack of documentation.

The taxpayers are appealing to the Full Federal Court from the decision of Davies J.

TaxCounsel Pty Ltd
ACN 117 651 420

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Tax Tips

by TaxCounsel Pty Ltd

The expanding TPB code of conduct

The obligations of registered tax practitioners under the Code of Professional Conduct have recently been substantially increased in important respects.

Background

The statutory Code of Professional Conduct (the Code) is an important feature of the tax practitioner registration regime[1] that is governed by the *Tax Agent Services Act 2009* (Cth) (TASA).

A potential breach of the Code that comes to the attention of the Tax Practitioners Board (TPB) would be likely to prompt the Board to conduct an investigation under the investigation provisions of the TASA.[2] In the event that, after conducting an investigation, the TPB is satisfied that there has been a failure to comply with the Code, the TPB can take a number of courses of action, ranging from the giving of a caution to the termination of registration.[3]

The Code obligations are defined by s 30-10 TASA and, as originally enacted, comprised 14 obligations that were grouped under the headings: Honesty and integrity; Independence; Confidentiality; Competence; and Other responsibilities.

As a result of amendments made by the *Treasury Laws Amendment (2023 Measures No. 1) Act 2023*, the Code was extended to include, under the "Other responsibilities" heading, two obligations relating to the employment of, or arrangements with, a disqualified entity (as defined). That amending Act also included, as a Code obligation, any obligations determined under s 30-12 TASA.[4]

Section 30-12 provides that the Minister may, by legislative instrument, determine obligations that relate to the professional and ethical conduct of registered tax agents and BAS agents. The section stipulates that the obligations determined may elaborate or supplement any aspect of the Code, but must not be inconsistent with the Code.

New Code obligations

In the exercise of the power conferred by s 30-12, a legislative instrument was made on 1 July 2024 which sets out a range of new Code obligations. The legislative instrument is called the Tax Agent Services (Code of Professional Conduct) Determination 2024 (the Determination). An explanatory statement in relation to the legislative instrument was also released.

The Code obligations created by the Determination relate to the following:

1. upholding and promoting the ethical standards of the tax profession;
2. false, incorrect or misleading statements;
3. conflicts of interest in dealings with government;
4. maintaining confidentiality in dealings with government;
5. keeping proper client records;
6. ensuring that tax agent services provided on an agent's behalf are provided competently;
7. quality management systems; and
8. keeping clients informed of all relevant matters.

These new obligations reinforce the necessity for registered tax practitioners to be proactive and, as necessary, have systems in place to ensure that they are compliant with the Code obligations. It is expected that the TPB will issue guidance materials intended to support registered tax practitioners in complying with the new Code obligations.[5]

This article considers aspects of the obligations that relate to (2) above. For convenience, these obligations are referred to as "the Code statement obligations".

Commencement

As the Determination was originally made, it was to generally apply on or after 1 August 2024 (the day the Determination commenced), subject to a transitional provision in relation to (8) above.

The Assistant Treasurer announced on 1 August 2024 that a transitional rule will be inserted into the Determination that will provide firms with 100 employees or less until 1 July 2025, and larger firms with 101 employees or more until 1 January 2025, to bring themselves into compliance with the Determination.

Interpretation of legislative instruments

As pointed out above, the new Code obligations have been created by a legislative instrument.

For the purposes of the interpretation of a legislative instrument, the *Acts Interpretation Act 1901* (Cth) applies to the instrument as if it were an Act and as if each provision of the instrument were a section of an Act.[6] This means, for example, that the explanatory statement issued in relation to the Determination can be used in the interpretation of the Determination in the circumstances in which s 15AB of the *Acts Interpretation Act 1901* would permit the use of an explanatory memorandum in the interpretation of an Act.

Further, the *Legislation Act 2003* provides that expressions used in any legislative instrument have the same meaning as in the enabling legislation as in force from time to time.[7] This means, for example, that references to the

Commissioner in the Determination are references to the Commissioner of Taxation. Also, because any expression used in the TASA that is defined in the *Income Tax Assessment Act 1997* (Cth) (ITAA97) has that defined meaning,[8] the expression "entity" in the Determination has the meaning of "entity" in s 960-100 ITAA97.

Code breach reporting

In the context of considering a Code obligation, it is now important to keep in mind that, as a consequence of amendments made by the *Treasury Laws Amendment (2023 Measures No. 1) Act 2023*, a registered tax practitioner is required to notify the TPB of a significant breach (as defined) of the Code that the practitioner or another registered tax practitioner has committed on or after 1 July 2024.[9] Depending on the circumstances, a breach of the Determination after it becomes operative may be required to be notified to the TPB.

Code statement obligations

The Code statement obligations in the Determination are potentially relevant where a registered tax practitioner:

1. makes a statement to the TPB or to the Commissioner;
2. prepares a statement that the registered tax practitioner knows, or ought reasonably to know, is likely to be made to the TPB or the Commissioner by an entity; or
3. permits or directs someone else to make or prepare such a statement (s 15(1) of the Determination).

There will be a breach of the Code statement obligations if, at the time of the making of the statement (see (1)), the time when the statement is prepared (see (2)) or the time when the permitting or directing occurred (see (3)), the registered tax practitioner knew (or ought reasonably to have known) that the statement was false, incorrect or misleading in a material particular, or that the statement omits any matter or thing without which the statement is misleading in a material respect (s 15(1) of the Determination).

The Code statement obligations also provide for the situation where the obligations are not breached when a statement is made but the registered tax practitioner later becomes aware that a statement was false, incorrect or misleading when the statement was made. This situation is considered below under the heading "Becoming aware statement is false etc".

Further, it is immaterial whether or not the registered tax practitioner is acting in the capacity of a registered tax practitioner. The explanatory statement states that this means that the registered tax practitioner may be acting in another professional role, such as during consultation on draft legislation, or in relation to the tax practitioner's personal tax affairs, or in any other capacity.

False, incorrect or misleading

The Code statement obligations are potentially attracted if a statement is "false, incorrect or misleading" in a material particular.

In the context of the offence provisions and the administrative penalty provisions that apply in the context of statements, the expression used is that the statement is "false or misleading" in a material particular. In those contexts, it is settled that the word "false" is used to mean incorrect or erroneous.[10]

The Code statement obligations expand the "false or misleading" concept by the inclusion of the word "incorrect" so that the relevant expression is "false, incorrect or misleading". This means that no issue of construction as to the meaning of "false" arises. "Incorrect" is relevantly defined in the *Macquarie Dictionary* as "not correct as to fact: an incorrect statement".

"Material particular"

In relation to the concept of a statement being false, incorrect or misleading in a "material particular", the explanatory statement to the Determination states:

> "The provision is concerned with particulars that are material in nature. That is, it is not concerned with particulars that are trivial in the circumstances in which the statement has been made. A statement should not be contrary to fact, nor should it give the wrong impression with regard to a material particular. Expanding this obligation to include statements made in a tax practitioner's personal and professional activities highlights the importance of a tax practitioner's role in representing the tax profession and preserving public confidence in the tax system, particularly when making representations to the Board or Commissioner in relation to their own or their clients' tax affairs. Honesty and integrity are fundamental to any profession governed by a code of ethics, that must act in the best interests of those they represent or serve, and is also responsible and accountable to the public for maintaining trust and integrity in a regulatory system in which they operate and have a level of guardianship over."

Statements and civil penalties

When considering the operation of the Code statement obligations, it is important to note that the TASA has a civil penalty provision that applies where a registered tax practitioner makes a false or misleading statement.[11]

Significantly, the wording of this civil penalty provision mirrors the wording of the Code statement obligations. Thus, for the civil penalty provision to be attracted, the registered tax practitioner must: (a) make a statement to the Commissioner;[12] (b) prepare a statement that the practitioner knows, or ought reasonably to know, is likely to be made to the Commissioner by an entity; or (c) permit or direct an entity to do a thing mentioned in (a) or (b). The similarity of (a), (b) and (c) with the terms of the Code statement obligations (see (1), (2) and (3) above) will be noted and it is submitted that decisions relating to the operation of the civil penalty provision are relevant in relation to the operation of the Code statement obligations.

Making a statement

The Code statement obligations potentially apply where a registered tax practitioner makes a statement to the TPB or the Commissioner, and the civil penalty provisions relating to statements potentially apply where a registered tax practitioner makes a statement to the Commissioner.

The concept of a statement was considered by Franki J in *Given v Pryor*.[13] His Honour said:

> "It is necessary to examine the meaning of the word 'statement' … It seems reasonably clear that a statement may be made orally or in writing. One of the definitions in the *Oxford English Dictionary* (1933 edn), vol 10, in relation to 'statement' is: 'A written or oral communication setting forth facts, arguments, demands or the like.'"

Statement made to TPB or Commissioner

The view taken in the explanatory statement is that (1) above (making a statement to the TPB or to the Commissioner) covers:

> "… statements made directly by a registered tax practitioner (not for or on behalf of another) …"

The explanatory statement gives, as examples of statements made to the TPB, a statement by a tax agent in an application for registration or for the renewal of registration in relation to being a fit and proper person or having relevant skills and experience. As an example of a statement made by a registered tax practitioner to the Commissioner, the explanatory statement gives a statement made in the agent's own income tax return.

It is submitted that, if these views are intended to mean that (1) above does not apply where a statement is made in a tax return prepared and lodged by a registered tax practitioner on behalf of a taxpayer, then that view is not correct. That this is so is demonstrated by the decisions of the Federal Court which have considered the operation of the civil penalty provisions of the TASA that apply in relation to statements.

For example, in *Tax Practitioners Board v Kim (No. 2)*,[14] a registered tax agent lodged 79 individual tax returns based on information given to him by scammers. For each return lodged, the registered tax agent completed a declaration that:

- the return had been prepared in accordance with information supplied by the taxpayer;
- the tax agent had received a declaration from the taxpayer stating that the information provided to him was true and correct; and
- the tax agent was authorised by the taxpayer to lodge the return on their behalf.

Perram J held that, each time the registered tax agent made such a declaration, he contravened the particular civil penalty provision noted above relating to the making of a statement to the Commissioner.

It is submitted that the approach adopted by Perram J in this case would also be relevant if the facts were to arise now and there was an issue as to whether the Code statement obligations had been breached,[15] particularly having regard to the similarity of the wording of the Code statement provision and the civil penalty statement provision that is noted above.

Also, where a registered tax agent is corresponding with the Commissioner in relation to, say, an objection against an assessment, it is suggested that it could be said that a statement in the correspondence would be made by the registered tax agent to the Commissioner. That this is so is, it is submitted, supported by the fact that, for the purposes of the administrative penalties regime provided for in the *Taxation Administration Act 1953* (Cth), it is expressly provided that a statement made by a taxpayer's agent is treated as if it had been made by the taxpayer.[16]

Other Australian government agencies

The Code statement obligations also apply to a statement that is made to or prepared for an Australian government agency (other than the TPB or the Commissioner) (s 15(3) of the Determination). It is immaterial whether the tax agent is acting in their capacity as a registered tax agent. An Australian government agency is defined in s 995-1 ITAA97 as the Commonwealth, state or territory, or an authority of the Commonwealth, state or territory. The concept of an Australian government agency includes, for example, the Australian Securities and Investments Commission, the Department of the Treasury, and the Australian Competition and Consumer Commission.

Preparing a statement

In relation to (2) above (preparing a statement), the explanatory statement states that it covers statements prepared by a registered tax practitioner, such as where the practitioner prepares a document for a client to provide to the TPB or the Commissioner in the client's name, provided that the practitioner knows, or ought reasonably to know, that the statement will be provided to the TPB or the Commissioner.

Permitting or directing

In relation to (3) above (permitting or directing), the explanatory statement states that it would apply where a registered tax practitioner delegates work to staff who may or may not themselves be registered tax practitioners, or there is any other attempt to circumvent the false, incorrect or misleading statement obligation by having someone else prepare or make the statement.

Becoming aware statement is false etc

The relevant time at which the Code statement obligations apply is the time when the statement is made etc, and the obligations operate if, at that time, the maker of the statement knew, or ought reasonably to have known, that the statement was false, incorrect or misleading in a material particular, or omitted any matter or thing without which the statement was misleading in a material respect.

The Code statement obligations also provide for the situation where a registered tax practitioner makes, prepares or permits, or directs the making of a statement (as envisaged in (1), (2) and (3) above), and the practitioner later becomes aware that the statement was false, incorrect or misleading in a material particular at the time it was made, or that the statement omitted any matter or thing without which the statement was misleading in a material respect (s 15(2) of the Determination).

In that event, as soon as possible after the practitioner becomes so aware, the practitioner must take all reasonable steps to:

a. where the registered tax professional made the statement (or permitted or directed someone else to make the statement) – correct the statement;

b. where the registered tax professional prepared the statement (or permitted or directed someone else to prepare the statement) – advise the maker of the statement that the statement should be corrected; and

c. where the registered tax professional prepared the statement and the maker does not correct the statement within a reasonable time – notify the TPB or the Commissioner that the statement is false, incorrect or misleading in a material particular, or omitted some matter or thing without which the statement is misleading in a material respect (s 15(2) of the Determination).

The obligation to correct a statement applies to a statement that is made by a registered tax practitioner and was false, incorrect or misleading at the time it was made, regardless of when the registered tax practitioner becomes aware that the statement was false, incorrect or misleading.

Statement not false etc at time made

There is no obligation under the Determination to take action in relation to a statement that was not false, incorrect or misleading at the time it was made, but later becomes false, incorrect or misleading because of some later event, for example, there is a change to the law that operates on a retrospective basis, or there is a decision of a court or tribunal that finds that the law operates differently to what had been the generally understood interpretation and administrative practice, or the TPB or the Commissioner withdraws guidance and advice relied on in the preparation of the statement.

The explanatory statement states that, while s 15 of the Determination does not extend an obligation to correct a statement that was not false, incorrect or misleading at the time it was made, but later becomes false, incorrect or misleading because of some later event, it may nonetheless be appropriate for the tax practitioner to take action in relation to such a false, incorrect or misleading statement where they are advising on the matter or on a related matter.

The explanatory statement also states that other obligations under the TASA or the Code may apply to past statements that become false, incorrect or misleading after they are made, such as the obligation to lawfully act in the client's best interests or to notify the TPB of a change in circumstances.

The explanatory statement further states that (c) above covers, for example, where a tax practitioner prepares a client's tax return and then submits the return to the Commissioner on the client's behalf. As the tax practitioner would require the client's consent to request an amendment to the income tax assessment, made on information based on the income tax return, the obligation instead requires the tax practitioner to advise the client to take action to correct the statement themselves, or to authorise the tax practitioner to take the necessary action to correct the statement on their behalf.

The explanatory statement states that the new Code statement items oblige tax practitioners to employ high levels of honesty and integrity in the service that they provide, and encourage accountability for statements that they make or prepare and responsibility for ensuring that the TPB and the Commissioner have access to the most accurate information so as to ensure ongoing public trust in the tax profession and tax system.

The correction or notification in relation to false, incorrect or misleading information will also be factored into the consideration of any potential sanction in relation to the original false, incorrect or misleading statement where the tax practitioner's involvement in that statement was a breach of the Code.

If a tax practitioner discloses confidential information as permitted by s 15 of the Determination or another legal obligation, that will not be a breach of the general confidentiality obligations in the Code. Notifying the TPB or Commissioner that a statement was false, incorrect or misleading in a material particular at the time it was made (as required by s 15 of the Code) will also not contravene the general confidentiality requirements in the Code, as those requirements do not apply to the extent that there is a legal duty to disclose.

Observations

The expansion of the Code obligations means that registered tax practitioners will need to carefully monitor their potential exposure to a breach of the Code. In this regard, any explanatory materials published by the TPB will be of prime importance.

Postscript

The TPB has now released a draft information sheet in relation to the false, incorrect or misleading Code obligation (TPB(I) D54/2024).

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References

1 The tax practitioner registration regime applies to tax agents and BAS agents. References to a registered tax practitioner are to a registered tax agent or a registered BAS agent.

2 These provisions are contained in Subdiv 60-E TASA.

3 S 30-15 TASA. That section provides that, where the TPB is satisfied that there has been a failure to comply with the Code, the TPB "*may* do one or more of the following". This gives the TPB a discretion whether to apply a sanction and, if a sanction is to be applied, what that sanction should be in the particular circumstances. It should be noted that there are also sanctions under s 60-125 TASA (Outcomes of investigations) that can apply where, as a result of an investigation, it is found that conduct breaches the TASA. These sanctions include, but are wider than, the specific sanctions for a breach of the Code. For the operation of these two sanction regimes, reference may be made to *Clifford v Tax Practitioners Board (No. 2)* [2024] FCA 557.

4 S 30-10(17) TASA.

5 The TPB has released a timeline of the expected release of draft guidance on the new Code obligations for consultation. See item 5 of the Tax News column in this issue of the journal (page 88).

6 S 13(1)(a) of the *Legislation Act 2003* (Cth).

7 S 13(1)(b) of the *Legislation Act 2003*.

8 S 90-1(2) TASA.

9 S 30-40 TASA. This notification obligation was considered in the February 2024 Tax Tips column (page 375).

10 See generally PS LA 2012/4.

11 S 50-20 TASA.

12 The civil penalty provision does not apply to statements made to the TPB.

13 (1979) 39 FLR 437 at 439.

14 [2015] FCA 263. See also *Tax Practitioners Board v Su* [2014] FCA 731 and *Tax Practitioners Board v Li* [2015] FCA 233.

15 Other Code obligations would be potentially breached in the circumstances (for example, acting honestly and with integrity).

16 S 284-25 of Sch 1 to the *Taxation Administration Act 1953*.

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The Dux of CTA2A Advanced for Study Period 3, 2023 discusses the vital role of Australia's complex tax system and how mastering it can be highly rewarding for both professionals and clients.

Steve Tanner
Manager
Roberts & Morrow, Brisbane

With a Bachelor of Business in Accounting under his belt, Steve became a chartered accountant and has worked in various roles in boutique and large firms. It is Steve's passion for tax advisory work that defines his recent years, adding depth to his already impressive expertise.

Deciphering tax

When we asked Steve "why tax?", his response echoed a sentiment shared by many in the field: a profound love for problem-solving and an interest in law. "Tax allows me to be involved in both of these on a daily basis," he said, emphasising that the tax system "is fundamental to the prosperity of all Australians, it is constantly changing, widely complex (sometimes to a fault) but can be very rewarding, if well understood, to help clients achieve their goals".

The rewarding path

The most rewarding part of Steve's role is mentoring budding talents within his team and unravelling complex puzzles alongside them. This collaborative spirit not only fosters growth, but also cultivates a deeper understanding of tax intricacies.

Education: the key to mastery

Steve undertook the CTA2A Advanced subject as part of our Chartered Tax Adviser Program. He said that the section on CGT roll-overs, in particular, helped him to develop a stronger understanding. "We often undertake group restructures for various commercial reasons and tax can often impede progress if not well understood. Divisions 122 to 124, Div 615 and Subdiv 328-G of the *Income Tax Assessment Act 1997* (Cth), as well as demergers, are all vital areas that have greatly added to my skillset."

When questioned about what he thought was the most interesting part of the subject, Steve said that it was a three-way tie between the taxation of trusts, CGT roll-overs and the small business CGT concessions. "All of these are vital to my day-to-day knowledge in serving the needs of our clients. In my experience, the taxation of trusts would have to be one of the most misunderstood areas in practice. CGT roll-overs and the small business CGT concessions are both highly technical and very important when it comes to clients undertaking tax-effective restructures for expansion, succession planning or selling their business."

The Tax Institute experience

Reflecting on his educational journey with The Tax Institute Higher Education so far, Steve commented on the pragmatic approach, stating that it was "the most commercially practical education I have ever undertaken". Modules in CTA2A Advanced are taught online by seasoned tax professionals, where questions and answers are exchanged in real time. Steve found the module notes very thorough with practical examples. Steve said that it's the "comprehensive notes and meetings with experts well-versed in their area of expertise that make studying with The Tax Institute so worthwhile".

Words of wisdom

As he steps closer to the CTA designation, Steve attributes his success, aside from having a well-planned schedule, to "understanding the fundamentals of what the concepts are trying to achieve and the reason for their existence. Keeping it simple and always falling back to asking 'why' helps me when I get stuck".

To aspiring tax professionals, Steve offers this sage advice: "Don't treat it as a box-ticking exercise, approach your learning and education as an opportunity to build your skillset to better serve your clients and pass on knowledge to your colleagues, particularly juniors who are interested in growing."

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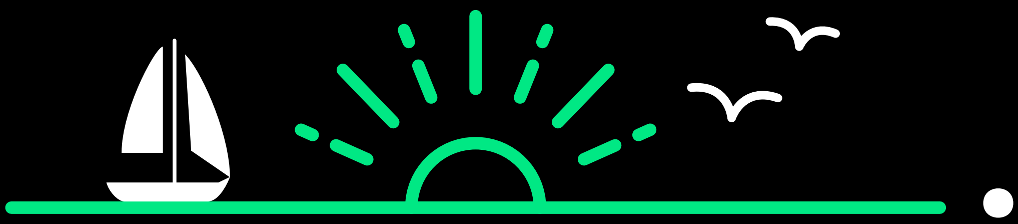

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PepsiCo falls flat for the ATO

by Cameron Blackwood, ATI, Head of Tax, Eugenia Kolivos, Head of Intellectual Property, Luke Imbriano, Partner, Craig Boyle, Special Counsel, Michael Carroll, Senior Associate, and Julia Bolodurina, Senior Associate, Corrs Chambers Westgarth

The *PepsiCo* case is one of the more significant tax cases in recent times, and it touches on a number of important considerations for multinationals. It explores what constitutes an embedded royalty for tax purposes, the concept of consideration for the use of intangible assets, and the application of Australia's diverted profits tax anti-avoidance provisions. This article focuses on the recent decision of the Full Federal Court, which has now been appealed by the Commissioner. The outcome of the Commissioner's special leave application, and any final High Court judgment, will provide some much needed certainty and clarity around the above issues.

Introduction

The Full Federal Court, in a decision handed down on 26 June 2024, has found in favour of PepsiCo, Inc (PepsiCo) in its royalty withholding tax and diverted profits tax disputes with the Commissioner. This overturned the previous decision and findings of the Federal Court at first instance.[1]

The decision is important on a number of levels. Most notably, this is in respect of the court's findings and comments regarding the analysis and interpretation of key elements of Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). The *PepsiCo* dispute also represents the first occasion on which the operation of the diverted profits tax provisions, inserted within Pt IVA in 2017, has been judicially considered.

The findings and comments of the majority judgment of the court in respect of the characterisation of intellectual property arrangements are also insightful and timely, particularly given the current focus of the Commissioner and the government on intangibles, and the associated, fast-changing regulatory landscape.

Background to the PepsiCo dispute

Colvin J summarised the factual background to the *PepsiCo* dispute:[2]

> "These appeals concern agreements by which the holders of intellectual property in established and valuable beverage brands agreed to supply to a buyer the essential (and secret) components to make the beverages so that the buyer could make and sell the branded beverages to its own customers …"

More specifically:

- the agreements were two separate exclusive bottling agreements (the agreements), entered into in 2009 by PepsiCo and Stokely-Van Camp, Inc (SVC), respectively (both companies being US companies and part of the PepsiCo Group), with Schweppes Australia Pty Ltd (Schweppes) (Schweppes being an Australian company owned by Asahi Breweries). Schweppes was an unrelated third party to both PepsiCo and SVC;
- under the agreements, Schweppes was the sole distributor and bottler in Australia of the Pepsi, Mountain Dew and Gatorade beverages in the relevant income years, which ended 30 June 2018 and 30 June 2019;
- under the agreements, PepsiCo and SVC nominated PepsiCo Beverage Singapore Pty Ltd (PBS) to sell or supply the beverage concentrate to Schweppes, which enabled the relevant beverages to be made (PBS being an Australian company and part of the PepsiCo Group). Schweppes paid PBS for the concentrate in accordance with invoices issued to it by PBS, with the sale price determined in accordance with the terms of the agreements;
- PBS, in turn, was supplied with the concentrate by Concentrate Manufacturing (Singapore) Pte Ltd (CMSPL) (CMSPL being a Singaporean company and part of the PepsiCo Group);
- CMSPL produced the concentrate according to a recipe or formula provided by PepsiCo and SVC. The money received by PBS for the supply of concentrate to Schweppes was transferred by PBS to CMSPL, less a margin, for its initial purchase of the concentrate from CMSPL; and
- under the agreements, Schweppes was granted the right to use trademarks and other intellectual property in Australia to enable it to manufacture, bottle, sell and distribute the finished beverages in branded PepsiCo Group packaging. The agreements provided for Schweppes to pay for the concentrate, but did not expressly provide for the payment of a royalty for the right to use the intellectual property.[3]

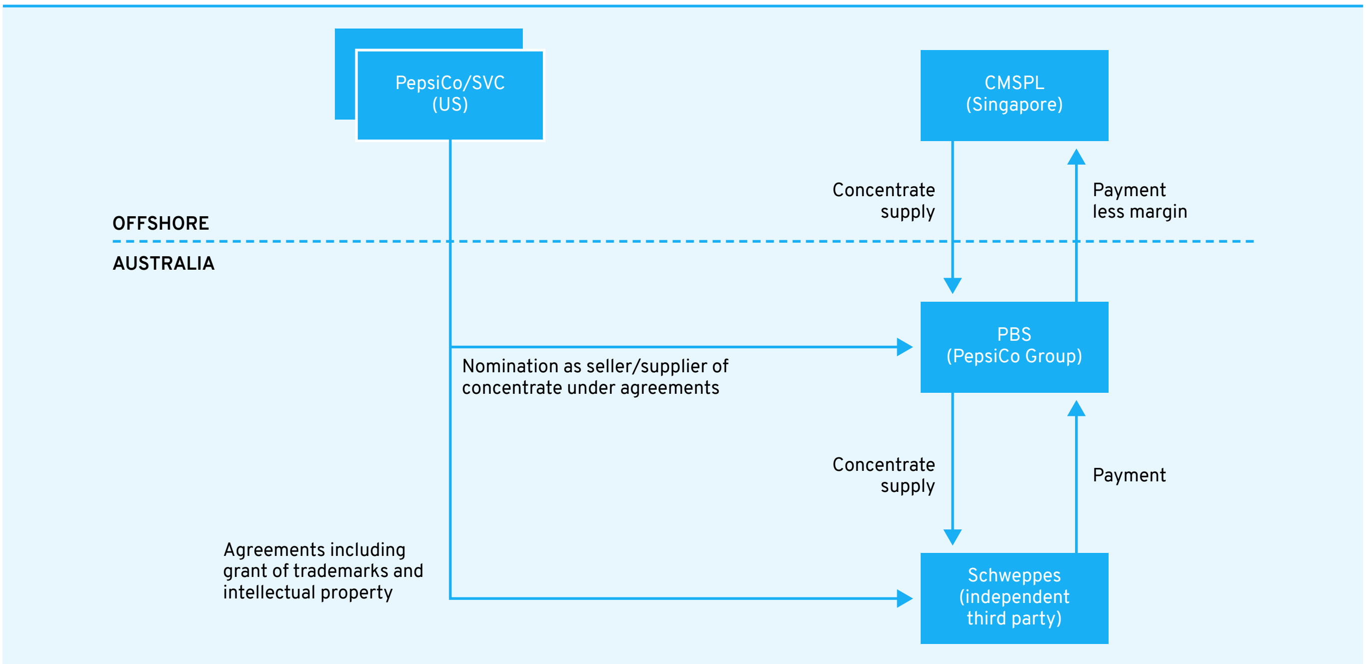
A diagrammatic representation of the above is shown in Diagram 1.

Background to the issues in dispute

The issues in dispute between PepsiCo and the Commissioner were also summarised by Colvin J:

> "138. … Broadly speaking, there are two aspects to the appeal proceedings. The first concerns whether the agreed price paid for concentrate as provided for by the

Diagram 1. The PepsiCo arrangements



[agreements] included royalties which were derived by PepsiCo and SVC as income such that they were liable to pay withholding tax on the royalty amounts. The second, which arises only if there is no withholding tax liability, concerns whether entry into each of the [agreements] was a scheme that gives rise to a diverted profits tax liability …"

Issue 1. Royalty withholding tax

There were two elements that the court needed to consider relating to the characterisation of the payments that Schweppes made to PBS for royalty withholding tax purposes:[4]

1. whether, on the proper construction of the agreements, the agreed price was payable in part for a royalty and not payable solely as consideration for the concentrate; and
2. whether the amounts paid under the terms of the agreements constituted "income derived" by PepsiCo and SVC, even though they did not receive those payments.

All three judges of the court (Perram and Jackman JJ in the majority judgment, and Colvin J in the minority judgment) ultimately concluded that the payments made by Schweppes to PBS for the concentrate were not income derived by PepsiCo and SVC for the purposes of s 128B(2B) ITAA36. This meant that the court unanimously rejected the Commissioner's primary position that PepsiCo and SVC were liable to pay royalty withholding tax in respect of these payments.

However, the court did differ on the question of whether the price paid for the concentrate, as provided for by the agreements, included an "embedded" royalty.

Embedded royalty

A key component of the court's analysis related to the definition of the term "royalty" within s 6(1) ITAA36. It also spoke to the requirement that, for a royalty payment to have been made, the payments are required to have been made "as consideration for" the use of relevant intangible or intellectual property.

Perram and Jackman JJ in the majority judgment favoured a somewhat literal and legalistic approach to their consideration of this issue, focusing on the express terms of the agreements and stating that:

> "10. … to determine whether the payments made by [Schweppes] to [PBS] were in part paid as consideration for the right to use the trade marks and other intellectual property, attention is to be confined to the terms of the contractual documents which, in this case, include at least the [agreements] …"

The majority also affirmed a key principle from the decision of Bennet J in *International Business Machines Corporation v FCT*,[5] acknowledging that:

> "12. … the question of whether payments are consideration for the right to use intellectual property rights, and therefore a 'royalty', for the purpose of s 128B of the ITAA 1936 is determined by the construction of the relevant agreement. Senior Counsel for both parties in the present case agreed that that was correct."

In determining the construction of the agreements, Perram and Jackman JJ concluded that:

> "21. … the Commissioner's submission that PepsiCo and SVC were giving away the right to use the trade marks for nothing unless some element of the concentrate price was seen as embedding some value for it, must be rejected."

In reaching this conclusion, they placed significant weight on their finding that the licence rights granted by PepsiCo and SVC to Schweppes did not exist "in isolation". Rather, "they were intertwined with [Schweppes'] obligations to distribute the beverages in Australia".[6]

A more complete view of the licence was one which acknowledged not only the benefits to Schweppes in being permitted to use the goodwill attaching to the trade marks, but also the restrictions and burdens imposed on Schweppes in utilising that goodwill, together with the benefits to PepsiCo and SVC in having Schweppes promote their goodwill in Australia.[7]

Perram and Jackman JJ also affirmed a key principle from the decision of Dixon CJ in *Davis Investments Pty Ltd v Commissioner of Stamp Duties (NSW)* (*Davis*),[8] acknowledging that "where parties to a conveyance have agreed the purchase price for a transfer on sale then the consideration for the transfer is that agreed price".[9]

They went further and stated that this "particular issue arising in the context of section 128B of the ITAA 1936 is determined by the construction of the relevant agreement", preferring a "formal expression" approach.[10]

> "for a postulate to constitute a reasonable alternative it 'should correspond to the substance of the scheme'"

In citing *Davis* with approval, Perram and Jackman JJ endeavoured to reconcile certain decisions of the High Court regarding the imposition of duty on the transfer of property, in response to the Commissioner's submissions "that the consideration for a transfer of property could be something different to that which the parties had agreed it to be".[11]

In distinguishing the High Court decisions in *Dick Smith*[12] and *Lend Lease*,[13] in the context of citing *Davis* with approval, Perram and Jackman JJ concluded that *Dick Smith* and *Lend Lease* apply when:

"33. …

(a) the parties to an agreement have agreed that an item of property or the conferral of a right is in return for a nominated price;

(b) the agreement provides for the transfer of other items of property or the performance of other obligations for value;

(c) on its proper construction the agreement shows that the transfer of the property in (a) can only be in return for all of the value in (a) and (b)."

The majority further stated:

"36. In this case, we do not think that the concentrate prices in the [agreements] are of this kind … The right to use the trade marks and other intellectual property was not the central property disposition or transaction which [the agreements] contemplated. Rather, the central bargain under the [agreements] was the establishment of an exclusive arrangement to distribute PepsiCo/SVC's beverages in Australia …

37. … It follows that the consideration for the purchase of the concentrate was the price the parties stipulated for it in the [agreements]. As such, the payments made by [Schweppes] to [PBS] did not include an element which was a royalty for the use of the trade marks (since the payments were not in consideration for the right to use the trade marks)."

Colvin J in the minority also endeavoured to reconcile the decisions of the High Court in *Davis*, *Dick Smith* and *Lend Lease*, but instead concluded that:

"186. … *Davis* does not assist in resolving a case like the present where the agreement has other dimensions, save that … it places an emphasis upon understanding the precise character of the commercial dealing effected by the terms in which the agreement is expressed."

In considering the nature of the dealing provided for by the agreements, and dissenting from the majority judgment as to whether there was a royalty, Colvin J stated:

"194. … regard to the whole of the terms of the [agreements] makes plain that it is not an agreement to supply concentrate. The nature of the transaction or dealing recorded in the agreement is one in which PepsiCo appoints [Schweppes] to bottle, distribute and sell branded beverages …

195. … If the amount that is required to be paid under the [agreements] is for the concentrate alone then the right to distribute the branded products is being afforded without any part of the monetary consideration being attributable to the licence to use the valuable brands of PepsiCo. That is a commercially unreasonable view of the terms of the [agreements] considered as a whole."

Derivation

Notwithstanding the conclusions reached by the majority as to the royalty-free nature of the payments under the agreements, Perram and Jackman JJ also considered whether the amounts received by PBS from Schweppes could constitute income derived by PepsiCo and SVC for royalty withholding tax purposes.

The majority noted that the Commissioner's submission in this regard was based on the contention that the consideration for the concentrate had been paid by direction to PepsiCo and SVC.[14] The majority rejected this submission, noting that "there can be no payment by direction unless there is an antecedent monetary obligation owed by [Schweppes] to PepsiCo/SVC".[15]

The majority concluded that there was no such antecedent obligation as, under the agreements, it was clear that a related entity nominee of PepsiCo/SVC under the agreements would be the entity selling the concentrate.[16] Further, while there were certain contractual obligations that remained the responsibility of PepsiCo/SVC, as PepsiCo/SVC "had neither possession of nor title to the concentrate … they did not deliver the concentrate either actually or constructively".[17]

As such, as there "was no sale of concentrate by PepsiCo/SVC it cannot be the case that [Schweppes] was ever obliged to pay them for something they were not selling".[18] Accordingly, the payments made by Schweppes to PBS were not income derived by PepsiCo and SVC for the purposes of the royalty withholding tax provisions as the payments did not "come home" to PepsiCo and SVC.[19]

Colvin J agreed with the reasoning of the majority judgment in relation to the non-derivation of income by PepsiCo and SVC.[20]

Issue 2. Diverted profits tax

The diverted profits tax provisions were introduced into Pt IVA in 2017. In broad terms, this gave rise to the need for the court to consider the application of the "customary" machinery provisions of Pt IVA regarding "scheme", "tax benefit" and "purpose" to the arrangements between PepsiCo and SVC with Schweppes.

Importantly, amendments were also made in 2013 to Pt IVA which saw the introduction of s 177CB ITAA36. These amendments are relevant to identifying a tax benefit in connection with a scheme and, in particular, in determining whether a postulate is a reasonable alternative for the purposes of considering what might reasonably be expected to have happened, but for the scheme.

Of significance in the majority judgment, Perram and Jackman JJ observed as follows in connection with the formulation of reasonable alternative postulates to the scheme/arrangements entered into, for the purposes of Pt IVA:

> "67. … In review proceedings of the present kind, it is the taxpayer which bears the burden of proving that assessments are excessive … Proving that the Commissioner's postulates are unreasonable does not in itself discharge that burden. It remains the burden of the taxpayer to show on all of the evidence that the tax benefit would not reasonably be expected to have been obtained if the schemes had not been entered into …
>
> 68. What this means in practice in a proceeding such as the present is that PepsiCo must show that there is no reasonable postulate for the purposes of section 177CB(3). Naturally, this will include demonstrating that the Commissioner's postulates are not reasonable but PepsiCo must also demonstrate on the evidence that there is no other reasonable postulate."

Perram and Jackman JJ found that, in framing the scheme the subject of the dispute, the Commissioner did so in a manner that did "not, in any way, depend on the prices at which the concentrate was to be sold".[21] Accordingly, this gave rise to the consequence that:

> "53. … the scheme relied upon [by the Commissioner] operates regardless of the concentrate price and, in particular, even where that price does *not* reflect the value … placed upon the intellectual property licence."

In the words of Perram and Jackman JJ:

> "51. … the Commissioner's scheme case begs the question of why the concentrate price should be understood as including a royalty …"

and

> "53. … it is not possible to conduct the kind of inquiry implicit in the Commissioner's scheme case without detailed analysis of the pricing under the [agreements]."

Rather, the Commissioner's scheme case assumed that a royalty component was included in the concentrate price. This was the same assumption that the experts for both the Commissioner and PepsiCo had been asked to make in determining a value for the intellectual property licence. As such, the difficulty that arose for Perram and Jackman JJ was "there was no evidence before the Court that this assumption was correct", nor was there any "corresponding evidence which showed that [the value of the licence granted under the agreements] was being recovered through the concentrate price".[22]

Accordingly, while the Commissioner identified two postulates that were contended to be reasonable alternatives to the entry into or the carrying out by PepsiCo and SVC of the scheme/arrangements entered into, these were ultimately rejected by Perram and Jackman JJ. This was primarily on the basis that the commercial and economic substance of these postulates (which incorporated the use of, or payments for the use of, trade marks and other intellectual property, in addition to payments for the concentrate) were different to the scheme/arrangements entered into.

More specifically, the majority found that, having regard to the explanatory memorandum that accompanied the introduction of s 177CB,[23] "for a postulate to constitute a reasonable alternative it 'should correspond to the substance of the scheme'".[24] Perram and Jackman JJ stated:

> "75. In this case, the Court must therefore assess the commercial and economic substance of the scheme and the commercial and economic substance of each postulate and reach a conclusion as to whether they correspond. It is necessary therefore to assess the commercial and economic substance of the scheme, on the one hand, and that of the [Commissioner's alternative] postulates, on the other."

In considering the commercial and economic substance of the scheme/arrangements entered into, the majority also found that "[t]he commercial and economic substance of the scheme was that the price agreed for concentrate was for concentrate",[25] and that:

> "81. Consequently, neither the scheme advanced by the Commissioner nor any of the evidence provides material from which it may be inferred that the commercial and economic substance of the scheme was that the concentrate price included a royalty for the licence of the intellectual property."

Further, Perram and Jackman JJ also found that PepsiCo had also discharged the higher burden of showing that there were no reasonable alternative postulates to the scheme/arrangements entered into, in addition to showing that the Commissioner's postulates were not reasonable.

They found that the only postulates that could bring the payments made by Schweppes within the diverted profits tax provisions of Pt IVA were those in which the payments made by Schweppes for the concentrate could be seen as being made in part for the grant of intellectual property rights by PepsiCo and SVC. Given the terms of the scheme as framed by the Commissioner, and the state of the evidence before the court, there could be no such reasonable alternative postulate.[26]

As such, the majority concluded that, in the absence of a postulate that could be a reasonable alternative to the scheme/arrangements entered into, there could be no operation of s 177CB(3) and, correspondingly, PepsiCo and SVC could not be taken to have obtained, and did not obtain, a tax benefit in connection with a scheme for the purposes of Pt IVA and the diverted profits tax provisions therein.

In contrast, Colvin J found that the scheme provisions within Pt IVA, and the existence or otherwise of a reasonable alternative postulate, were required "to be considered in respect of a transaction which includes an amount which is consideration for the use of the trade marks".[27]

As such, having regard to the differing conclusion reached regarding the embedded royalty question, Colvin J found that:

> "215. … the [agreements] resulted in a tax benefit because, if the [agreements] had not been entered into, then a reasonable postulate was that the [agreements] would have provided for the royalty to be paid to PepsiCo or SVC … as the holder of [intellectual property rights]."

While all three judges also ultimately concluded that the "principal purpose" test under s 177J(1)(b) ITAA36, which relates to the entering into or carrying out of a scheme to obtain a tax benefit, would have been satisfied, Perram and Jackman JJ in the majority judgment noted that this conclusion was reached only on the basis of a "highly artificial assumption" in contrast to their previous conclusions that, as a matter of commercial and economic substance, there was evidence that the payments made by Schweppes included a royalty for the use of the trade marks and other intellectual property, together with an accompanying necessary assumption that the Commissioner's scheme incorporated that aspect in its terms.[28]

Detailed observations on the PepsiCo dispute

On 8 August 2024, the Commissioner applied to the High Court for special leave to appeal from the whole of the judgment of the Full Federal Court. While currently a matter of speculation as to whether any special leave application may be granted by the High Court, there are a number of factors that may tend towards this outcome.

Given the Commissioner's and the government's current focus on intangible arrangements, the decision in *PepsiCo* represents a potentially unfavourable outcome for the Commissioner that could have broader application beyond the specific facts, circumstances and industry involved in the present case.

Factors include:

- announcements in this year's Federal Budget regarding the application of penalties for mischaracterised or undervalued royalty payments to which royalty withholding tax would otherwise apply; and
- the Commissioner's detailed TR 2024/D1 regarding the characterisation of payments as royalties in respect of software arrangements. It endeavours to promote an expansive view of the concept of "consideration" and the relevance of all surrounding circumstances of an arrangement beyond the terms of an agreement, which also removes the concept of "simple use".

The ATO has noted in a media release issued on 9 August 2024 that it would defer the finalisation of TR 2024/D1, pending the outcome of any High Court proceedings and any possible consideration by the High Court of related matters in *PepsiCo*. Given the existence of separate Federal Court proceedings involving similar issues and disputes with another large global participant within the beverage industry, any granting of the special leave application by the High Court is a matter of high public and professional interest to both the Commissioner and taxpayers alike.

Federal Budget's intangibles integrity measure

Somewhat lost in the above is also the announcement by the government in this year's Federal Budget that the previously announced intangibles integrity measure would no longer be implemented. This was to be targeted at entities making payments relating to intangible assets connected with low corporate tax jurisdictions, and had proceeded to exposure draft legislation stage.

While this will now be addressed by other means (ie the implementation of BEPS principles), it is perhaps indicative of the changing regulatory landscape associated with the taxation of intangibles, which, in broad terms, may benefit from definitive judicial consideration and conclusions.

"Consideration" is of fundamental importance

Both the Full Federal Court's majority and minority judgments in *PepsiCo* devote considerable time and comment in endeavouring to reconcile the apparent contrast in historical decisions of the High Court regarding the determination of the concept of "consideration" in a number of well-known duty cases. While, at first instance, this may be seen to be disconnected with issues regarding royalty withholding tax and diverted profits tax, the definition of "royalty" in the income tax legislation promotes the concept of "consideration" to one of fundamental importance when considering issues regarding the existence or otherwise of embedded royalties.

This aspect of the judgments in the Full Federal Court has been focused on by the Commissioner in the grounds of appeal within the High Court special leave application. Further consideration and clarification by the High Court of this line of authority will therefore be of high interest to both the Commissioner and taxpayers.

The Commissioner has also included as a ground of appeal that income (in the form of royalties) was derived by PepsiCo and SVC. Given that all three judges of the Full Federal Court found that this was not the case, any High Court analysis of this aspect of the *PepsiCo* dispute will also be of high relevance.

Concept of the "counterfactual"

The *PepsiCo* dispute represents the first occasion where the operation of the diverted profits tax provisions has been judicially considered. In addition, the previous decision and findings of the Federal Court at first instance, together with the majority judgment of Perram and Jackman JJ in the Full Federal Court, also represents the first time that the amendments made in 2013 to Pt IVA, in respect of the concept of the "counterfactual" and the determination of a reasonable alternative postulate, have been considered in detail.

In particular, the majority judgment of Perram and Jackman JJ was able to deal with the Pt IVA requirements surrounding how the existence or absence of reasonable alternative postulates are demonstrated, in large part because of the evidentiary constraints faced by the Commissioner. These constraints included the view of the majority that, in order to frame a reasonable alternative postulate in the circumstances, evidence in the form of a detailed analysis of the economics of the agreements was required. Such analysis, in turn, would have to include other benefits and burdens flowing to PepsiCo under the agreements, and the cost to PepsiCo of manufacturing the concentrate, in order to show that the concentrate price under the agreements included a value for the licences provided to Schweppes.

Given the burden of proof faced by taxpayers under s 177CB(3), as articulated by Perram and Jackman JJ, it remains to be seen whether similar diverted profits tax or Pt IVA outcomes may arise, or indeed may even be capable of arising, in different factual circumstances and where such evidentiary constraints are not present.

These points may be factors, in and of themselves, that may support the High Court's consideration and granting of any special leave application. This aspect of the majority judgment in the Full Federal Court, and in particular the potential implications for any dispute arising under Pt IVA, and not just a dispute arising within the context of the diverted profits tax provisions, has also been focused on by the Commissioner in the grounds of appeal within the special leave application.

Other IP matters of fundamental importance to taxpayers

In addition to the above, the decision of the Full Federal Court in *PepsiCo* also highlights other matters that are of fundamental importance to taxpayers in general, and taxpayers with intellectual property arrangements.

It is apparent from all aspects of the Full Federal Court's reasoning – both the majority and minority judgments – that the manner of drafting commercial agreements is critical. Whether the literal and "express" approach of the majority judgment or the broader "commercial" approach of the minority judgment is preferred, what seems clear is that the more specific and comprehensive the language of a contract, and the less ambiguous that language and the subject matter of that contract, the better.

Looking at the *PepsiCo* dispute, this is particularly the case in respect of transactions that involve or potentially involve the use of, or payments for, intellectual property, which in turn will likely involve other specialist areas of law (such as copyright/trade mark law).

The use of expert evidence

The use of expert evidence and the manner in which such experts are briefed are also of critical importance in resolving any dispute between the Commissioner and taxpayers.

This reflects Perram and Jackman JJ's comments in the majority judgment in particular. They indicated that the assumptions made by the Commissioner's expert in conducting his valuation, together with the absence of a detailed economic analysis of the agreements, gave rise to significant evidentiary implications from the perspective of the Commissioner. This is together with associated technical consequences in respect of the interpretation and application of the diverted profits tax provisions. It therefore becomes imperative that taxpayers seriously consider the basis, including the context, on which an expert is instructed. For example, given the evidentiary restrictions ultimately focused on by the majority, it may be necessary to instruct different experts for different purposes (eg for the purposes of settlement discussions with the Commissioner, compared to the purposes of litigation).

Operating at arm's length

Finally, the majority judgment in the Full Federal Court acknowledged that PepsiCo/SVC and Schweppes were operating at arm's length.[29] The minority judgment acknowledged that PBS paid an arm's length price to CMSPL for the supply of the concentrate.[30] Accordingly, the transfer pricing provisions in Div 815 of the *Income Tax Assessment Act 1997* (Cth) were not relevant to the dispute between PepsiCo and the Commissioner.

Given the significance of the decision of the Full Federal Court in *PepsiCo*, together with the ongoing focus of the Commissioner and the government on intangible arrangements, it remains to be seen whether the Commissioner may seek to test the operation of the diverted profits tax provisions within the context of intellectual property arrangements involving cross-border related parties and the application of the transfer pricing provisions.

Summary of key takeaways

1. The Full Federal Court found in favour of PepsiCo, meaning that PepsiCo is not subject to either royalty withholding tax or diverted profits tax in respect of certain cross-border intellectual property licensing arrangements involving unrelated Australian third parties. The decision will be of high relevance to Australian taxpayers and multinational groups with similar third party commercial arrangements.

2. The taxation treatment of intellectual property arrangements continues to be a focus area of the ATO, and is subject to ongoing change, contrasting opinion, differing interpretation and uncertainty.

3. Taxpayers should remain vigilant and proactively review relevant arrangements. In particular, they should reflect on the ATO's willingness to consider the application of the diverted profits tax anti-avoidance provisions in circumstances where payments for intellectual property may be viewed as containing royalty components.

4. Such review should include an objective assessment of the terms of any contracts and legal agreements that record relevant arrangements. Contemporaneous documentation and evidence that support the commercial nature of relevant arrangements should also be reviewed, including any associated economic analysis and the basis on which that analysis has been undertaken.

5. The statements made by the majority of the Full Federal Court regarding how the 2013 amendments to Pt IVA operate in determining or identifying a tax benefit will also be relevant to the application of Pt IVA more generally (subject to any High Court decision if the Commissioner's special leave application is granted).

6. The decision represents a *potentially* unfavourable outcome for the Commissioner that could have broader application. This is particularly relevant in the context of announcements in this year's Federal Budget regarding the application of penalties for mischaracterised or undervalued royalty payments, to which royalty withholding tax would otherwise apply.

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2 *PepsiCo, Inc v FCT* [2024] FCAFC 86 at [136].

3 [2023] FCA 1490 at [5b] and [6].

4 [2024] FCAFC 86 at [138].

5 [2011] FCA 335.

6 [2024] FCAFC 86 at [17].

7 [2024] FCAFC 86 at [21].

8 [1958] HCA 22.

9 [2024] FCAFC 86 at [26].

10 [2024] FCAFC 86 at [27] and [28].

11 [2024] FCAFC 86 at [26]. See the decisions of the High Court in *Chief Commissioner of State Revenue (NSW) v Dick Smith Electronics Holdings Pty Ltd* [2005] HCA 3 (*Dick Smith*) and *Commissioner of State Revenue (Vic) v Lend Lease Development Pty Ltd* [2014] HCA 51 (*Lend Lease*), and the Commissioner's submission (also at [26]) that the principle in *Davis* was qualified by the subsequent decisions in *Dick Smith* and *Lend Lease*.

12 *Chief Commissioner of State Revenue (NSW) v Dick Smith Electronics Holdings Pty Ltd* [2005] HCA 3.

13 *Commissioner of State Revenue (Vic) v Lend Lease Development Pty Ltd* [2014] HCA 51.

14 [2024] FCAFC 86 at [39].

15 [2024] FCAFC 86 at [40].

16 [2024] FCAFC 86 at [41].

17 [2024] FCAFC 86 at [42].

18 [2024] FCAFC 86 at [43].

19 [2024] FCAFC 86 at [45] and [46].

20 [2024] FCAFC 86 at [207].

21 [2024] FCAFC 86 at [53].

22 [2024] FCAFC 86 at [50].

23 See the Tax Laws Amendment (Countering Tax Avoidance and Multinational Profit Shifting) Bill 2013 (Cth).

24 [2024] FCAFC 86 at [74].

25 [2024] FCAFC 86 at [82].

26 [2024] FCAFC 86 at [100].

27 [2024] FCAFC 86 at [214].

28 [2024] FCAFC 86 at [110] and [133].

29 [2024] FCAFC 86 at [51].

30 [2024] FCAFC 86 at [148].

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Revisiting the ESIC measures

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It has now been a number of years since the early-stage innovation company (ESIC) measures were first introduced in 2016, and the ESIC measures have garnered somewhat little attention among the mainstream tax community during this time. The ESIC measures can provide powerful outcomes for investors in ESICs and, therefore, advisers should endeavour to keep the ESIC measures at the forefront of their minds in order to maximise the availability of the concessions for their clients. This article seeks to revisit the ESIC measures while highlighting the planning opportunities and pitfalls experienced by the authors in practice. The article covers a range of issues, including corporate groups seeking ESIC eligibility, structuring investments in ESICs, and technical issues with the principles-based test, among others.

Introduced by the Turnbull Government in 2016, the early-stage innovation company (ESIC) measures have steadily ticked along, garnering somewhat little attention among the mainstream tax community.

The significance of the ESIC concessions may appear understated. This article seeks to revisit the powerful outcomes that can be achieved for investors in ESICs, while highlighting the planning opportunities and pitfalls experienced by the authors in practice.

The legislative framework and key concepts

Preliminary observations

Before addressing the various planning opportunities and traps associated with the measures, it is worthwhile providing a brief overview of the relevant legislative criteria.

The ESIC measures are contained in Subdiv 360-A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Where available, the measures can provide taxpayers who subscribe for new shares in an ESIC with the following tax concessions:

- a non-refundable carry-forward tax offset equal to 20% of the taxpayer's investment in the ESIC, capped at $200,000 per taxpayer per annum (for sophisticated investors); and
- concessional modified CGT treatment on the newly issued shares in the ESIC.

The concessional modified CGT treatment includes:[1]

- where the shares held in an ESIC are disposed of between the period of more than 12 months and less than 10 years of ownership, no capital gains or losses will arise on the disposal of the shares; and
- where the shares are held for more than 10 years, the shares receive a market value cost base uplift on the 10th anniversary of ownership.

It can be seen that the ESIC measures are capable of providing taxpayers with considerable income tax benefits. Having said this, given ESICs are typically high-risk prospects, care is required in seeking to classify an investment as an ESIC, as any capital losses arising from the investment will be disregarded.

Eligible investors

Investors seeking to access the ESIC measures must subscribe for, and be issued with, shares in a company that constitute equity interests under the ITAA97. It follows that the ESIC concessions will not be available where the investor acquires its shares in the investee company via share transfer.

As stated above, the maximum $200,000 per annum tax offset is available to "sophisticated investors".[2] If the investor does not qualify as a sophisticated investor, the ESIC concessions limit that investor's total investment in the investee company to $50,000 (equivalent to a maximum tax offset of $10,000).[3] If that investment amount is exceeded, the non-sophisticated investor loses the ability to claim the ESIC concessions altogether.[4]

The sophisticated investor test applied under the ESIC regime is set out in the *Corporations Act 2001* (Cth)[5] which provides a number of pathways for an investor to qualify as a sophisticated investor.

An investor most commonly qualifies as a sophisticated investor where they (or, if a company or trust, the controller) hold a qualified accountant's certificate at the time of the share issue stating that the investor (or their controller):

- has gross income of at least $250,000 for each of the last two financial years; or
- has net assets of at least $2.5m.[6]

In addition to the above, there are also a number of other requirements which, although more procedural in nature, should not be ignored. These requirements are as follows:[7]

- investors cannot be widely-held companies or early stage venture capital limited partnerships;[8]
- the investor and investee company cannot be affiliates of each other at the time of the issue of the equity interests;

- immediately after the issue of the new shares, the investor cannot hold issued share capital in the investee company (or an entity connected with the company) that carries rights to exercise more than 30% of the total voting power or receive more than 30% of any distributions of income or capital (the 30% rule); and
- the shares cannot be issued to the investor pursuant to an employee share scheme.[9]

On the basis that the above requirements are satisfied, the final requirement that needs to be met is that the investee company qualifies as an ESIC at the time of the issue of the new shares.[10]

When is a company an ESIC?

In order for the investee company to be deemed an ESIC, this requires that the company satisfies a suite of requirements that are broadly split into two distinct limbs. Those limbs are:[11]

1. the "early stage" limb; and
2. the "innovation" limb.

The early stage limb is determined against the following criteria, requiring that the company immediately before the investment (ie the issue of shares):[12]

- is not listed on any stock exchange;
- was either:
  - incorporated within the last three income years (the latest being the income year of the investment);
  - registered on the Australian Business Register within the last three income years (the latest being the income year of the investment); or
  - incorporated within the last six income years (the latest being the income year of the investment) and (together with its 100% subsidiaries) has total expenses of $1m or less over the last three income years before the income year of the investment;
- has (together with its 100% subsidiaries) assessable income of $200,000 or less in the income year before the investment;
- has (together with its 100% subsidiaries) total expenses of $1m or less in the income year before the investment; and
- is not a foreign resident.

It can be seen from the above that, as time goes on, the ESIC requirements become increasingly difficult for an existing company to satisfy.

The innovation limb requires the investee company to meet one of two tests,[13] being the "points-based test" or the "principles-based test".

The points-based test requires that the investee company falls within certain objective innovation criteria which are contained in s 360-45 ITAA97 and are repeated in the Appendix to this article for ease of reference. There are eight different criterion, each of which, when satisfied, awards the company with points that range between 25 and 75 points per criterion. If the investee company can accumulate 100 points, the points-based test and innovation limb are satisfied.

The principles-based test requires the company to demonstrate that:[14]

- the company is genuinely focused on developing for commercialisation one or more new or significantly improved products, processes, services, marketing or organisational methods;
- the business relating to those products, processes, services or methods has a high growth potential;
- the company has the potential to be able to successfully scale that business;
- the company has the potential to be able to address a broader than local market, including global markets, through that business; and
- the company has the potential to be able to have competitive advantages for that business.

None of the above words and phrases are defined in the tax legislation. The principles-based test is therefore highly subjective but is far less rigid in its application than the points-based test.

The explanatory memorandum to the legislation[15] that introduced the ESIC measures does, however, provide some guidance on the test, and for now is the primary source of aid in applying the above phrases.

In this regard, the plain language of the principles-based test and the explanatory memorandum make it clear that there must be an innovation being developed by the ESIC and a business that aims to exploit that innovation.[16]

Other key takeaways from the explanatory memorandum include that:[17]

- the innovation needs to be "new or significantly improved" for the applicable addressable market (eg the Australian market);
- improvements resulting from the customisation of existing products and minor extensions such as updates will not be considered "new or significantly improved" innovations;
- the requirement that the company is developing an innovation "for commercialisation" requires that there is a spectrum of activities leading to the sale of the innovation or the generation of economic value for the company; and
- the need for the company to be able to demonstrate that the innovation is able to address a broader than local market means a market that is broader than a local city, area or region, so a capability of addressing in the future a national, multinational or global market would suffice.

Planning issues for ESICS

While the policy intent of the ESIC measures is to "encourage new investment in small Australian innovation companies with high-growth potential",[18] in the authors' experience, there are a number of technical issues that may be considered counterproductive to this statement. Some of these issues are fleshed out below.

Corporate groups

In order for a taxpayer to qualify for the ESIC concessions, the company issuing shares must be the same company that meets both the early-stage limb and the innovation limb.

A historic point of contention among some advisers has been whether the principles-based test requires that the company in which the investment is being made must itself carry on innovative activities, or whether such activities can instead be carried on by other members of a broader corporate group.

This issue often arises in the context of multi-tiered corporate structures involving a holding company and one or more subsidiary companies. Sometimes the subsidiary companies will hold valuable intellectual property relating to the innovation and/or carry on the business of commercialising the innovation, while the holding company plays a passive or limited role (such as providing finance to the subsidiaries). In these situations, the issue becomes whether an investment in the holding company can qualify for the ESIC concessions.

It has been the authors' view that the language contained in the provisions of the principles-based test does require the investee company to carry on innovative activities in its own right (eg developing the innovation for commercialisation).

In the first decision of any court or tribunal to consider the ESIC measures, the Administrative Appeals Tribunal (AAT) has recently taken the same view. To this effect, the decision in *ZWBX and FCT*[19] (*ZWBX*) involved the following corporate structure:

- IP Co — which held the intellectual property being developed as the innovation;
- Trading Co — which licensed the innovation from IP Co in order to carry on a business in relation to the innovation, including the innovation's development and commercialisation; and
- Holding Co — which wholly owned IP Co and Trading Co and therefore acted as the "head company" for the corporate group.

Investors who were issued with shares in Holding Co sought to claim the ESIC concessions on their investment.

Although Holding Co was a passive holding company, the taxpayer reasoned that, by reference to policy intent and the inclusion of references to "100% subsidiaries" in the early-stage limb of the ESIC criteria, the principles-based test in the innovation limb could be satisfied where subsidiaries of Holding Co carried on the innovative activities. This was, in the taxpayer's view, on the basis that the objective purpose of the criteria allowed for there to be a "unity of purpose" concept such that the actions of a corporate group as a whole could be relied on to satisfy the principles-based test (ie the collective activities of Trading Co and IP Co could be attributed to Holding Co).

The AAT, agreeing with the Commissioner of Taxation, rejected this approach, finding that the principles-based test is to be applied to the activities of the specific investee company. As there was no evidence of Holding Co undertaking any innovative-related activities in its own right, Holding Co was not an ESIC and an investment in the company was ineligible for the ESIC concessions.

In reaching the above conclusion, it is important to note that there were no agency, joint venture or partnership agreements in place between Holding Co, IP Co and Trading Co.[20] In the authors' view, having such agreements in place may have assisted in establishing that the relevant investee company was genuinely engaged in the innovative activities and was therefore an ESIC.

Income tax consolidated groups

It appears in *ZWBX* that, at the time the investment was made by the investors, the corporate group was not an income tax consolidated group.[21] This has since raised whether consolidating the corporate group might have resolved the issues raised in *ZWBX*.

In short, it might be viewed that as the "single-entity rule"[22] applies to treat a consolidated group as one taxpayer, this in effect might impute the activities of all subsidiary members to the head company for the purposes of determining its status as an ESIC. In the authors' view, this is unlikely to be of any assistance in establishing that the activities of a subsidiary are the activities of a head company.

Although the single-entity rule dramatically alters the income tax treatment of both a head company and its subsidiaries, this is limited to two narrow purposes:[23]

1. the head company core purposes; and
2. the entity core purposes.

The single-entity rule should therefore arguably have no application in the above circumstances and, as such, the activities of the subsidiaries should not be imputed to the head company (and vice versa).

The authors are not aware of any case law authority or binding guidance released by the Commissioner on this exact issue under the ESIC measures. However, there is a non-binding discussion paper from 2017[24] which broadly supports the position:

> "*Where the head company and its 100% subsidiaries are members of a consolidated group, the single entity rule in section 701-1 operates for the period of membership.* Under the single entity rule, transactions and arrangements between members of a consolidated group are taken to occur between parts of the head company.
>
> *However, the single entity rule only has effect for head company and entity core purposes*, being either to work out the income tax liability or loss of the head company or an entity in the group. *These core purposes do not*

include determining the income tax consequences for an investor under Subdivision 360-A." (emphasis added)

Furthermore, there are a number of other income tax measures where the same interpretation broadly applies when determining the income tax liability of a non-group entity in respect of activities concerning a consolidated group.[25]

Structuring issues

As is evident from the above, correctly structuring the investee company is critical to accessing the ESIC concessions.

In the authors' experience, due to the restrictions placed on the form that an ESIC can take, investee companies will often be structured to serve the dual purpose of holding the valuable innovation and carrying on the business of commercialising the innovation. This structure typically overcomes many of the issues associated with ensuring that the investee company is adequately involved in the activities that need to be met to satisfy the principles-based test.

Notwithstanding the above, in the authors' view, an investee company can still qualify as an ESIC where the relevant trading operations are conducted in an entity which is separate from where the valuable innovation is held.

> "… the principles-based test may still be satisfied where the ESIC engages other entities … via the general principles of agency."

In this regard, there is no requirement under the legislation for the innovation to be owned by the ESIC – that the company is commercialising the innovation and using it in a business is sufficient. In the same vein, the principles-based test may still be satisfied where the ESIC engages other entities to hold the innovation or perform activities for the ESIC on its behalf via the general principles of agency.[26]

Therefore, advisers should give thought to ESIC structures that involve the ESIC carrying on the business activities and holding the innovation for the purposes of the concessions, but engaging with other entities to develop the innovation on behalf of the ESIC. This may involve the provision of labour and plant and equipment. Where such a structure is desired, tailored written agreements should be put in place to preserve the income tax and commercial outcomes.

Maximising the tax offset

There are a number of considerations that investors should take into account so as to maximise their tax offset.

In this respect, as stated, the tax offset is capped at $200,000 per taxpayer per year. To the extent that a taxpayer carries forward any unused part of an ESIC tax offset, it is added to the cap for the next year and takes precedence over future tax offsets that can be earned on any subsequent qualifying investments in an ESIC.[27]

By way of example, if an investor subscribed for $1m of shares in an ESIC in year one, the investor would receive a tax offset of $200,000 on that investment. If the investor carried forward part of that tax offset to year two, say, $50,000, because that amount was unused, and then subscribed for a further $1m of shares in the ESIC in year two, the investor would only be entitled to receive an offset of $150,000 on that investment. This is because the investor has existing carried-forward ESIC tax offsets totalling $50,000 when making their second investment and can only have $200,000 in ESIC tax offsets at any given time.[28]

Turning to trust investors, it should be noted that, where a trust under its terms has beneficiaries or unitholders that are entitled to fixed entitlements to capital gains, the ESIC tax offset is attributable to those members in accordance with those fixed entitlements.[29]

In this regard, another planning point to raise is that, because of the $200,000 cap being determined per investor, if there is a syndicate of investors seeking to invest, in order to maximise the availability of the tax offset for the syndicate of investors, it will be preferable for each investor to invest directly in the ESIC rather than via a syndicated entity such as a company or unit trust.

Diagram 1 shows a comparison of four investors investing in an ESIC via a unit trust against each investor investing via their own separate discretionary trust structure.

It can be seen that investing via a syndicated entity significantly reduces the tax offsets available to the syndicate due to the way in which eligibility for the tax offset is determined and limited. However, if a unit trust structure is adopted by one or more investors, helpfully, any capital gains that are disregarded under the modified CGT treatment can be accessed by the unitholders without giving rise to CGT event E4 consequences.[30]

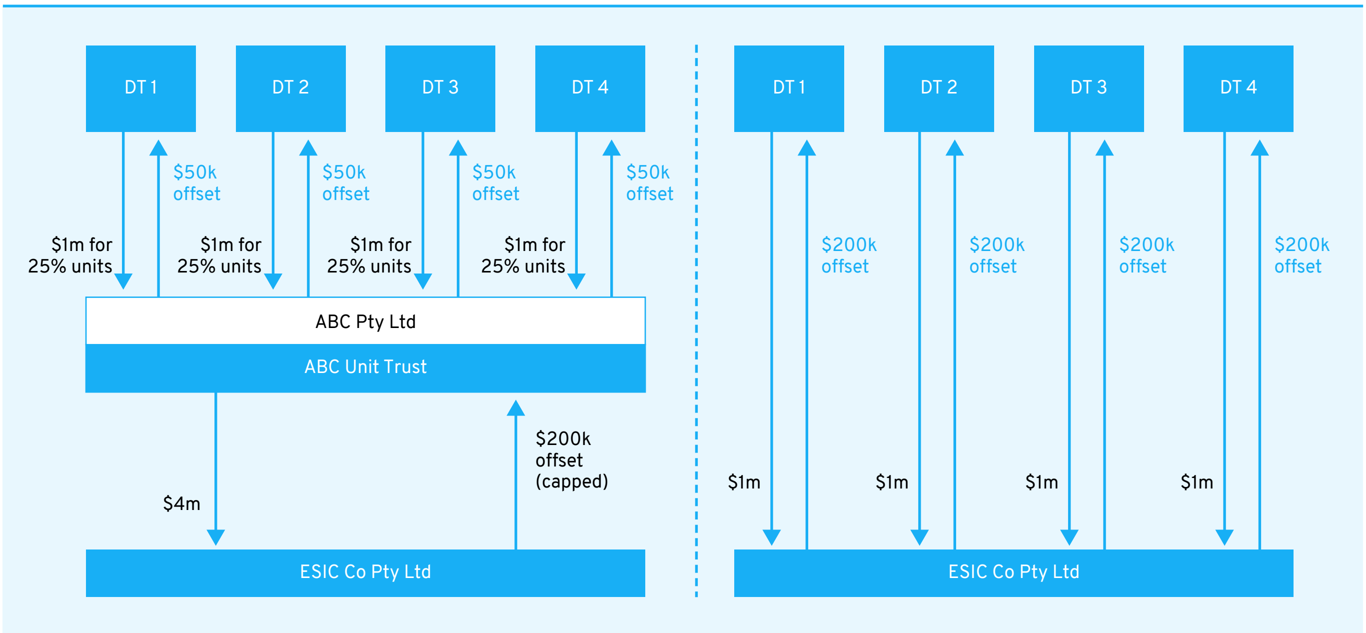
In the authors' opinion, in most circumstances, investors are often best placed to make their qualifying investment in an ESIC via a discretionary trust structure. This is not only because of the commonplace advantages that come with utilising a discretionary trust, such as asset protection and the ability to distribute income and capital to a range of beneficiaries, but also because of how a discretionary trust factors in with the rules governing the tax offset.

To this effect, where an investment is made via a discretionary trust, the trustee may elect to allocate the tax offset derived from the investment to any person that is a potential beneficiary of the trust as to income or capital.

Importantly, this means that the tax offset can be allocated to any beneficiary, regardless of whether that beneficiary receives any income or capital in the income year in which the tax offset is derived.[31]

A trap to be aware of, however, is that the trustee must make a written determination in order to allocate the offset to a beneficiary, and that determination must be

Diagram 1. Comparison: application of ESIC tax offset



made before the expiry of three months from the end of the income year in which the tax offset is derived (unless a further amount of time is provided by the Commissioner).[32] This requirement must be complied with even in circumstances where the trust has fixed entitlements and the beneficiaries or unitholders can only receive an allocation of the tax offset in accordance with those entitlements.

Failure to make a determination can potentially result in the tax offset being lost altogether. This can occur if the trustee is itself not liable to any income tax in the income year in which the tax offset is derived.[33]

Investors can also invest in an ESIC via a self-managed superannuation fund. If this is the case, it is the trustee, and not the member, that is entitled to utilise the non-refundable tax offsets against other income tax liabilities.[34] Of course, high-risk investments in ESICs would need to tie in with fund's overall investment strategy.[35]

Developing for commercialisation

When applying the principles-based test, a practice that appears to have been developed by the Commissioner in a number of private binding rulings has arguably limited the availability of the ESIC measures to investors. The issue stems from the following requirement of the principles-based test:[36]

> "(i) the company is genuinely focussed on *developing for commercialisation* one or more new, or significantly improved, products, processes, services or marketing or organisational methods;" (emphasis added)

The somewhat innocuous phrase "developing for commercialisation" is often overlooked. However, significantly, the Commissioner has taken the view that this requires that the innovation being developed by the ESIC is not yet at a stage where it has been "commercialised".[37] Rather, the innovation must be at a pre-commercialisation stage at the relevant time that the investor makes its investment.[38]

The Commissioner's reasoning for this appears to be that the ESIC measures are focused on companies which are at an "early stage" and, therefore, if the innovation has been commercialised, sufficient investment has already been made such that these measures do not provide an incentive that is consistent with the policy intent.

The authors' experience in making submissions to the Commissioner on ESIC matters is largely consistent with the above. That is, the Commissioner has required that the innovation must not yet be widely available or deployed in the market. Further, the innovation must be at a pre-market ready phase, such as a beta, alpha or pre-alpha stage, where there are levels of research and development, marketing and investment required to further develop and refine the product so that it is ready for market.

Having sufficient evidentiary material on hand, such as white papers for the innovation, business plans, forecasts, marketing plans and development roadmaps, is critical in order to establish that the relevant innovation is at a "pre-commercialised" phase and that the innovation is currently "being developed" for commercialisation by the investee company.

In the authors' view, seeking a private binding ruling on the principles-based test is often necessary in order to risk manage the legislative interpretative issues (see further below).

The affiliate dilemma

As stated, in order for an investor to qualify for the ESIC concessions, the investor and the investee company cannot be affiliates of each other at the time the relevant shares are issued.[39]

In other words, the ESIC must not act, or reasonably be expected to act, in accordance with the investor's directions or wishes, or in concert with the investor, in relation to the affairs of the business of the ESIC, and vice versa.

The affiliate test is not often an issue when it comes to dealing with new investors or "angel" investors that are seeking to invest into the ESIC. Sometimes, however, it is one of the "founders" of the innovation that is seeking to invest further funds into the ESIC and, in these circumstances, great care is required when assessing whether their investment qualifies for the concessions.

The explanatory memorandum to the legislation which introduced the ESIC measures states that the affiliate restriction is imposed in order to target the tax incentives to new investors in an ESIC rather than merely subsidise existing investments.[40] The explanatory memorandum goes on to provide that:[41]

> "For example, a director-owner of an ESIC would be precluded from qualifying for a tax offset, as the ESIC would be an affiliate of the director-owner."

When considering this issue, two important qualifications to the affiliate test must be borne in mind:[42]

1. entities will not be considered affiliates merely because of the nature of the business relationship shared between them; and
2. directors of a company or a company and a director will not be affiliates merely because of their relationship in relation to the affairs of the company.

As a starting point, on the basis that the founder (or their related entity) investing in the ESIC satisfies the 30% test, it will assist in substantiating that there is no affiliate relationship if the founder is one of a number of directors of the company. Further, it will also be of assistance if a majority of the directors of the board can be regarded as acting independently of the founder.

It might also be of assistance if there are shareholders agreements in place which provide that a number of significant decisions (ie acquisitions of significant assets, admission of new directors, capital raises etc) of the board cannot be done without the consent of a special majority of the shareholders.

In any event, care is required for investments in an ESIC by any founders of the innovation, and it is understood by the authors that this is an area that the Commissioner will often target on a review or an audit of an ESIC.

Points-based test — what's the point?

Having regard to the many issues raised under the principles-based test, one may query whether the points-based test might be the easier route for a company to satisfy the innovation limb of the ESIC criteria.

In the authors' experience, while the points-based test can in some instances be satisfied, advisers will often find that it is too soon in the ESIC's lifecycle for many of these criteria to be capable of being satisfied.

For instance, in the case of a start-up software company, the different items of intellectual property being developed would not typically be in the nature of patents. Further, research and development tax incentives might not yet have been sought in a previous income year by the company or Commonwealth accelerator grant programs entered into. This often leaves the principles-based test as the only viable avenue for the company to pursue in obtaining ESIC status for its potential investors at the time those investors are willing to invest.

Nonetheless, satisfying the points-based test can remove much of the uncertainty and subjectivity associated with the principles-based test. Where this is the objective, advisers should take care to avoid the common traps.

As an example, participating in an accelerator program will award companies 50 points towards the 100 point total needed to meet the test. However, not all accelerator programs meet this criteria. For example, the following accelerator programs are potentially ineligible under the points-based test:

- the accelerator's support is not time-limited;
- there is no competitive and open process to enter into the accelerator;
- the entity operating the accelerator has not operated it (or other accelerator programs) for at least six months (at the time the eligible share issue occurs); and
- the program has not been completed by at least one cohort of entrepreneurs (at the time the eligible share issue occurs).[43]

Furthermore, accelerator programs are to be distinguished from other forms of start-up based programs, such as incubator programs. Incubator programs may not strictly meet the definition of an accelerator program as defined under the points-based test.

The ESIC participating in incubator programs can, however, potentially assist in demonstrating that the company is genuinely focused on developing for commercialisation its innovation and thus contribute to meeting the principles-based test.

While there are many other common traps with the points-based test, the above should highlight to advisers that the test should not be regarded as the automatic "easy route" to obtaining ESIC eligibility.

When should a ruling be sought?

As stated, the principles-based test is highly subjective. In this context, and acknowledging the substantial tax concessions that can be afforded under the ESIC measures, there can be significant risk in accessing the concessions on a self-assessed basis.

In the authors' experience, in order to risk manage against the considerable uncertainty posed by the ESIC measures, it is often preferable to seek a private binding ruling from the Commissioner on ESIC eligibility and, in particular, on the principles-based test. This could be sought by the investor in respect of various aspects of the ESIC criteria pertaining to their affairs, and/or by the company in respect of their eligibility as an ESIC. To this effect, company boards may be keen to obtain a private binding ruling to use in their promotions to potential investors.

If seeking a ruling, being able to produce contemporaneous and detailed evidence substantiating the investor and company's eligibility under the various requirements of the ESIC measures is imperative.

Also, the Commissioner will often engage experts from AusIndustry in order to assist in analysing the technical nature of any innovation that is purported to satisfy the principles-based test. Therefore, having a sound technical basis for why the innovation meets the various principles-based test requirements is important.

If a private binding ruling is being sought on the principles-based test, the following documents will likely be key in substantiating satisfaction of the criteria:

- business/strategic plans;
- cash flow projections;
- marketing plans;
- technical white papers;
- budget and management reports;
- any records regarding trademarks, patents and other intellectual property;
- any marketing reports, industry studies or research reports;
- organisational charts; and
- any agreements with third parties for commercialisation of the innovation.

In the authors' experience, the ATO may, in some instances, also want to meet with company representatives in a "pitch" style meeting to further investigate and understand the innovation.

Capital raising issues

As stated above, the investor must be issued with *new* equity interests in the ESIC in order to be eligible for the ESIC concessions on their investment. Practically, this means that it will not be viable for a company to issue convertible notes to an investor and for the investor to claim the ESIC concessions on such an investment. This is because convertible notes would not meet the definition of an "equity interest".

On the other hand, "SAFE" notes,[44] depending on how they are structured, can potentially meet the definition of an equity interest, although care should be taken when drafting documents under this arrangement to achieve the desired outcomes.

The SAFE note typically has a conversion event (such as an initial public offering or an exit event), contains a discount and has a valuation cap. Importantly, SAFE notes do not have a term or maturity date.

Issues for the ongoing management of ESICs

There are a number of other issues that advisers should be aware of relating to the ongoing management of ESICs, including:

- ESICs must report to the ATO by 31 July each year where any investors have sought to claim the ESIC concessions in relation to the company in the prior financial year.[45] This is often satisfied by way of lodging an ESIC report via the ATO's dedicated ESIC reporting portal. The report (among other matters) details the names of any eligible investors, the quantity of qualifying shares issued to each investor, and how the ESIC has assessed its eligibility for the measures (eg self-assessment);
- care is required when undertaking subsequent restructures of the ESIC. An investor's modified CGT treatment can potentially cease if certain CGT roll-overs are used in the restructuring of an ESIC company. Such roll-overs include the Subdiv 124-M scrip-for-scrip roll-over and Div 122 wholly owned company roll-overs.[46] Given the common occurrence of restructures in the start-up space, this is a trap to be aware of in the ongoing management of the ESIC;
- one of the requirements of the early-stage limb is that the investee company has total expenses of less than $1m.[47] The Commissioner considers that the concept of "total expenses" under the ESIC measures equates to the general accounting concept of an expense (as opposed to the tax concepts of deductible expenditure versus capital).[48] It is therefore important for accountants to carefully consider the capitalisation and expensing of research and development costs associated with the innovation. Correctly capitalising costs which genuinely contribute towards the recognition of an accretion in the value of the innovation being developed will therefore greatly assist in ensuring that a company remains eligible for the ESIC measures;
- advisers should bear in mind at all times that the ESIC measures are, at their core, a "point-in-time" test. If future investments are made by investors, each individual tranche needs to be reassessed against the ESIC measures as a whole. This includes revisiting whether the potential ESIC still meets the principles-based test if that is what has historically been relied on to satisfy the innovation limb. It might be the case that the company's operations have changed to the point that it is no longer developing its innovation for commercialisation and therefore it is critical that each tranche of new shares issued are carefully assessed;
- further to the above, investors should be careful of incremental acquisitions in ESICs. As to this point, the 30% rule should be observed on any new investment to ensure that the investor does not hold more than 30% of the issued share capital in the ESIC. If future investments in the company by the investor no longer qualify for the measures, as a positive, those shares that were issued at a time when the investor did qualify will retain their

modified CGT treatment and any unused tax offsets from prior years will remain available; and

- although the benefits of obtaining ESIC eligibility have been readily established in this article, not all qualifying ESIC investments will become the next "unicorn" investment. It should be borne in mind that many ESICs are likely to fail as investments, given their high-risk nature. Where an ESIC investment does not ultimately succeed, it should be remembered that any capital losses made on the investment are lost under the modified CGT treatment (see above).

Wrapping up

The concessions available to investors via the ESIC measures are uniquely powerful and can present a number of tax planning opportunities, as well as pitfalls, for advisers.

As the ESIC framework begins to mature and interpretive issues are "ironed out", advisers should endeavour to keep the ESIC measures front of mind in order to maximise the availability of the concessions for their clients.

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Appendix. 100 point innovation test[49]

Item	Points	Innovation criteria
1	75	At least 50% of the company's total expenses for the previous income year is expenditure that the company can notionally deduct for that income year under section 355-205 (about R&D expenditure).
2	75	The company has received an Accelerating Commercialisation Grant under the program administered by the Commonwealth known as the Entrepreneurs' Programme.
3	50	At least 15%, but less than 50%, of the company's total expenses for the previous income year is expenditure that the company can notionally deduct for that income year under section 355-205 (about R&D expenditure).
4	50	(a) the company has completed or is undertaking an accelerator program that: (i) provides time-limited support for entrepreneurs with start-up businesses; and (ii) is provided to entrepreneurs that are selected in an open, independent and competitive manner; and (b) the entity providing that program has been providing that, or other accelerator programs for entrepreneurs, for at least 6 months; and (c) such programs have been completed by at least one cohort of entrepreneurs.
5	50	(a) a total of at least $50,000 has been paid for equity interests that are shares in the company; and (b) the company issued those shares to one or more entities that: (i) were not associates of the company immediately before the issue of those shares; and (ii) did not acquire those shares primarily to assist another entity become entitled to a tax offset (or a modified CGT treatment) under this Subdivision; and (c) the company issued those shares at least one day before the test time.
6	50	(a) the company has rights (including equitable rights) under a Commonwealth law as: (i) the patentee, or a licensee, of a standard patent; or (ii) the owner, or a licensee, of a plant breeder's right; granted in Australia within the last 5 years (ending at the test time); or (b) the company has equivalent rights under a foreign law.
7	25	Unless item 6 applies to the company at the test time: (a) the company has rights (including equitable rights) under a Commonwealth law as: (i) the patentee, or a licensee, of an innovation patent granted and certified in Australia; or (ii) the owner, or a licensee, of a registered design registered in Australia; within the last 5 years (ending at the test time); or (b) the company has equivalent rights under a foreign law.
8	25	The company has a written agreement with: (a) an institution or body listed in Schedule 1 to the *Higher Education Funding Act 1988* (about institutions or bodies eligible for special research assistance); or (b) an entity registered under section 29A of the *Industry Research and Development Act 1986* (about research service providers); to co-develop and commercialise a new, or significantly improved, product, process, service or marketing or organisational method.

A Matter of Trusts

by Phil Broderick, CTA, Sladen Legal

Changing directors: landholder duty trigger

The use of a rarely used "anti-avoidance" provision, which triggers landholder duty when there is a change of control of the trustee of a unit trust, has been upheld by VCAT.

A VCAT decision has upheld the use by the Victorian State Revenue Office (VSRO) of a rarely used landholder duty provision (originally introduced as an "anti-avoidance" measure), despite the taxpayer not acquiring any further units in a Victorian landholding unit trust. This decision confirms the breadth of the landholder duty provisions that can capture taxpayers that obtain the capacity to make financial decisions over landholding companies or trusts.

The use of this provision could have wide-ranging implications for changes to directorships of landholding unit trusts and companies (at least in Victoria).

What happened?

On 11 July 2024, in *Tao v Commissioner of State Revenue (Review and Regulation)*,[1] VCAT upheld that the change in directorship of the corporate trustee of a landholding unit trust was deemed to be a relevant acquisition and therefore triggered landholder duty. At the time of writing, this decision had been appealed.

Legislation

Landholder duty in Victoria generally only applies to the acquisition of interests in a landholding unit trust or company which is above the relevant thresholds (20% of units or 50% of shares). However, there are number of provisions in the *Duties Act 2000* (Vic) (Duties Act) which expand the circumstances when landholder duty is incurred. One of those is where a person acquires control over a landholder under s 82 of the Duties Act.

Section 82 provides as follows:

> "**Acquisition of control**
>
> (1) Despite anything to the contrary in this Part, if a person within a 3 year period acquires, directly or indirectly, control over a private landholder, other than by a relevant acquisition dutiable under this Part, then, on the acquiring of that control, the person is taken, for the purposes of this Part, to have made a relevant acquisition in the landholder of –
>
> (a) 100%; or
>
> (b) a lesser percentage determined by the Commissioner to be appropriate in the circumstances.
>
> (2) For the purposes of subsection (1), a person acquires control over a private landholder if the person acquires the capacity to determine or influence the outcome of decisions about the private landholder's financial and operating policies, taking into account –
>
> (a) the practical influence the person can exert in addition to any rights the person can enforce; and
>
> (b) any practice or behaviour affecting the private landholder's financial or operating policies (even if that practice or pattern of behaviour involves the breach of an agreement or a breach of trust).
>
> (3) Subsection (1) applies regardless of interests or economic entitlements held by any other person in the private landholder."

As noted above, the effect of s 82 is that, where control has been acquired over a landholder by a person, that person is deemed to have made a relevant acquisition in the landholder of 100% unless the Commissioner determines a lesser percentage is appropriate in the circumstances.

The "anti-avoidance" purpose of s 82 is to apply landholder duty where, while there may not have been a change in equity ownership in a landholder, there has been a change in control of the landholder, ie in the context that, with the change in control, ultimate economic ownership might change or could be changed.

This "anti-avoidance" nature of s 82 was acknowledged in the explanatory memorandum of the Duties Amendment (Landholder) Bill 2012 (Vic), which included the following paragraph:

> "Section 82 contains the control provision. This provision existed under the former land rich duty provisions, and deals with circumstances whereby, without acquiring a significant interest, a person obtains control over a private landholder by another means. For example, the holders of interests may cede control to the person and make such arrangements in respect of their interests that would allow the person to benefit or exercise rights which could confer benefits similar to holding an interest …"

Background

66 William Road Pty Ltd (Trustee Co) was the trustee of the WCT Unit Trust, which held a development property in Victoria with a value above $1m. The WCT Unit Trust was therefore a "landholder" for the purposes of s 71(1) of the Duties Act.

Units in the WCT Unit Trust were held:

- 50 units by Maclaw No. 547 Pty Ltd as trustee for The Mountain Highway Unit Trust (being an entity associated with the original director of Trustee Co);

- 25 units by Fredco Incorporated Ltd as trustee for Nomsec No. 1 Ltd (being an entity controlled by an overseas investor); and
- 25 units by Amber Investments Pty Ltd (being a company of which Mr Tao was the majority shareholder).

The original director was the sole shareholder and director of Trustee Co.

Trustee Co as trustee of the WCT Unit Trust acquired a property for the purposes of developing it. To help fund the venture, Trustee Co as trustee of the WCT Unit Trust borrowed money from a commercial bank.

Trustee Co fell behind in its loan obligations and the development of the property. As a result, Mr Tao and the overseas investor became concerned about the "[alleged] serious mismanagement" by the original director as director of Trustee Co.

On 11 February 2014, Mr Tao acquired four shares in Trustee Co, and on 6 March 2014, he became the sole director and secretary of the company. Consequently, Mr Tao became directly involved in negotiations with the commercial bank in an effort to save the venture. This was unsuccessful and, on 20 April 2015, controllers were appointed over Trustee Co, the development property was sold, and the bank loan was repaid. It appears that all of the investors ultimately made a loss.

In 2019, the Commissioner issued a duty assessment to Mr Tao imposing duty of $199,650 (plus penalties and interest) under s 82 on the basis of his acquiring control of Trustee Co via his acquisition of four shares in Trustee Co and his appointment as the sole director/secretary of that company. That is, despite neither Mr Tao nor Amber Investments Pty Ltd acquiring any further units in the WCT Unit Trust, Mr Tao was assessed for duty on the basis that he made a "relevant acquisition" in the WCT Unit Trust as a result of acquiring control of that trust under s 82.

Issues before VCAT

The main issue before the tribunal was whether Mr Tao acquired control of the WCT Unit Trust for the purposes of s 82. This turned on the following:

- whether Mr Tao acquired the "capacity to determine or influence the outcome of decisions about the WCT Unit Trust's financial and operating policies";
- if so, whether that was sufficient to engage s 82 or if it was necessary that Mr Tao also obtain an interest in the WCT Unit Trust which is equivalent to a beneficial interest; and
- if Mr Tao held a "significant interest" in the WCT Unit Trust, whether it should be reduced to 75% to take account of the 25% interest in the trust already held by Amber Investments Pty Ltd.

Control of the WCT Unit Trust

Mr Tao argued that he was responsible for the "day-to-day management" of Trustee Co which merely involved fulfilling decisions set by the unitholders of the WCT Unit Trust, and that he did not have control of the WCT Unit Trust's financial and operating policies as required to engage the change of control provisions in s 82.

The Commissioner contended that, when Mr Tao acquired the shares in Trustee Co and became its sole director, he "acquired not just the capacity, but the practical ability, to determine or influence [the WCT Unit Trust's] financial and operating policies" and that he "did not have the capacity to determine" those matters before he became a director.

The tribunal found that s 82 was focused on the strategic direction of a landholder rather than day-to-day management. It was determined that, once Mr Tao became the sole director, he controlled the strategic direction of the WCT Unit Trust, notwithstanding the continued influence of the other two investors and that they could have used their combined unitholdings to remove Mr Tao.

Application of s 82 without acquiring any further interest

Mr Tao argued that the Commissioner had sought to make dutiable a transaction that did not give rise to an acquisition of a legal or beneficial interest in the landholder. At no stage did Mr Tao obtain any further unitholding in the WCT Unit Trust, nor did Mr Tao acquire any benefit or ability to exercise rights as a unitholder when he became the sole shareholder and director of Trustee Co.

The Commissioner contended that the construction of s 82 does not leave room for an equivalence test.

The tribunal held that it was not necessary that Mr Tao also obtained an interest equivalent to a beneficial interest in the WCT Unit Trust for s 82 to be engaged:

> "96. Turning to the context, it is important to recognise that section 82 only applies where there is no relevant acquisition under sections 79 (i.e. of a direct or beneficial interest in a trust) or 81 (i.e. of a synthetic or economic interest in a trust). This, of itself, suggests that section 82 is not intended to be linked to any beneficial or synthetic interest in the trust."

Should the deemed interest acquired be reduced below 100%

Mr Tao contended that it was appropriate that the percentage of the relevant acquisition be reduced to 25% to take account of the interest in the WCT Unit Trust held by Amber Investments Pty Ltd.

Controversially, the Commissioner submitted that Mr Tao had failed to establish the "nature or extent of any control interest held prior to the relevant acquisition, personally or in combination with Amber Investments Pty Ltd" and that duty should be assessed on the basis of a "100% acquisition".

The tribunal held that the appropriate reduction was 15% (being 60% of 25%). This was on the basis that Mr Tao held 60% of the shares in Amber Investments Pty Ltd.

That is, the reduction was calculated on the 25% of the units held by Amber Investments Pty Ltd in the WCT Unit Trust multiplied by the 60% of the shares held by Mr Tao in Amber Investments Pty Ltd.

The tribunal held that it was appropriate to take account of pre-existing interests held in the landholder, even where those interests are not held directly:

> "124. Nevertheless, in circumstances where the Landholder Regime has been accepted as an anti-avoidance provision, to prevent the indirect acquisition of a landholder without paying duty, I consider it appropriate to take account of pre-existing interests held in the landholder, even where those interests are not held directly."

Decision

The tribunal held that, when Mr Tao acquired the shares in and became the sole director of Trustee Co, he acquired the capacity to determine or influence the outcome of decisions about the financial and operating policies of the WCT Unit Trust and therefore obtained control of it for the purposes of s 82. This was despite the fact that no further units in the WCT Unit Trust were acquired directly by Mr Tao or indirectly by his interest in Amber Investments Pty Ltd.

The only saving grace for Mr Tao is that the tribunal determined to reduce the percentage acquisition to 15% (which in turn reduced the amount of his landholder duty liability).

Overreach of "anti-avoidance" rules

The Victorian state taxes legislation contains a number of provisions where the reach of the respective provision extends beyond the mischief that that provision is seeking to prevent. Examples include the economic entitlement duty, the sub-sale duty, where landholders are deemed to hold land of discretionary trusts and, in this case, s 82 of the Duties Act.

This type of tax drafting effectively relies on the VSRO correcting this overreach by administering the law in accordance with its purpose or under an implicit understanding that the VSRO will only apply these provisions in an "anti-avoidance" manner. Unfortunately, that leaves the taxpayer at the "mercy" of the VSRO in applying the law and, as this case shows, there is often little that the courts can do against the wide drafting of such provisions.

As noted above, the "anti-avoidance" purpose of s 82 was to apply landholder duty where, while there may not have been a change in equity ownership in a landholder, there has been a change in control of the landholder, ie in the context that, with the change in control, ultimate economic ownership might change or could be changed.

In the author's view, s 82 was not intended to apply in a situation like this where the "change of control" is from one of the current investors to another of the current investors and where there is no change in, nor any intention to change, the ultimate equitable ownership of the landholder.

In this case, the change of directorship was to enable the existing investors to deal with problems with the operation of the landholder and issues with the landholder's bank. To apply duty on that director's original (non-dutiable) investment in the unit trust seems to be an unfair result that was surely not intended by the legislator.

An alternative outcome could have been to reduce the acquisition to 0% on the basis that no economic acquisition occurred as a result of the change of directorship. Further, the VSRO could have exercised its general power of administration to not assess landholder duty here, on the basis that s 82 was not intended to apply to these types of situations.

For the taxpayer, the only way that they could have avoided the application of s 82 was to not change the directorship and shareholding (presumably that would have been commercially undesirable) or to change the trustee of the WCT Unit Trust (which may have been difficult, given the issues with the bank).

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Reference

1 [2024] VCAT 637.

Superannuation

by Daniel Butler, CTA, and
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How does NALI interact with CGT?

The interaction between the NALI and CGT provisions can result in disproportionate tax outcomes as small NAL gains can taint large arm's length gains.

Non-arm's length income (NALI) applies a 45% tax to both the ordinary and statutory income of a superannuation fund. A net capital gain is statutory income. However, how does NALI interact with the CGT provisions?

The ATO has recently released TD 2024/5 to outline its current view on the interaction between the NALI and CGT provisions of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

The question of how NALI interacts with the CGT provisions is discussed below and, unfortunately, the answer is not nice; it's rather nasty. The legislation urgently needs fixing!

Overview

Broadly, s 295-550(1) ITAA97 defines NALI of a complying superannuation fund to include an amount of ordinary or statutory income obtained as a result of a scheme in which the parties were not dealing at arm's length.

Naturally, the statutory income of a superannuation fund includes capital gains made by the fund, and this is calculated under the method statement in s 102-5(1) ITAA97.

When does ATO consider a capital gain to be NALI?

The ATO states in para 7 of TD 2024/5 that a capital gain resulting from a non-arm's length (NAL) scheme is considered to be NALI under s 295-550(1) where either of the following apply:

- the amount of the capital gain is more than the amount that the fund might have been expected to derive if the parties had been acting at arm's length in relation to the scheme; or
- for SMSFs or small APRA funds –– when gaining or producing the capital gain, non-arm's length expenditure (NALE) is incurred (including nil expenditure) in respect of a CGT asset that is less than the amount of a loss, outgoing or expenditure that the fund might have been expected to incur if those parties were dealing with each other at arm's length in relation to the scheme.

Importantly, the ATO notes in para 9 of TD 2024/5 that the amount of statutory income from capital gains that is NALI cannot exceed the superannuation fund's net capital gain calculated under the method statement in s 102-5(1) for the relevant income year. This means that, where the amount of NALI capital gains exceeds the net capital gain (ie once losses and discounts are applied in accordance with the method statement), the amount of NALI from capital gains is equal to the net capital gain of the superannuation fund.

A NAL capital gain taints an arm's length capital gain

Does the interaction between the NALI and CGT provisions lead to a NAL capital gain tainting an arm's length capital gain?

Yes, the ATO confirms this position in TD 2024/5. Thus, technically, it is possible that a $100 NAL gain will taint a $1m arm's length gain if it is crystallised in the same income year. However, where a NAL gain exceeds the fund's net capital gain, the amount of the NAL gain equals the fund's net capital gain.

You might very well think that a $100 "tainted" gain should not taint an arm's length capital gain as that would presumably be a shortcoming in the legislation. However, the ATO's role is to administer tax legislation and it is the ATO's construction of the legislation that gives rise to this outcome. Therefore, the legislation needs fixing as otherwise it may result in some disproportionate and unfair outcomes.

The tainting impact of a NAL gain: ATO example

A NAL gain tainting an arm's length gain is highlighted in example 3 in TD 2024/5 which deals with an SMSF that receives inflated capital proceeds of $5m for an asset worth $1.5m. We have extracted this example below with some minor amendments.

Example

Hakuho is one of the trustees of the SMSF which had made the following in the 2022–23 income year:

- $1m arm's length capital gain;
- $5m NAL gain as reported by the SMSF. However, this capital gain arose as a result of a CGT event where the SMSF received capital proceeds of $6m for a CGT asset with a market value of $1.5m (noting that the arm's length cost base for this CGT asset was $1m). If the parties had dealt with each other at arm's length in respect of the scheme, the gain would have been $500,000. As such, s 295-550(1)(a) applies as the relevant income under the scheme is more than what might have been expected to have

Example (cont)

been derived if the parties had been dealing with each other at arm's length in relation to the scheme; and

- there are no assessable contribution or contributions.

The SMSF had a current year capital loss of $100,000 and no previous net capital losses. Both capital gains are discount capital gains.

The net capital gain as calculated under s 102-5(1) was $3,933,333.34. Section 116-30(2) ITAA97 generally applies to replace the capital proceeds with the market value of the CGT asset if the capital proceeds are more than the market value of the CGT asset if parties did not deal with each other at arm's length. However, s 116-30(2C) provides that the market value substitution rule in s 116-30(2) does not apply where the capital proceeds from the CGT event exceed the market value and, assuming that those capital proceeds were statutory income, the proceeds would be NALI. The net capital gain is, therefore, calculated as:

$6,000,000 (capital gain consisting of $1,000,000 arm's length component and ($5,000,000 NAL component) – $100,000 (capital losses) – $1,966,666.66 (1/3 SMSF CGT discount) = $3,933,333.34

The example then highlights how the tax payable is calculated pursuant to the method statement in s 295-10 ITAA97 (which deals with "How to work out the tax payable by superannuation entities").

Example (cont)

Step 1 – not applicable.

Step 2 – work out the entity's assessable income and deductions, taking into account the special rules in Div 295 ITAA97:

The assessable income is $3,933,333.34. The deductions are nil.

Step 3 – work out the entity's taxable income:

Assessable income of $3,933,333.34 less deductions of nil, equals $3,933,333.34 taxable income.

Step 4 – calculate the non-arm's length component:

The NAL component is $3,933,333.34.

This amount is calculated as the lesser of:

$3,933,333.34 (the NALI amount) – $0 (deductions) = $3,933,333.34

and

the taxable income of $3,933,333.34 less assessable contributions of $0 plus deductions of $0 attributable to those contributions.

Example (cont)

While the capital gain reported under the scheme was $5m, the NAL gain cannot exceed the SMSF's net capital gain.

Capital loss and discount percentage are not deductions.

The low tax component of the taxable income is nil.

Step 5 – apply the applicable rates as set out in the *Income Tax Rates Act 1986* (Cth):

The NAL component of $3,933,333.34 is taxed at the highest marginal rate (45%) and the low tax component of $0 is taxed at 15%.

Step 6 – not applicable.

The above example demonstrates that, where a NAL gain is crystallised in the same income year as an arm's length gain, the entire net capital gain will be tainted and taxed at the NALI tax rate of 45%. In this example, the $1m arm's length capital gain was tainted and taxed at 45%. Thus, a NAL gain effectively taints any other capital gain in the same income year.

Market value substitution rule: cost base

Paragraph 8 of TD 2024/5 highlights that a NAL gain is subject to the CGT market value substitution rules contained in s 112-20. For example, where an asset is purchased by a fund for less than its market value and the parties are not dealing at arm's length, the market value of the asset is deemed to be the cost base of the asset for the purposes of calculating a future capital gain.

Section 116-30 usually results in the market value of an asset being substituted where the capital proceeds exceed the market value of the asset and the parties are not dealing at arm's length. However, as noted in the example above, this rule has been modified in the case of superannuation funds under s 116-30(2C) meaning there is no substitution of the market value of the asset and therefore no reduction in the capital proceeds. Thus, in the example, the inflated capital proceeds were taxed as NALI.

Rejection of alternative views

TD 2024/5 also explains the Commissioner's position on several alternative views to the interpretation of the NALI and CGT provisions.

Notably, the Commissioner expressly rejects the view that the amount of NALI in relation to a NAL gain can be calculated by reference to the tainted gain alone, but must be considered in relation to an amount that takes into account both arm's length and NAL gains.

Capital losses

TD 2024/5 also discusses the treatment of capital losses. Broadly, capital losses reduce the amount of net capital gain under the method statement in s 102-5. Thus, one strategy that may be considered if you have a tainted capital gain in an income year is whether any capital loss can be realised to offset the capital gain to produce a lower net capital gain. However, before doing so, you should consider, among other things, the following:

- the ATO's view in the "wash sales" ruling TR 2008/1;
- the Federal Court deciding in *Merchant v FCT*[1] that, among other things, the family trust's $56m+ capital loss realised on the sale of Billabong Ltd shares to the Gordon Merchant Superannuation Fund was part of a Pt IVA tax scheme to offset the $85m capital gain on the sale of Plantic Technologies Ltd shares held by the family trust; and
- obtaining expert tax and SMSF advice.

Conclusion

SMSF trustees and advisers must be aware of the nuances of how the CGT provisions interact with the NALI provisions. As some commentators say: "What's logic got to do with tax law?" Naturally, expert advice should be obtained if there is any doubt.

TD 2024/5 also highlights the need for an urgent legislative fix to address disproportionate and unfair outcomes for superannuation funds, eg where a $100 NAL gain taints a $1m arm's length gain.

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Reference

1 [2024] FCA 498.

Alternative Assets Insights

by Luke Bugden, Christina Sahyoun and Lynda Brumm, PwC

Australia's foreign resident CGT regime

Treasury has released a consultation paper on the federal government's proposal to amend Australia's foreign resident CGT regime.

Overview

Consultation has commenced on the government's proposals to amend the capital gains tax (CGT) rules which apply to foreign residents. This includes a consultation paper[1] which addresses the 2024–25 Federal Budget proposal to strengthen the rules, as well as draft law to give effect to the 2023–24 Mid-Year Economic and Fiscal Outlook proposal to increase the foreign resident capital gains withholding (FRCGW) tax rate and reduce the withholding threshold that currently applies to real property interests.

In detail

The current foreign resident CGT regime broadly seeks to tax foreign residents on three types of assets: taxable Australian real property; indirect Australian real property interests (IARPI) (ie shares and other membership interests in entities that predominantly hold Australian real property); and assets used in an Australian permanent establishment. Furthermore, there is a form of withholding by the purchaser from the relevant proceeds relating to the disposal of relevant CGT assets.

Strengthening the foreign resident CGT regime

The consultation paper addresses the Budget proposal to strengthen the foreign resident CGT regime in relation to CGT events commencing on or after 1 July 2025 by way of:

- clarifying and broadening the types of assets on which foreign residents are subject to CGT to ensure that assets with a close economic connection to Australian land and/or natural resources are appropriately captured within the tax law;
- amending the point-in-time principal asset test to a 365-day testing period (applicable to IARPI) so as to address an integrity risk preventing a CGT-free sale of membership interests at a time when the underlying entity does not derive more than 50% of its market value from taxable Australian real property; and
- requiring foreign residents disposing of shares and other membership interests exceeding $20m in value to notify the ATO prior to the transaction being executed.

The proposed measure to clarify and broaden the CGT base for foreign residents is said in the paper to be consistent with accepted international tax principles and appropriate, since these assets derive their economic value from the use of Australian land and/or natural resources. This change will have a particular impact in determining whether shares or other membership interests in an Australian entity represent IARPI and potentially raise specific and complex valuation issues.

The consultation paper lists the following as examples of the sort of assets that would fall within the proposed broader foreign resident CGT base:

- leases or licences to use land situated in Australia, including pastoral leases and licences, or a lease of land that is used in a manner that gives rise to the creation of emissions permits;
- Australian water entitlements in relation to land situated in Australia;
- infrastructure and machinery installed on land situated in Australia which includes land subject to a mining, quarrying or prospecting right of an entity. Some examples set out in the consultation paper include energy and telecommunications infrastructure, such as wind turbines, solar panels, batteries, transmission towers, transmission lines and substations. Transport infrastructure has also been included, such as rail networks, ports and airports, as well as heavy machinery installed on land for use in mining operations (eg mining drills and ore crushers);
- an option or right to acquire one of the above assets (or similar asset types with a close economic connection to Australian land and/or natural resources); and
- a non-portfolio membership interest in an entity where more than 50% of the underlying entity's market value is derived from the above assets.

Accordingly, any foreign investor in the Australian infrastructure, transport, energy and resources sectors will be affected by this change.

No consultation questions have been asked in relation to this measure in the consultation paper. However, it is unclear as to the breadth of this proposal and the extent to which an asset may be considered to have a "close economic connection" to Australia. This may not always be clear. Note that the paper indicates that it is not proposed to extend the application to the disposal of livestock and equipment used in agriculture and forestry, even though, arguably, these assets have an economic connection to the land.

The amendments are proposed to apply to CGT events on a prospective basis. There is no mention in the consultation paper about a transitional rule so as to grandfather existing assets held by foreign residents that currently are not subject to CGT but which may now be brought into the Australian tax net under the broadened CGT base.

While this has not been previously announced, the consultation paper also flags views on the appropriateness of the policy principle to continue to exclude economic interests that derive their value from taxable Australian real property (such as by creating a "total return swap" which may ultimately give rise to a future acquisition of the underlying asset) held by a foreign resident from Australian CGT. Although the general anti-avoidance rules, and other specific integrity rules, in the tax law will continue to apply, the prospect of additional integrity rules being considered is raised.

Principal asset test

In terms of the proposed amendment to the point-in-time principal asset test to a 365-day testing period (applicable to indirect real property interests), a question will arise as to how taxpayers will practically monitor valuations of their investments over a 12-month period and, in particular, whether this will add an additional compliance burden and cost for foreign investors that would not otherwise be relevant for Australian resident investors.

Requirements to notify the ATO

The proposed requirement for notifying the ATO in relation to CGT events from 1 July 2025 is that a foreign resident vendor disposing of membership interests exceeding $20m in value must notify the ATO when they make a declaration to a purchaser that the sale is "not an indirect Australian real property interest" (non-IARPI), ie that it is not subject to CGT. Treasury is interested in views on the appropriateness of the $20m threshold.

The proposal is that the ATO notification must be made by the vendor in an approved form at least 28 days before the earlier of the relevant CGT event or settlement. The prospect of a longer period of time to notify the ATO is put forward in the consultation paper in the interests of enhancing the ATO's ability to review the declaration and potentially disagree with the assertion and recommend that the transaction be subject to FRCGW.

There is no change for vendors who are of the view that a transaction is in respect of an IARPI and hence subject to CGT (and consequential FRCGW by the purchaser). In all other cases where declarations that the asset is non-IARPI are made, the vendor should be prepared for potential ATO scrutiny as the notification requirement will provide the ATO with information on high value transactions and in close to real time. This may create uncertainty as to the timing of transactions and, in particular, whether it will impact completion and the flow of funds in a transaction.

FRCGW rate and threshold changes

Since 1 July 2016, the FRCGW regime has applied to impose an obligation on the purchaser of certain Australian real property and related interests to withhold an amount from the applicable proceeds and remit this amount to the ATO where the relevant property is acquired from a foreign resident vendor. The amount withheld is not a final tax in that the vendor is entitled to a credit for any amounts withheld following the lodgment of an income tax return on the making of an income tax assessment.

The draft law proposes the following changes:

- increasing the rate at which withholding applies for relevant CGT assets from 12.5% to 15%; and
- removing the current $750,000 threshold before which withholding applies for transactions involving either taxable Australian real property or an indirect Australian real property interest that provides company title interests.

These changes will apply to acquisitions of relevant CGT assets (typically the date of contract) made on or after the later of 1 January 2025 and the commencement of this measure which will be 1 January, 1 April, 1 July or 1 October following enactment of the rules.

The Commissioner's power to vary the rate of withholding by a purchaser will continue to apply, and for some taxpayers this may become particularly important in light of the changes.

We previously have seen both the rate and the threshold change since the FRCGW rules first applied. The draft explanatory materials indicate that the planned increase in the current 12.5% withholding rate is due to this rate increasingly resulting in a shortfall of assessed income tax payable on capital gains of foreign residents, particularly due to the upwards shift in the value of Australian real property.

It is expected that these amendments will progress quickly through parliament so that they can be enacted well before a potential 1 January 2025 start date.

The takeaway

The proposed amendments to broaden the foreign resident CGT base will have a significant impact on foreign investment into these new targeted Australian asset classes, in particular infrastructure and energy projects. An additional tax impost may add to the all-in cost associated with these projects and therefore may impact the type of investors who will likely invest in these assets.

Notwithstanding that the consultation paper states this proposed change will bring foreign residents' CGT outcomes into closer alignment with the tax treatment for Australian residents, and with international tax best practice, there will be a significant Australian tax rate differential between foreign investors and complying Australian superannuation funds which have a 10% or 15% CGT rate on exit for these types of investments.

Affected taxpayers will need to be aware of the consequences of these upcoming changes before entering into a transaction for the sale or purchase of any direct or indirect real property interest. There will still be uncertainty in the market as to the breadth of these measures so the consultation process and future legislation will be critical.

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Reference

1 Treasury, *Strengthening the foreign resident capital gains tax regime*, consultation paper, July 2024. Available at https://treasury.gov.au/sites/default/files/2024-07/c2024-546457-cp.pdf.

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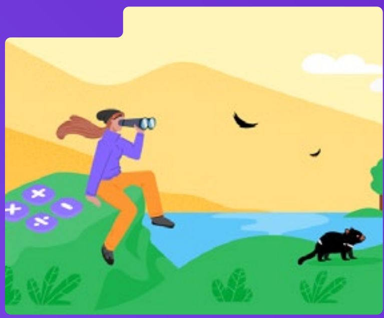

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The Tax Institute would like to thank the following presenters from our August CPD sessions. All of our presenters are volunteers, and we recognise the time that they have taken to prepare for the paper and/or presentation, and greatly appreciate their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

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