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The Tax Institute

Taxation in Australia

Donations to school building funds

Fiona Martin, CTA

The tax implications of subdividing land

Gayathri Krishnan, CTA

Contents

Cover article

Feature article

Insights from the Institute

Regular columns

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

September – what happened in tax?

The following points highlight important federal tax developments that occurred during September 2024. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 138 (at the item number indicated).

Personal services businesses and Pt IVA

The Commissioner has released a draft practical compliance guideline that explains when the ATO will be more likely to have cause to apply compliance resources to consider the potential application of the general anti-avoidance provisions (Pt IVA of the *Income Tax Assessment Act 1936* (Cth)) to an alienation arrangement where personal services income of an individual is derived through a personal services entity that is conducting a personal services business (PCG 2024/D2). **See item 1.**

Officeholder data-matching program

In a gazette notice published on 26 August 2024, the ATO gave notice of an officeholder data-matching program under which it is estimated that records relating to more than 11 million individuals will be obtained. **See item 2.**

Property management data-matching program

In a gazette notice published on 26 August 2024, the ATO gave notice of a property management data-matching program under which the ATO will acquire property management data from property management software companies for 2018–19 to 2025–26. **See item 3.**

Lifestyle assets data-matching program

In a gazette notice published on 26 August 2024, the ATO announced that it will acquire lifestyle assets data from insurance providers for 2023–24 to 2025–26. **See item 4.**

TPB: 2024–25 plan

On 19 August 2024, the Tax Practitioners Board (TPB) launched its plan for 2024–25 which is dedicated to building on the TPB's relationships with the profession, the public and key stakeholders and to supporting the government's reform agenda. **See item 5.**

Administrative penalties: no remission

The AAT has rejected a taxpayer's contention that the Commissioner should have remitted penalties that had been assessed to her as a result of false claims that had been made by her (*Bootlis and FCT* [2024] AATA 2723). **See item 6.**

Landholder duty: Victoria

In a unanimous decision, the Victorian Court of Appeal (Kennedy, Macaulay and Lyons JJA) held that 18 separate investors who acquired 99.99% of the issued shares in a landholder pursuant to a broadly circulated information memorandum amounted to substantially one arrangement and that, accordingly, the Commissioner had correctly assessed the applicant to landholder duty (*Oliver Hume Property Funds (Broad Gully Rd) Diamond Creek Pty Ltd v Commissioner of State Revenue* [2024] VSCA 175). **See item 7.**

Penalty unit increase

An amending Bill (the Crimes and Other Legislation Amendment (Omnibus No. 1) Bill 2024), which was passed by the House of Representatives on 11 September 2024, is amending the *Crimes Act 1914* (Cth) to increase the Commonwealth penalty unit amount to $330, with effect from the date the amendments become law.

Penalty units are used to fix the maximum amount that can be payable for monetary penalties imposed for criminal offences in Commonwealth legislation and territory ordinances. The penalty unit mechanism allows for the maximum monetary penalty for all offences under Commonwealth law, including territory ordinances, to be automatically adjusted with a single amendment to s 4AA of the *Crimes Act 1914*. This removes the need for multiple legislative amendments and ensures that monetary penalties in Commonwealth legislation and territory ordinances remain comparable.

The penalty unit concept is relevant, for example, for the purposes of Pt III of the *Taxation Administration Act 1953* (Cth) which proscribes various conduct (such as the failure to comply with taxation requirements and the making of false or misleading statements).

The concept is also relevant in the context of the *Tax Agent Services Act 2009* (Cth). The fixing of a penalty for extensive breaches of the prohibition imposed by s 50-5 of that Act on the provision of tax agent services while unregistered was recently considered by the Federal Court in *Tax Practitioners Board v Van Dyke* [2024] FCA 899.

Provision is made for the automatic consumer price index adjustment of the penalty unit amount every three years. The three-yearly indexation cycle will continue as usual, with the next indexation increase occurring on 1 July 2026 (which is three years from the last automatic indexation).

President's Report

by Todd Want, CTA

Reflecting on The Tax Summit

President Todd Want reflects on The Tax Summit 2024 and congratulates the Community Achievement Award recipients.

Last month, we held the biggest event of our yearly CPD calendar – The Tax Summit. I think it's safe to say that it was an incredible experience for all involved, from the organising committee who put their minds and hearts to work in shaping the event, through to the delegates who attended and made it what it was.

Celebrating The Tax Summit 2024

The Tax Summit has always included the largest, broadest tax program of the year, covering streams such as corporate, ethics, small and medium enterprises, tax disputes, and hot topics.

Although the calibre of the program and the speakers remains consistently high year after year, it seems that, each year, the Summit also brings us something new and exciting. 2024 was no different.

This year, our CTA members enjoyed an exclusive CTA lounge – just a little token of our appreciation for the dedication and support that these members routinely show for The Tax Institute. The rest of the delegates weren't left behind, with plenty of goodies, prizes and experiences on offer for all.

I know that I speak for the whole Tax Institute team when I say we had a blast connecting and chatting with members.

Community Achievement Award recipients

During The Tax Summit, we gathered for the annual gala dinner, a glitzy affair much loved by our attendees. The theme was "Moulin Rouge", and the tax profession did not disappoint – it was a fantastic turnout of frocked-up partygoers.

But beyond the good food, good wine and good company, we had a purpose at the gala dinner. We used this opportunity to celebrate those members of our community who have gone above and beyond in their service to the Institute, their fellow members and the tax community.

I would like to extend my congratulations to this year's recipients of our Community Achievement Awards.

Community Champion

- Annemarie Wilmore, Johnson Winter Slattery

Tax Service Award

- NSW: Michael Walpole, CTA, UNSW Business School
- VIC: Karen Goodfellow, CTA, Goodfellow Tax Advisory
- QLD: Morag Ingham, CTA, Findex
- SA: Simon How, CTA, Bentleys SA
- WA: Jemma Sanderson, CTA, Cooper Partners Financial Services
- TAS: Janine Healey, CTA, The WD Booth Charitable Trust

Tax Trailblazer Award

- NSW: Jake Berger, Pitcher Partners
- VIC: Edward Hennebry, FTI, Sladen Legal
- QLD: John Elliott, CTA, Strategic Edge Business Services
- SA: Alexandra Nicola, Thomson Geer Lawyers

Congratulations also went out to members celebrating their 25th or 50th anniversary with The Tax Institute. As we look to the future of the tax profession, and as we work to welcome and support the new generation of tax professionals, we are reminded that the knowledge and wisdom of these longstanding members are invaluable to us as a community.

Thank you

Last, but most certainly not least, I would like to extend a wholehearted thank you on behalf of everyone at the Institute. Our thanks go out to:

- more than 80 speakers for their efforts over many months in preparing content and delivering sessions. Your shared expertise is highly valued and your generosity is appreciated;
- our sponsors who not only support us in helping make the event what it is, but also support our members with their services;
- the organising and program committees for the extensive thinking and planning that went into an event and program of this magnitude, all given voluntarily and generously;
- our chairs and volunteers who have been on the ground helping to run The Tax Summit smoothly and effectively;
- ATO volunteers who supported us on the day; and
- our delegates and members who attended – without you, there would be no Summit.

This year brought another fabulous event, and planning now starts for The Tax Summit 2025.

CEO's Report

by Scott Treatt, CTA

The Tax Summit and the tax conversation

CEO Scott Treatt recaps The Tax Summit 2024 and progressing the conversation on tax.

The Tax Summit has wrapped for another year and I am so proud that we were able to offer such a high quality and valuable experience to not only our members, but also the wider tax profession.

With over 50 sessions covering most of the tax landscape, it's hard to pick out favourite moments and highlight sessions from the event. But I'll give it a try.

Of course, our keynotes warrant mention. We heard a wonderful Justice Hill Lecture from Professor Miranda Stewart, CTA, University of Melbourne, and the Commissioner's Address from Rob Heferen, Commissioner of Taxation. The Hon Julie Bishop took part in a fireside chat, sharing her perspectives on career, business and our overall economic position. I know this was a crowd favourite.

Another crowd pleaser was the insightful and very funny demographer, Simon Kuestenmacher, who used his demographic know-how and data to peer into the future of the tax profession over lunch. I think this session left us all with a lot of food for thought.

The panel sessions gave rise to in-depth and interesting conversations, offering a number of perspectives and examining the past, present and future of tax from a range of different angles.

The Breakout streams were also full of interesting perspectives, ideas and insights. A particular standout I noticed was the session titled "Handling ATO reviews – a roadmap for what lies ahead" with Angelina Lagana, CTA, where the room was full to bursting.

Tax Summit and the tax conversation

All of these sessions came together under the overall theme for The Tax Summit, which was "Frame the Future". We explored what the tax profession and the tax system could look like as the new generation of tax practitioners come up through the ranks.

The Tax Summit is a wonderful opportunity for the tax profession to have these much-needed conversations. In a field as complex and ever-changing as tax, it's easy to be swept up in the day-to-day of providing excellent advice for clients and to lose sight of the big picture. Events like The Tax Summit create space to step back and ask the big questions of each other – and, hopefully, to kickstart solutions and ideas for the answers.

Personally, I will say that it lit a fire of inspiration in me to see so many talented and dedicated tax professionals in one place, working to better their knowledge and connecting with each other. There's nothing quite like it for reminding you why we do what we do. I hope all of you who attended walked away with the same feeling of renewed energy.

The Tax Summit also gives us a chance to celebrate our community and strengthen the relationships that help build our professional circles. I echo Todd's congratulations to the recipients of our Community Achievement Awards, and his thanks to the people who contributed in different ways the make The Tax Summit possible.

What now?

Though we have closed on the biggest CPD event of our year, the work has certainly not slowed down at The Tax Institute! We continue to work to support our members through education, resources, advocacy and future events.

In fact, we introduced delegates at The Tax Summit to our latest offering in the education space, Tax Academy for individuals. Previously available only to firms upskilling their staff, Tax Academy micro-credentials are now open to all learners. These short, online-only courses allow professionals, who are either looking to specialise or to learn more about a certain topic within the tax world, to do so at their own pace and fit their learning alongside other commitments. We are so excited about this new step in our education offering, and hope it serves our community well. Our website experience for Tax Academy purchases is still in beta testing, so we appreciate your patience as we complete it, and welcome your feedback.

Thank you again to everyone who attended and contributed to The Tax Summit this year. We'll see you again in 2025!

Tax Counsel's Report

by Huigenia Ostik, FTI

Australia's DTT expansion program

We consider the latest stage of Australia's double tax treaty expansion program and key themes from submissions during the related consultation.

Background

On 13 December 2023, the government announced the latest stage of the double tax treaty (DTT) expansion program (the program). The program was initiated by the previous government in September 2021 and extended by the current government in November 2022 and again in December 2023.

This latest stage involves negotiating "first time DTTs" (FTDTTs) with Brazil and Ukraine, and updating existing DTTs (EDTTs) with Korea, New Zealand and Sweden. Treasury consulted on the above stages, and submissions were published in 2021, 2022 and 2024, respectively.

Progress

Since the program's inception, Australia has entered into FTDTTs (with attached protocols) with:

- Iceland: signed in October 2022 and entered into force in Australia on 6 November 2023;
- Portugal: signed in November 2023 but yet to enter into force; and
- Slovenia: signed in September 2024 but yet to enter into force.

Themes arising from the submissions

The key themes of the submissions on the latest stage of the program published earlier this year include:

Requests for an FTDTT with Hong Kong: Several submissions called for negotiations with Hong Kong for an FTDTT. Citing the need for certainty in taxation matters to match the certainty provided by the recent Australia–Hong Kong free trade agreement, it was also noted that Hong Kong is negotiating double tax agreements with a number of Australia's DTT partners, including Germany and Israel. These submissions echoed earlier calls by The Tax Institute for a Hong Kong FTDTT.

Various Australian superannuation fund-related requests: While recognising that some DTTs (for example, the Swiss DTT) already address the following concerns, there is a widely recognised need for Australia to ensure that its DTTs:

- include a definition of "recognised pension fund" (including a reference to Australian superannuation funds (ASFs)) in art 3 and cross-reference this concept in articles that, for example, define "resident" and regulate maximum rates of tax in the other state on dividend and interest income. Such an inclusion would mean that ASFs would have more certainty that they could access DTT benefits (such as reduced rates of, or exemption from, withholding tax); and
- provide a reciprocal exemption from taxation on dividends from portfolio holdings and on interest income in the other state where these are held by an ASF. Currently, Australia provides an exemption in s 128B(3)(jb) of the *Income Tax Assessment Act 1936* (Cth).

Non-discrimination provisions: The impact of the High Court judgment in *Addy v FCT*[1] is important to consider when negotiating non-discrimination provisions. In the context of the program, this would include the need for careful consideration of the scope of any non-discrimination provisions included in Australia's FTDTTs and to review the scope of the non-discrimination provisions in its EDTTs (ie the amending protocol of the India EDTT and the text of the NZ EDTT).

"Most favoured nation" style considerations: When considering conditions under which DTT benefits may be available, Australia may consider agreeing to more favourable conditions where it has agreed to such conditions under other DTTs. Broadly, most favoured nation provisions require Australia to renegotiate EDTTs where it subsequently agrees to more favourable terms with other DTT partners. While some of Australia's EDTTs contain most favoured nation provisions in relation to dividends (eg the protocol of the Korean EDTT), the EDTTs with NZ and Sweden do not. This means that, in order to provide greater DTT benefits in relation to dividend taxation under these two EDTTs, Australia would need to negotiate the amendment of the relevant provisions. Submissions have referred to the need to standardise the treatment of dividend taxation under: (1) the NZEDTT with that under the EDTT with the US; and (2) the Swedish EDTT with that under a number of EDTTs, including those with Germany and the UK.

Comments

To date, Australia has entered into 48 DTTs. The recent announcement of the signature of the Slovenian FTDTT indicates that Australia is continuing with the program. The text of Australia's three most recently entered FTDTTs (with Iceland, Portugal and Slovenia) reveals that some of the concerns noted above appear to have been factored into recent negotiations (eg restrictively worded non-discrimination provisions and an inclusion of a definition of "recognised pension fund" (including ASFs)). This may constitute Australia's approach moving forward in relation to these provisions. Perhaps less clear is whether Australia will standardise conditions for reduced dividend taxation in its EDTTs along most favoured nation lines. This may remain a "watch this space" item.

Reference

1 [2021] HCA 34.

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Tax News – the details

by TaxCounsel Pty Ltd

September – what happened in tax?

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

The Commissioner's perspective

1. Personal services businesses and Pt IVA

The Commissioner has released a draft practical compliance guideline that explains when the ATO will be more likely to have cause to apply compliance resources to consider the potential application of the general anti-avoidance provisions (Pt IVA of the *Income Tax Assessment Act 1936* (Cth) (ITAA36)) to an alienation arrangement where personal services income (PSI) of an individual is derived through a personal services entity (PSE) that is conducting a personal services business (PSB) (PCG 2024/D2).

PCG 2024/D2 provides practical guidance on the types of alienation arrangements that the ATO considers to be at "low" or "higher" risk of Pt IVA applying and the likelihood of the ATO having cause to apply compliance resources to review those arrangements.

For the purposes of PCG 2024/D2, alienation of PSI occurs when the services of an individual are provided by an interposed entity (the PSE) controlled by or associated with the individual rather than directly by the individual who performs the services. Alienation arrangements create a compliance risk when they are used to retain income in the PSE (referred to as "retention of profits" arrangements) or divert income to associates (referred to as "income-splitting" arrangements), or both, so that the income is taxed at an overall lower rate.

The ATO has a longstanding view on the treatment of PSI according to ordinary tax rules and the potential application of Pt IVA, and its predecessor, s 260 ITAA36, to income-splitting and retention of profits arrangements. There have been many cases where those provisions have been found to apply to the alienation of PSI. Nevertheless, and despite the note to s 86-10 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) (which states that the general anti-avoidance provisions of Pt IVA ITAA36 may still apply to cases of alienation of PSI that fall outside Div 86 ITAA97), the ATO is aware that some taxpayers incorrectly assume that, where a PSB is being conducted and the provisions of Div 86 do not apply, Pt IVA will also not apply to their income-splitting or retention of profits arrangements.

PCG 2024/D2 states that existing guidance and judicial decisions have made clear that Pt IVA can apply to alienation arrangements involving income splitting and the retention of profits where the dominant purpose of a participant in a scheme was to obtain a tax benefit. In an alienation arrangement, a tax benefit will generally arise because an amount is not included in the assessable income of the individual, being an amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the individual if the scheme had not been entered into.

While the introduction of the PSI rules in Pt 2-42 ITAA97 had the practical effect of narrowing the scope for Pt IVA to apply to alienation arrangements (because, where it applies, no tax benefit is obtained), it did not otherwise affect the continued operation of Pt IVA. Currently, where a PSE qualifies as a PSB and therefore the PSI rules do not apply, it continues to remain possible that Pt IVA will apply to the scheme under which the services are provided.

Although PCG 2024/D2 addresses the likelihood (risk) that an alienation arrangement will bring Pt IVA into question and should be reviewed, it does not provide detailed guidance on when Pt IVA could potentially apply to arrangements involving income splitting or the retention of profits. Existing guidance material covering the administration and application of Pt IVA more broadly is available in PS LA 2005/24.

An arrangement is considered low risk where the net PSI received through the PSE is assessed in the form of assessable income (for example, as dividends, salary and wages, or pursuant to s 97 ITAA36) to the individual whose personal efforts or skills generated that income and tax is not deferred. In contrast, a higher-risk arrangement will include either, or both, an income-splitting or retention of profit arrangement which diverts PSI away from the individual or facilitates the deferral of tax.

PCG 2024/D2 does not affect the ATO's compliance approach to other tax issues that might arise in connection with PSE arrangements, for example, whether Div 7A ITAA36 applies to an arrangement within the PSE's group.

2. Officeholder data-matching program

In a gazette notice published on 26 August 2024, the ATO gave notice of an officeholder data-matching program under which it is estimated that records relating to more than 11 million individuals will be obtained.

Under the program, the ATO will acquire officeholder data from the Australian Securities and Investments Commission (ASIC), the Office of the Registrar of Indigenous Corporations (ORIC), the Australian Charities and Not-for-profits Commission (ACNC) and Australian Business Registry Services (ABRS) for 2023–24 to 2026–27.

The data items include name, address, date of birth, Australian business number, email address, contact phone number, business name, organisation class, organisation type, organisation status, state of incorporation, officeholder type, role type, officeholder role start and end dates as recorded on the publicly available ASIC companies register, the ORIC register of Aboriginal and Torres Strait Islander corporations, and the ACNC charity register.

The objectives of the officeholder data-matching program are to:

- enable ABRS to increase uptake of the director identification number (director ID) through better information on officeholders recorded by ASIC, ORIC and the ACNC;
- effectively link persons known to the ATO to officeholders and their associated companies as recorded on the ASIC companies register, the ORIC register of Aboriginal and Torres Strait Islander corporations, and the ACNC charity register;
- promote voluntary compliance and strengthen community confidence in the integrity of the tax and superannuation systems by publicising the running of this data-matching program;
- identify and educate company officeholders who may be failing to meet their registration and ongoing payment, withholding or lodgment obligations and assist them to comply;
- identify and educate new company officeholders of their director ID obligations;
- identify and contact company officeholders to confirm registration details, including contact numbers, addresses or names;
- help to ensure that company officeholders are fulfilling their tax and superannuation reporting and compliance obligations;
- identify, deter and disrupt those promoting or engaging in illegal phoenix activity; and
- better utilise registry data to combat unlawful activity.

3. Property management data-matching program

In a gazette notice published on 26 August 2024, the ATO gave notice of a property management data-matching program under which the ATO will acquire property management data from property management software companies for 2018–19 to 2025–26.

The data items include:

- property owner identification details (name, address, phone number, date of birth, email address, business name and ABN, if applicable);
- property details (property address, date property first available for rent, property manager name and contact details, property manager ABN, property manager licence number, property owner or landlord bank details); and
- property transaction details (period start and end dates, transaction type, description and amounts, ingoings and outgoings, and rental property account balance).

It is estimated that records relating to approximately 2.3 million individuals will be obtained each financial year.

The objectives of the property management data-matching program are to:

- identify and educate individuals and businesses which may be failing to meet their registration or lodgment obligations and help them to: lodge their income tax returns; correctly report assessable income from a rental property in their individual income tax return; correctly report associated rental deductions in their individual income tax return; and comply with CGT obligations for properties used to derive rental income;
- gain insights to help develop and implement strategies, which may include educational or compliance activities for individuals and businesses which lease or let real property; and
- promote voluntary compliance and increase community confidence in the integrity of the tax and superannuation systems.

4. Lifestyle assets data-matching program

In a gazette notice published on 26 August 2024, the ATO announced that it will acquire lifestyle assets data from insurance providers for 2023–24 to 2025–26.

Insurance policy data will be collected for the following classes of assets, where the asset value is equal to or exceeds the nominated thresholds:

Asset class	Minimum asset value threshold
Caravans and motorhomes	$65,000
Motor vehicles, including cars, trucks and motorcycles	$65,000
Thoroughbred horses	$65,000
Fine art	$100,000 per item
Marine vessels	$100,000
Aircraft	$150,000

The data items include:

- client identification details (name, address, phone number, date of birth, Australian business number, email address); and
- policy details (insurance brand name, policy number, policy inception date, start date of current policy, end date of current policy, last date policy was updated, total value insured, purchase price of the property insured, registration or identification number of the property, vehicle details (year, make, model), finance, policy cost, description of the property insured, primary use type).

The data will be acquired and matched to improve the ATO's compliance risk-profiling of taxpayers and provide a holistic view of their assets and accumulated wealth.

The lifestyle assets data-matching program will allow the ATO to identify and address a number of taxation risks, including:

- omitted or incorrect reporting of income – taxpayers who are accumulating or improving assets with insufficient income reported in their tax returns which would show the financial means to pay for them;
- omitted or incorrect reporting of income and/or capital gains – taxpayers disposing of assets and not declaring the income and/or capital receipts on those disposals, or declaring them incorrectly;
- incorrect claiming of GST credits – taxpayers may be purchasing assets for personal use through their business or related entities and claiming GST credits that they are not entitled to;
- omitted or incorrect reporting of FBT – taxpayers may be purchasing assets through their business entities and applying those assets to the personal enjoyment of an associate or employee, giving rise to an FBT liability; and
- use of assets by self-managed superannuation funds (SMSFs) in breach of the law – SMSFs may be acquiring assets but applying them for the present-day benefit of the fund's members or other related parties.

5. TPB: 2024–25 plan

On 19 August 2024, the Tax Practitioners Board (TPB) launched its plan for 2024–25 which is dedicated to building on the TPB's relationships with the profession, the public and key stakeholders and to supporting the government's reform agenda.

The TPB Chair, when presenting the TPB's direction for 2024–25, emphasised that the TPB values the integral role that tax practitioners, coregulators and professional associations play in maintaining the integrity of the tax profession and the tax system.

The TPB plan sets out the roadmap for the organisation and focuses on four key areas for improvement:

1. prepare TPB people, technology and culture for the future;
2. foster opportunities to collaborate and partner;
3. make it easy for tax practitioners to work with the TPB; and
4. strengthen the TPB's regulation practice.

Some of the main actions in the corporate plan are to drive reform, understand tax practitioner behaviour to better target compliance activities, and increase confidence through transparency.

The TPB Chair highlighted that the next 12 months will bring continued improvements to professional standards arising from government reforms designed to strengthen the integrity of the profession. The reforms will enhance the Code of Professional Conduct, ensure that the TPB has appropriate powers and penalties, and improve the secrecy and oversight frameworks that guide the TPB's operations.

The TPB will investigate and act against unregistered tax return preparers and those who are non-compliant with the *Tax Agent Services Act 2009* (Cth).

Recent case decisions

6. Administrative penalties: no remission

The AAT has rejected a taxpayer's contention that the Commissioner should have remitted penalties that had been assessed to her as a result of false claims that had been made by her (*Bootlis and FCT*[1]).

Before the AAT, the taxpayer admitted having made a mistake but said, in effect, that the Commissioner should have realised it and that she had got nothing out of it. The AAT said that it was true that her claim was unsuccessful in that it was rejected before any money was paid to her. However, that did not alter the fact that she tried in a very blatant way to obtain a deduction to which she was not entitled.

The AAT referred to the following passage from the joint judgment of Spender, Ryan and Emmett JJA in *Archibald Dixon as Trustee for the Dixon Holdsworth Superannuation Fund v FCT*:[2]

> "23 … it is clear that, whether or not the Commissioner suffers a financial detriment by reason of the fact that there is a shortfall amount has nothing to do with the imposition of administrative penalties or their remission.
>
> 24 It must follow, therefore, that, for the purposes of the exercise of the discretion to remit, it can be of no consequence whether a taxpayer's false statement was detected before the Commissioner allowed or paid an input tax credit to a taxpayer, on the one hand, or whether, on the other hand, the Commissioner detected the overpayment after an input tax credit had been paid and recovered the amount, together with an amount in respect of the general interest charge.
>
> 25 The general interest charge must be taken to be an accurate approximation of the loss suffered by the Commissioner for not having received a relevant amount or for having paid an amount that should not have been paid. The Commissioner will be compensated for any harm, if any harm has been occasioned. It therefore does not matter, in the context of the exercise of the discretion to remit a penalty, whether or not any harm has been done. The mere fortuity that a false statement has been detected by the Commissioner before any harm is done is a matter that may not be taken into account in the exercise of the discretion to remit the penalty."

7. Landholder duty: Victoria

In a unanimous decision, the Victorian Court of Appeal (Kennedy, Macaulay and Lyons JJA) held that 18 separate investors who acquired 99.99% of the issued shares in a landholder pursuant to a broadly circulated information memorandum amounted to substantially one arrangement and that, accordingly, the Commissioner had correctly assessed the applicant to landholder duty (*Oliver Hume Property Funds (Broad Gully Rd) Diamond Creek Pty Ltd v Commissioner of State Revenue*[3]).

The applicant was a special purpose vehicle established for the purpose of a property development project at Diamond

Creek known as the "Diamond Creek project". In 2011, the applicant purchased the property at 272 Broad Gully Road, Diamond Creek, Victoria (the property). In 2014, the applicant circulated an information memorandum which sought to raise $1.8m through an issue of 1.8 million shares in order to fund the development of the property. It was a condition of the information memorandum that the target of 1.8 million shares be achieved by 26 June 2014. In the result, on 2 July 2014, the applicant issued 1.8 million shares to 18 investors.

The Victorian Commissioner of State Revenue assessed the applicant for duty on the basis that the investors acquired their interests in the applicant via an "associated transaction", and therefore the acquisition of shares by the 18 investors constituted a "relevant acquisition" for the purposes of s 78(1)(a)(ii)(C) of the *Duties Act 2000* (Vic). Relevantly, acquisitions are "associated transactions" for this purpose if they "form, evidence, give effect to or arise from substantially one arrangement, one transaction or one series of transactions" (para (b)). A Vice President of the Victorian Civil and Administrative Tribunal upheld the assessment.

On appeal from the decision of the tribunal, the Court of Appeal held that the Vice President made no error in upholding the assessment. The focus of the language in para (b) of the definition of "associated transaction" was not on the individuals concerned, but on the relationship between the acquisitions and the singular "arrangement" or "transaction" (or "series of transactions"). Further, para (b) focused on the objective terms and circumstances surrounding the acquisitions. It was relevant to consider whether there was some connection or interdependence between the circumstances by which the investors acquired their interests, such that the acquisitions might be characterised as, essentially, "one" arrangement.

The Court of Appeal considered that there were a number of objective interconnecting factors, which together combined to support a finding that the acquisitions formed, evidenced, gave effect to, or arose from substantially "one arrangement", or alternatively "one series" of transactions:

1. the acquisitions were interconnected in circumstances where no individual acquisition could go ahead at all unless a total of $1.8m was raised;
2. the content of the statutory contract (the applicant's constitution) provided that the investors, together, had an interest in an entity which was to undertake a single land development project via an entrenched management structure through an entity which was to be wound up at the end of the project; and
3. the effect of the acquisitions of the shares on the same day, and in the same way, was to substantively alter the shareholding in the landholder from being an "Oliver Hume" entity to an entity owned by a group of private investors (as to 99.99%).

In such circumstances, the Vice President made no error in finding that the acquisitions were "associated transactions" even though the investors were not acquainted with one another.

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References

1 [2024] AATA 2723.

2 [2008] FCAFC 54.

3 [2024] VSCA 175.

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Tax Tips

by TaxCounsel Pty Ltd

Executor or trustee?

In the context of a deceased estate, it is important for income tax purposes to determine whether the executor has completed their executorial duties.

Background

When a taxpayer dies, there are various tax issues that may arise in relation to the broken tax period to the date of the taxpayer's death and to the tax period or tax periods that occur after death until the deceased estate is finalised.

In many situations, the tax issues that arise will not present any great difficulty, and for the purposes of some issues, there will be statutory provisions that govern the particular situation. For example, the CGT provisions of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) not only contain provisions that govern the general operation of the CGT provisions in the case of an individual's death, but also provisions that govern particular situations, for example, how the CGT main residence exemption provisions operate.

One issue that can arise with some frequency is determining whether the administration of a deceased estate has reached the time when the executor ceases to be an executor (either generally or in respect of some asset or assets) and becomes a trustee for the purposes of applying the provisions of Div 6 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). Once that time is reached, the beneficiaries will be presently entitled to (and so will be taxed on) the income of the estate for an income year.[1]

The decided cases on the executor/trustee issue are mostly concerned with non-tax issues. A recent example of such a case is the decision of the Western Australian Supreme Court in *Kelly v Connell as executor of the estate of John Kelly*.[2]

This article considers the decision in that case and also an ATO ruling that gives the Commissioner's views on how the present entitlement concept in Div 6 operates during the stages of the administration of a deceased estate.[3]

The facts

In the *Kelly* case, the plaintiff was the son of the late John Charles Kelly (the deceased) who died on 6 April 2023. By a will made on 3 March 2023, the deceased appointed the first defendant as the executor of the will and the trustee of the trusts created pursuant to its terms. The first defendant was the deceased's granddaughter. The third defendant was the deceased's daughter and the plaintiff's sister. Probate of the deceased's will was granted to the first defendant on 19 July 2023.

The principal provisions of the will were pecuniary legacies to grandchildren (amounting in aggregate to $935,000), a gift of shares to the second defendant, and a gift of the residuary estate to the first defendant to hold on trust for the plaintiff and the third defendant in equal shares.

The plaintiff applied for an order under the *Family Provision Act 1972* (WA) that the deceased's will be varied by making provision for a specific bequest in his favour of $2,850,000. By a chambers summons (which were the proceedings before the court), the plaintiff applied for an order "pursuant to s 89 of the *Trustees Act 1962* (WA) (or the court's inherent jurisdiction in relation to trustees) that the first defendant was empowered, has the authority to do and is directed to pay forthwith to the plaintiff the sum of $200,000 (or such other amount as the court sees fit)".

The estate was in the administration phase. The estimated net value of the estate was $3,588,562. After payment of the pecuniary legacies and the transfer of shares to the second defendant, the estimated net value of the residuary estate was $2,480,000 less the costs and expenses of administering the estate.

Section 89 of the Trustees Act provides:

> "(1) Where in the opinion of the Court any sale, lease, mortgage, surrender, release or other disposition, or any purchase, investment, acquisition, retention, expenditure or other transaction is expedient in the management or administration of any property vested in a trustee, or would be in the best interests of the persons, or the majority of the persons, beneficially interested under the trust, but it is inexpedient or difficult or impracticable to effect the disposition or transaction without the assistance of the Court, or it or they cannot be effected by reason of the absence of any power for that purpose vested in the trustee by the trust instrument (if any) or by law, the Court may by order confer upon the trustee, either generally or in any particular instance, the necessary power for the purpose, on such terms, and subject to such provisions and conditions (if any) as the Court may think fit …
>
> (2) …
>
> (3) …
>
> (4) An application to the Court under this section may be made by the trustees, or by any of them, or by any person beneficially interested under the trust."

Section 7A of the Family Provision Act provides that the court may make an interim order in favour of a claimant for provision under the Act who was totally or partially dependent on a deceased immediately before the deceased's death.

The plaintiff contended that s 89 of the Trustees Act applied to executors of deceased estates. Tottle J held that, on a proper construction of the section, the relief sought by the plaintiff could not be sustained either by reference to s 89 of the Trustees Act or the inherent jurisdiction of the court.

Executor or trustee

In the course of his judgment, Tottle J considered the distinction between an executor and a trustee. His Honour said that there are similarities between the role played by an executor of a deceased estate and the role of a trustee, but they were distinct offices that could not be equated with each other.

In relation to the application of the distinction in practice, Tottle J referred to and quoted from *Jacobs' law of trusts in Australia*,[4] including the following passage:

> "The principal duties of an executor are to get in the assets of the deceased, to pay debts, to pay the legacies given by the will, and to distribute the assets. If a testator appoints the same person as executor and trustee, which is usual nowadays, then that person acts as executor when performing executorial duties, and thereafter while continuing to hold the property is a trustee. However, if called upon at any future time to deal with assets in the estate which may be subsequently discovered, the person, although a trustee in respect of the balance of the property, will take the new assets as executor. Thus, the same person may be both executor and trustee in respect of different assets in the same estate. Further, if the executor carries out an instruction in the will to set aside a fund and hold it on trust for certain beneficiaries, he or she will become a trustee in respect of that property. An important result of this is that the subject matter of that fund will thereupon cease to be part of the general estate of the testator, and therefore if there is any loss to the subject matter of the fund, that loss will fall on the beneficiaries of the fund, and not upon any other beneficiaries in the testator's estate. This is part of the principle that an executor on assenting to a legacy holds the subject matter of the legacy as trustee for the legatee.
>
> An executor who has performed all executorial functions may become a trustee by merely continuing to hold property. When the executor becomes a trustee of ascertained property, the beneficiaries then become owners of equitable interests in that property. Thus a beneficiary under a will does not, by reason of the will alone, obtain any title, legal or equitable, to any asset forming part of the testator's estate. When a beneficiary does obtain such a title, it is obtained as a result of the administration of the estate of the testator according to law and in accordance with the dispositions of the will.
>
> … In practice it is not easy to determine exactly when a person ceases to act as executor and commenced to hold the property as trustee. The test is clear – have the person's executorial duties in respect of that property ended; but the difficulty in practice is to ascertain precisely whether that is the case …"

Tottle J also referred to a number of relevant decisions of the courts in various jurisdictions, including the decision of Buss P in *Fremantle Lawyers Pty Ltd v Sarich*.[5] In that case, Buss P said:

> "A beneficiary under a will acquires upon the testator's death a right to have the deceased estate administered in accordance with the executor's duties. However, neither the legal nor the equitable ownership of the property the subject of a devise or bequest vests in the beneficiary at the time of the testator's death. The reason is that, prior to the administration of the deceased estate, no specific property is capable of constituting the subject property of any trust in favour of the beneficiary. At that stage it could not be identified what part or parts of the deceased estate would need to be realised for the purposes of administration. Accordingly, the beneficiary does not have a proprietary interest in each of the assets which are the subject of the devise or bequest."

Operation of s 89

Tottle J said that, in his view, there was considerable force in the defendants' submissions that s 89(1) of the Trustees Act could not be invoked by a beneficiary under a will when the estate was in the administration phase. The requirement in s 89(4) that the application be made by the trustees or "any person beneficially interested under the trust" taken in combination with the reference to "any property vested in a trustee" were matters of context that indicated that the legislature did not intend the extended definition of "trust" contained in s 6 of the Trustees Act to apply to s 89.

His Honour said that it was unnecessary for him to decide the question of whether s 89(1) can be invoked by a beneficiary under a will while the estate is in the administration phase. This was because, even if it were assumed in the plaintiff's favour that it can be, conferring a power on the first defendant to make an interim payment and directing her to do so was not "expedient in the management or administration of any property" vested in the first defendant. The conferral and exercise of such a power had no connection with the management or administration of the property of the estate. The purpose of the payment would be to confer a benefit on the plaintiff in circumstances quite unrelated to the management or administration of any property. Further, an interim payment would not be in the interests of the trust generally as opposed to being in the plaintiff's interest.

"Trustee" for tax purposes

For the purposes of income tax, the definition of "trustee" in s 6(1) ITAA36 expressly extends the term to include an executor or administrator.[6] However, the definition does not apply if a contrary intention appears. The provisions of Div 6 ITAA36 exhibit a contrary intention in so far as the operation of those provisions turns on the concept of a beneficiary being presently entitled to income of the trust (*FCT v Whiting*[7]).

In the *Whiting* case, Latham CJ and Williams J, in a joint judgment, said:

"Numerous authorities, many of which are collected in the recent decision of this Court in *Robertson v. Deputy Federal Commissioner of Land Tax*[8], have established that until an estate has been fully administered by payment or provision for the payment of funeral and testamentary expenses, death duties, debts, annuities, and legacies and the amount of the residue thereby ascertained, the income of the residuary estate is the income of the executors and not of the residuary beneficiaries. But [Rich J at first instance] did not consider that the principles enunciated in these authorities were applicable to the provisions of Part III., Div. 6, of the Act. With great respect, it appears to us that these provisions must be construed in the light of the general principles of law applicable to the administration of estates by executors and trustees at law and in equity. The crucial question is at what moment of time, having regard to these general principles and to the provisions of the trust instrument, can it be said that a beneficiary has become presently entitled to a share in the income of a trust estate. A beneficiary under a will may become entitled to a share of such income as an annuitant legatee or a residuary beneficiary. His right to share in such income would be determined by the trusts in the will … The only part of an estate which can be made available to satisfy the claims of the beneficiaries is that part which remains after the funeral and testamentary expenses, death duties and debts have been paid or provided for, if necessary out of the whole estate, including any income earned by the estate during the period of realization."

Latham CJ and Williams J went on to say that entries made in the books of the estate to adjust the rights of the beneficiaries in the income and capital of the estate can only operate subject to the satisfaction of the claims of, and cannot affect the rights of, the creditors. But, as had been made clear in the authorities, the existence of mortgage debts does not prevent the administration of the estate advancing from the stage when the liabilities to creditors are in the process of discharge to a stage when the beneficial trusts of the will can attach to assets which are not required to satisfy the mortgage debts.

"Trust estate"

There is, however, no statutory definition of the expression "trust estate" for the purposes of Div 6 ITAA36.

In *Thomas v FCT*,[9] Greenwood J at first instance said:

"90. Although the phrase *net income*, in relation to a trust estate, is defined by s 95(1) of the 1936 Act, the phrase *income of the trust estate* in s 97(1) is not defined. Nevertheless, as a matter of construction, the references in s 97(1) to a *beneficiary* of a *trust estate* who is *presently entitled* to *a share* of the *income* of the trust estate, coupled with the definition of trustee in s 6(1) of the 1936 Act, suggests a reference to the general law of trusts: *Commissioner of Taxation v Bamford* [2010] HCA 10 … ('*FCT v Bamford*') by the Court at [36] to [39].

91. The 'income of the trust estate' is the distributable income of the trust estate ascertained by the trustee (applying the general law of trusts), determined according to appropriate accounting principles taking account of relevantly applicable presumptions (if any) about receipts, outgoings and losses: *FCT v Bamford* at [17]) and the terms of the trust instrument, measured in respect of distinct income years."

If, as is suggested by these observations, the concept in Div 6 of the income of a trust estate is to be determined by the general law of trusts, it would seem to be arguable that whether there is income of a trust estate would depend on the existence of a trust estate according to trust law principles at the time of the derivation of the income.

This would mean, it is submitted, that, in the case of a deceased estate, there could only be income of a trust estate once executorial duties are completed.[10] While this may appear to be a view that would conflict with prevailing views in practice, it is suggested that the position should be clarified.

ATO ruling

In December 1990, the Commissioner released a ruling (IT 2622) which considers the concept of present entitlement for the purposes of Div 6 during the stages of administration of deceased estates.

After the executor obtains probate and the assets vest in the executor, those stages are:[11]

1. the initial stage: the net income of the estate is applied to reduce debts etc;
2. the intermediate stage: part of the net income of the estate that is not required to pay debts etc may be paid to beneficiaries; and
3. the final stage: debts etc are paid or provided for in full and the net income of the estate is available for distribution.

IT 2622 states that:

"9. Beneficiaries cannot enjoy present entitlement to income derived by a deceased estate during the administration of the estate. Income of a deceased estate in income years before the administration of the estate is complete, is the income of the executors or administrators and is not income of the beneficiaries."

Intermediate stage

During the intermediate stage of administration of a deceased estate, the point may be reached where it is apparent to the executor that part of the net income of the estate will not be required to either pay or provide for debts etc. IT 2622 states that, in such a case, the executor might, in exercise of the executor's discretion, in fact pay some of the income to, or on behalf of, the beneficiaries. The beneficiaries in this situation will be presently entitled to the income to the extent of the amounts actually paid to them or actually paid on their behalf. The fact that the estate has not been fully administered does not prevent the beneficiaries in this situation from being presently entitled to the income actually paid to, or on behalf of, the beneficiaries.[12]

Income derived after administration of estate is complete

IT 2622 states that the administration of the estate does not have to reach the stage where the estate is wound up for beneficiaries to enjoy present entitlement to the income of the estate. Once the executor has provided for all debts incurred by the deceased before their death and for debts incurred in administering the estate (eg funeral expenses) and has provided for distributions of specific assets or legacies, it will be possible to ascertain the residue with certainty, even though the executor may not have actually made all of the transfers necessary to satisfy these demands on the estate.

Where the estate is fully administered during an income year

Where the administration of a deceased estate is completed during the course of an income year, IT 2622 states that the longstanding practice of the ATO is to raise assessments on the basis that beneficiaries who are not under any legal disability should bear tax (under s 97 ITAA36) on their shares of the net income of the estate for that year to which they are presently entitled. If a beneficiary is under a legal disability, the relevant share of the net income of the estate would be assessed in the manner required by s 98 ITAA36.

This means that, on the last day of the income year, provided a beneficiary has become presently entitled to a share of the income of the trust estate on or before that day, the beneficiary is assessable on that share of the "net income of the trust estate" calculated in accordance with s 95 ITAA36. The calculation required by s 95 includes in the "net income of the trust estate" the assessable income derived by the trust estate for the whole of the income year concerned.[13]

IT 2622 states that it has also been the longstanding practice of the ATO to accept an apportionment in the income year in which the estate is fully administered. Where the executors and beneficiaries are able to demonstrate, through the striking of accounts at the completion of administration, the actual amounts of income derived in the periods before and after the day on which the estate was fully administered, an apportionment may be made as follows:

- income derived in the period between the beginning of the income year and the day administration was completed: assessed in the hands of the executors or administrators under s 99 ITAA36; and
- income derived in the period between the day administration was completed and the end of the income year: assessed to the beneficiaries presently entitled to the income in the manner required by s 97 or 98 ITAA36.

There must be evidence of the income derived during these periods, and apportionment of the net income of the trust estate in this manner must be requested by the taxpayers concerned, ie the executor (or administrator) and the beneficiaries. The ATO would not accept an apportionment of the income derived by the estate for the whole income year concerned into the two periods merely on a time basis, that is, simply by reference to the number of days in each period.

One exception to this alternative course of apportionment is that, if an executor (or administrator) does in fact pay part of the income of the estate to a beneficiary before the estate is fully administered (ie during the first of the periods mentioned above), the beneficiary would be assessed on the basis that they were presently entitled to that income.

Observations

That Div 6 ITAA36 gives rise to difficult issues has been apparent for some considerable time, and this is reflected in the fact that a draft ruling released in 2012 which considers the meaning of "income of the trust estate" in Div 6 (TR 2012/D1) still remains a draft ruling. It is submitted that the draft ruling should be finalised and that the issues referred to above that arise out of the concept of a "trust estate" should be addressed.

It should be noted that the Commissioner has issued a practical compliance guideline (PCG 2018/4) that is intended to enable certain legal personal representatives of less complex estates to finalise those estates before the expiration of the relevant review period without concern that they may have to fund an outstanding tax-related liability of the deceased person from their own assets. PCG 2018/4 sets out when a legal personal representative will be treated as having notice of a claim by the ATO (including a claim arising from an amended assessment).

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References

1 For the sake of simplicity, it is assumed that the deceased had a valid will by which they appointed an executor. The position as discussed will be the same if the deceased died intestate, or if not intestate, either the will did not appoint an executor or the executor named in the will has died or renounced probate. There will be an administrator (rather than an executor) in these situations.

2 [2024] WASC 274.

3 IT 2622.

4 JD Heydon and MJ Leeming, *Jacobs' law of trusts in Australia*, 8th ed, LexisNexis, 2016, paras 2-40 and 2.44.

5 [2019] WASCA 48.

6 Note also that, apart from a superannuation fund, an approved deposit fund or a pooled superannuation trust, the ITAA97 defines "trustee" to have the meaning given by s 6(1) ITAA36 (s 995-1 ITAA97).

7 [1943] HCA 45.

8 [1941] HCA 40

9 [2015] FCA 968.

10 TR 2012/D1 (Income tax: meaning of "income of the trust estate" in Division 6 of Part III of the Income Tax Assessment Act 1936 and related provisions) does not consider the meaning of the expression "trust estate".

11 Para 6 of IT 2622.

12 Para 14 of IT 2622.

13 Para 20 of IT 2622.

Higher Education

Charting new tax territory

The Dux of CTA2B Advanced in Study Period 3, 2023 shares insights into her educational and professional trajectory.

Jessica Bagnall
Associate
Grant Thornton, Brisbane

Building the foundation

Jessica commenced her career path at Grant Thornton while pursuing a Bachelor of Business, majoring in accountancy, at QUT. Her academic journey has been adorned with achievements, and she seamlessly transitioned into a full-time role post-graduation, crediting the organisation's supportive environment and focus on professional development.

Motivated by a desire to enhance her skills and theoretical understanding, Jessica embarked on the Chartered Tax Adviser (CTA) program. Encouraged by Grant Thornton as part of her professional development journey, the CTA program aligned directly with her everyday responsibilities and is viewed as an important part of building the skills and theory needed to apply tax legislation in practice.

Application in practice

As the Dux of CTA1 Foundations in Study Period 1, 2023, Jessica "gained a strong foundation across multiple areas of tax, including GST, FBT, individuals, trusts, companies and partnerships". She credits the subject for giving her the base knowledge needed as an entrant to the accounting workforce. Acknowledging that some of the calculations she learned are not used daily, mainly due to the technology available, she appreciated this understanding to identify when there may be an issue with the software or to solve more abstract problems, scenarios and client inquiries.

In CTA2B Advanced, Jessica "learned in detail about multiple, more technical and specialised aspects of FBT, GST, corporate tax, international tax, tax planning and anti-avoidance". She explained that this knowledge is used frequently in her work: "From the basics of what is assessable or deductible as applies to the majority of clients, to one specific little rule about partnerships that had a big tax impact on that client, these subjects have substantial applications to the client work I perform."

The benefits of studying at The Tax Institute Higher Education

Reflecting on her learning journey, Jessica highlights The Tax Institute's range of resources, industry expert-led lectures, and up-to-date study materials. The relevance of course content, coupled with the support from knowledgeable course Convenors, distinguishes the educational experience at The Tax Institute, providing an environment that is conducive to professional growth.

Navigating work–study–life balance

Balancing full-time work, study and personal commitments is no mean feat. Jessica's approach involves diligent weeknight lectures after work, leaving weekends for reading, activities and quizzes. That way she is free on other weeknights and some of the weekend to catch up on social and other activities. Jessica explains: "Overall, I aim to stay up to date in the materials and assessments so when it is time to start revising for the exam, I am revising content I have already learned, not cramming. This means I can cement the knowledge I already have and brush up on areas that I have forgotten or need to improve."

The power of curiosity

Jessica's advice to others considering study is to "ensure that, when you have chosen to study, it is a priority and not something that is neglected. If you are diligent and work hard, it will show in your results and in what you take away from the subject into the workplace and your broader life. Always be curious and don't be afraid to ask. If you are confused or have a different solution, ask why. You may learn something new or correct a misunderstanding".

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Donations to school building funds

by Fiona Martin, CTA, Emeritus Professor, UNSW Business School

The 2024 Productivity Commission report into philanthropy has recommended that the tax deduction for donations to school building funds is abolished. Donations to school building funds are currently tax deductible to the individual or corporate donor. The Commission's rationale was that school building funds benefit the parents and students at these schools, including ensuring that fees remained lower, and did not provide a public benefit, which is required for tax purposes. This article provides insights into why the tax deductible status of these funds should be abolished. The author argues that this is the fairer result from both historical and public policy perspectives.

Introduction

The 2024 Productivity Commission report into philanthropy has recommended that the tax deduction for donations to school building funds should be abolished.[1] This is despite 130 submissions from the principals of independent private schools and 800 individual submissions arguing that these funds ensure that these schools are able to continue to offer high quality education to their students.[2] The Commission's rationale was that school building funds benefit the parents and students at these schools, including ensuring that fees remained lower, and did not provide a public benefit, which is required for tax purposes.[3] Donations to school building funds are currently tax deductible to the individual or corporate donor. These funds are what is termed a "deductible gift recipient" (DGR) in the *Income Tax Assessment Act 1997* (Cth) (ITAA97).[4]

The Productivity Commission's arguments are supported by research of the Australia Institute in its submission to the New South Wales Government on funding of education when it stated:[5]

> "Schools – whether private or public – serve an essential public service. But they should exist in the public interest, especially if they receive public funding and tax concessions. Public funding is granted to private schools with the understanding that it be spent on education that is in the public interest. However, as this submission shows, many private schools convert this public funding into private benefit."

In 2011, the federal government commissioned a review of school funding (the Gonski review).[6] The review found that there was a significant overlap in the funding priorities of the federal government and the state and territory governments, and that this overlap led to duplication and inefficiency. As a result, it was difficult for governments and policymakers to decide how best to fund the needs of school systems and schools.[7] Schools also have very different starting points in terms of their knowledge and capacity to seek out and secure philanthropic donors in view of their student population, location and alumni.[8] The report pointed out that a school's ability to maximise the impact of philanthropic contributions was limited if principals lacked the time to utilise these resources effectively. The centralised nature of school systems, it stated, may also result in the limited discretion of principals to make certain resourcing decisions.[9]

Since the Gonski report, there have been significant reforms in government funding of the education system. Government schools in Australia currently receive around 80% of their funding from their state or territory government. The balance comes from the federal government. These schools receive what is termed "recurrent funding", which is calculated through the Schooling Resource Standard (SRS). This is an estimate of how much public funding a school needs to meet its students' educational needs. The calculation involves a base amount for every student and up to six needs-based loadings, relating to socio-educational disadvantage, location and English language proficiency.[10] Non-government schools receive the bulk of their funding from the federal government (80%), and the states and territories are responsible for 20% of the SRS for these schools.[11]

A 2023 report indicates that, in 2020, 98% of independent private schools in NSW were funded above the SRS and more than 98% of public schools were funded below it. Independent schools in this report do not include "systemic Catholic schools". One of the report's key findings was that the federal and NSW governments delivered $120m in overfunding to 130 independent schools in NSW. Thirty-eight per cent of all independent schools examined as part of this study received more than 100% of their designated SRS level of funding. At the same time, the NSW public school system was well below the minimum SRS funding levels.[12] Furthermore, a total of 36 private independent schools were each individually overfunded more than $1m in 2020.[13]

It should be noted that, when this research investigated non-government schools, it only looked at what are termed "independent" schools – this does not include "systemic Catholic schools". The overfunded independent schools included: St Augustine's College, overfunded by $6,904,674; Loreto Kirribilli, overfunded by $5,034,403; St Aloysius' College, overfunded by $4,675,350; and Oakhill College, Castle Hill, overfunded by $4,607,500.[14]

Further research provides egregious examples of the use of funds by independent private schools in NSW. It is suggested that these schools appear to be operating in breach of the relevant state/territory legislation that requires them not to operate for profit and to pay wages in line with market values. This legislation also states that these schools should only make expenditure required for the operation of the school. Examples of these breaches include:[15]

- Cranbrook School, which spent $125m on a five-story sandstone building that contains a double-height orchestra room, a 267-seat theatre, and an Olympic-sized indoor pool;
- The Scots College, which in 2019 paid a reported $29m to renovate a library so that it would resemble a Scottish Baronial castle; and
- The King's School, which paid $15m to buy six hectares of land next to Lane Cove National Park for staff and student camps.

A survey of private schools around Sydney in 2022 through an investigation by *The Sydney Morning Herald*, found that: school principals received remuneration packages of between $460,000 and $970,000, with an average of $687,000; at least four high school principals in NSW received salary and benefit packages of over $900,000; and that one school principal got over $1m.[16] This is much higher than the salaries of public school principals.

Research conducted in 2004 also indicates that independent private schools are both misleading parents into thinking that donations to the school building fund are part of their child's fees and pressuring parents by indicating that their child will be disadvantaged if donations are not made.[17]

Despite the apparent high level of funding from the federal and state/territory governments to independent private schools, Andrew Leigh, Assistant Minister for Competition, Charities and Treasury, has stated that the government will not support the Productivity Commission recommendation. He argues that:[18]

> "While the Government considers its response to the inquiry, the recommended changes to tax settings for donations to school building funds are not being considered.
>
> A world-class education system is essential to tackling inequality, driving economic growth and supporting well-paid, secure jobs and our school system is a key part of it."

What is a school building fund?

In order for a fund to be eligible as a school building fund and therefore a DGR under the tax legislation, it must have the following characteristics:

- the fund is a public fund; and
- the fund must be operated by or be:
  - an Australian government agency; or
  - a registered charity with the Australian Charities and Not-for-profits Commission.

There are currently around 5,000 school building funds, most of which are attached to independent private schools.[19]

The obvious requirements of a school building fund are that there is a fund, a school and a building. The fund must be established and maintained to receive and provide money solely for the "acquisition, construction or maintenance" of school buildings.

The building must be used as a school by either a government body, a public authority or a non-profit society or association, and the use of the fund must be for the acquisition, construction or maintenance of a building.

The boundaries around what is and is not a school are set out in ATO guidelines and the case law. TR 2013/2 states that a school should provide organised instruction or training on a regular and continuing basis. This instruction is generally provided in class form. In addition, it includes people assembling for regular study of some area of knowledge or activity that is not recreational in character.[20]

In *The Buddhist Society of Western Australia Inc v FCT (No. 2)* (*Buddhist Society*),[21] McKerracher J referred to the statement of Barwick CJ in *Cromer Golf Club Ltd v Downs* (*Cromer*):[22]

> "94 … that a school is 'a place where people, whether young, adolescent or adult, assemble for the purpose of being instructed in some area of knowledge or of activity' … [A] school is 'an institution in which instruction of any kind is given'."

The High Court in *Cromer* (and subsequent cases) applied a very broad, ordinary meaning to the term "school", and avoided any gloss on the dictionary definition or superimposing additional requirements such as appear in TR 2013/2.

McKerracher J in the *Buddhist Society* case also noted that, while regular, ongoing and systematic instruction may be provided by a school, the presence of these factors is not essential to satisfy the ordinary meaning of "school". Furthermore, the absence of regular, ongoing and systematic instruction does not confirm that an entity is not operating as a school.[23]

As a result of the *Buddhist Society case*, the ATO has issued a decision impact statement which provides that:[24]

- its previous views on whether an organisation is a "school", and on whether a building is "used as a school", are incorrect as these views are inconsistent with the law; and
- it is committed to reviewing and updating TR 2013/2 and the ATO's associated website guidance to reflect the new law, and to use the approach from the new law in reviewing future applications for school building fund endorsement.

A new ruling has not yet been published.

The term "building" has its ordinary meaning and includes one building, a group of buildings, a part of a building, or additions to a building. A building should be permanent in nature and protect attendees from the elements. Fixtures are accepted as part of a building. They must be affixed to a building and unable to be detached without substantial damage to the item itself or that to which it is attached. This would include heating systems, fixed air conditioning systems, and carpets permanently fixed to the floor. It does not include outdoor swimming pools and other outdoor areas.[25]

As noted earlier, approximately 5,000 school building funds are eligible for DGR status in Australia. Although some of these are attached to government schools, the majority are part of private schools.[26]

Tax deductibility of donations to school building funds

The tax deductibility of donations to school building funds began in 1954. Section 78 of the *Income Tax and Social Services Contribution Act 1954* (Cth) was amended to allow a tax deduction for donations to government schools and not-for-profit entities by adding the following subparagraph:[27]

> "(xv) a public fund established and maintained exclusively for providing money for the acquisition, construction or maintenance of a building used or to be used as a school or college by a government or public authority or by a society or association which is carried on otherwise than for the purposes of profit or gain to the individual members of that society or association."

At that time, the funding of the school education system in Australia was very different to today.

During the 1870s and 1880s, most Australian colonies passed laws that stopped public money going to non-government schools. Government funding only went to government schools. This meant that non-government schools (mostly run by churches) had to raise their own funds. In the 1960s, the Catholic Church tried to bring back government funding to its schools but could only get a small amount of money from the state/territory governments. At this time, the number of children attending secondary school had increased dramatically. Catholic schools, which relied on funds raised by the church in their local community, were suffering. They didn't have enough teachers, school buildings were old, and classrooms were overcrowded.

On 16 July 1962, about 2,000 Catholic school children arrived at Goulburn's six government schools, but the schools could take only 640 students. The schools did their best to welcome the new arrivals, while the Catholic nuns escorted children to their new Catholic schools.

In that same year, St Brigid's Primary School in Goulburn was told that it needed to upgrade its toilet blocks immediately, to meet health and safety standards. Unfortunately, the local Catholic community couldn't afford to repair the toilets, so the community decided to close all seven of Goulburn's Catholic schools for six weeks. There was a huge public outcry about this.[28]

In 1963, the then Prime Minister Sir Robert Menzies was re-elected. He ensured the passing of the *States Grants (Science Laboratories and Technical Training) Act 1964* (Cth). This brought in limited federal funding for both government and non-government schools. It was seen as a victory by Catholic schools, for equality and common sense.[29]

Since then, we have seen funding to non-government schools increase to the extent that there is credible research supporting the view that some of these schools, particularly elite independent schools, are receiving more funding than their public counterparts.[30]

Conclusion

Many of the submissions to the Productivity Commission in favour of retaining school building funds argued that their abolition would result in higher fees having to be charged for the school students. In its final report, the Productivity Commission stated that:[31]

> "Given the overarching rationales for government support for education, including as articulated in the funding principles developed in the Gonski review, there is not a compelling case for facilitating fee reductions via this particular mechanism [DGR status for school building funds], except where it is explicitly designed to achieve equity objectives to provide support for those in need."

This statement represents a strong and compelling argument for the abolition of the DGR status for school building funds except those that have equity objectives. This is not just a tax issue but one of social justice and inequality. The use of taxpayer money to fund independent private schools through a tax deduction provides a private benefit to the wealthy parents and alumni of elite private schools and is not justified on principles of social equity and cohesion.

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The tax implications of subdividing land

by Gayathri Krishnan, CTA, Senior Advisory Officer, NSW Trustee and Guardian

Proceeds from the sale of subdivided land can be taxed as either ordinary income, CGT, or both. Depending on the circumstances, proceeds may also be subject to GST. In the first scenario discussed in this article, where A and B subdivide land with their primary residence and sell the second lot immediately after subdivision, taxation will be limited to CGT only. In the second scenario, new dwellings are built after demolishing the original dwelling. The sale of the second lot is treated as a profit-making enterprise, subject to GST, ordinary income, and CGT. However, if the second lot is rented out for more than five years before sale, as in scenario 3, taxation will be limited to CGT only. Lastly, if the property was purchased pre-1985 and sold by the estate within two years of the owners' deaths, only CGT applies. Intent and careful planning are crucial, and consulting a tax accountant is recommended.

Introduction

With an increasing demand for housing, councils are showing a greater willingness to approve the subdivision of large residential blocks, allowing for the construction of duplexes. This article explores the tax implications associated with the following scenarios related to land subdivision and duplex construction:

- scenario 1: lot 1 retained as main residence, and lot 2 sold after subdivision;
- scenario 2: demolish existing residence, build on lot 1 and lot 2, retain lot 1 as main residence, and sell lot 2;
- scenario 3: demolish existing residence, build on lot 1 and lot 2, retain lot 1 as main residence, and lease lot 2 prior to sale; and
- scenario 4: deceased estate and subdivision.

When land is subdivided and sold, the proceeds may be assessed as ordinary income under s 6-5 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97) if the transaction is viewed as a commercial venture, or the proceeds may be assessed as capital gains under the CGT provisions in Pt 3-1 and Pt 3-3 ITAA97 if the sale is considered a mere realisation of capital assets.

The distinction between income and capital is critical for several reasons:

- tax-free gains may arise from the realisation of pre-CGT assets;
- capital losses may offset future gains;
- indexation may apply to reduce capital gains;
- small business concessions may be available; and
- the 50% CGT discount may apply, depending on the entity selling the asset.

Additionally, under s 9-40 of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GST Act), GST may apply to the sale of real property classified as a taxable supply. A sale is considered a taxable supply if it meets the following conditions:

- it is made for consideration;
- it is made in the course or furtherance of an enterprise;
- it is connected with Australia; and
- the seller is registered or required to be registered for GST.

An "enterprise" is defined in s 9-20 GST Act as an activity or a series of activities done:

> "(a) in the form of a business; or
>
> (b) in the form of an adventure or concern in the nature of trade; or
>
> (c) on a regular or continuous basis, in the form of a lease, licence or other grant of an interest in property."

According to MT 2006/1, an isolated transaction may still be considered an enterprise if the land was purchased with the intention to make a profit. Paragraph 159 of MT 2006/1 states that whether or not an activity constitutes an enterprise is a question of fact and degree depending on the circumstances of an individual case. Paragraph 234 of MT 2006/1 distinguishes between activities done in the form of a business and those done in the form of an adventure or a concern in the nature of trade. An isolated or one-off transaction that does not amount to a business may still have characteristics of a business deal.

There are various factors indicating that a taxpayer is involved in an enterprise, such as a change of purpose for which the land is held, the land is brought into account as a business asset, and borrowed funds are financing the development or acquisition.

Some common scenarios and an analysis of their tax implications are now considered.

Scenarios 1 to 3: background

A and B purchased a 1,000m^2 property in NSW as joint tenants on 1 July 1990 for $500,000, with the dwelling valued at $300,000 and the land valued at $200,000. They used it as their main residence until 1 July 2020, when they decided to subdivide the land due to health issues preventing them from looking after the property. After approval from the local council and incurring subdivision costs of $60,000, the subdivision into two equal parts (lot 1 and lot 2) was completed on 1 July 2022, with each lot valued at $400,000.

Scenario 1

A and B continued living in lot 1 and sold lot 2 on 1 March 2023 for $400,000, with associated selling costs of $10,000. The contract for sale was entered into on 31 December 2022 and settled on 1 March 2023.

Assessability under ordinary income

The first step in determining the tax implications of this transaction is to assess whether it falls within the definition of "ordinary income". While tax legislation does not explicitly define "ordinary income", its meaning is derived from general concepts. Typically, income generated from business activities is considered ordinary income.

We begin by determining whether A and B are conducting a business. According to TR 97/11, several factors are considered when establishing whether a taxpayer is carrying on a business. These factors include:

- whether the activity has a significant commercial purpose and character;
- whether the taxpayer's involvement goes beyond mere intention to engage in business;
- the presence of repetition and regularity in the activity;
- whether the activity is planned, organised and conducted in a business-like manner with a view to profit;
- the size and scale of the activity; and
- whether the activity is more appropriately classified as a hobby or recreational pursuit.

Based on the provided facts, A and B are not engaged in a business. They have no intention to generate profit from their activities, nor is there evidence of regularity or repetition in their actions. Furthermore, the land in question was not initially purchased with the intention of undertaking development activities.

Next, we examine whether the activity qualifies as a profit-making or commercial transaction in line with TR 92/3. Key indicators relevant to determining whether an isolated transaction constitutes a business or commercial operation include:

- the nature of the entity undertaking the transaction;
- the nature and scale of the taxpayer's other activities;
- the amount of money involved in the transaction;
- the magnitude of the profit sought or obtained;
- the nature, scale and complexity of the transaction;
- the manner in which the transaction was carried out;
- any connection between the taxpayer and other parties to the transaction;
- the nature of the property sold; and
- the timing and steps involved in the transaction.

Based on the facts presented, A and B have not engaged in similar activities in the past, nor have they been involved in any major development processes. They held the land for over 30 years, during which it served as their principal residence. Their actions suggest no intention to profit from the land as they only spent the necessary amounts to obtain subdivision approval. Additionally, A and B did not engage multiple parties, such as architects or property developers, to prepare the land for subdivision. The transaction was a straightforward, one-off sale, facilitated solely by a real estate agent for lot 2. Since the sale does not qualify as ordinary income, it will instead be assessed under the CGT provisions as it constitutes a mere realisation of assets.

CGT implications of the sale of the land

Under s 112-25 ITAA97, the subdivision of land into separate blocks does not itself trigger a CGT event. Each subdivided block is treated as a separate new asset. According to s 104-10(3) ITAA97, CGT event A1 occurs when the contract for the sale of lot 2 is executed which, in this case, took place on 31 December 2023. If the original land was acquired before 20 September 1985, the subdivided blocks would retain their pre-CGT status. However, this does not apply to lot 2 as the original property, including the land, was purchased after 20 September 1985.

The main residence exemption applies to any capital gain (or loss) from a CGT event related to a dwelling that was the taxpayer's main residence at the time of sale, along with adjacent land up to a maximum of two hectares. In this instance, A and B are selling the subdivided land separately so, according to s 118-165 ITAA97, the exemption does not apply to lot 2.

The costs of subdivision must be apportioned between the newly created blocks (lot 1 and lot 2) under s 112-25(3) ITAA97. As outlined in TD 97/3, the ATO allows the costs to be allocated between each lot based on an area basis or a market value basis. In this scenario, the original land value of $200,000 can be apportioned equally between lot 1 and lot 2, with $100,000 allocated to each. However, the selling costs are attributable solely to lot 2 and can be claimed in full.

The cost base for lot 2 is calculated as follows:

> Lot 2 land value at original time of purchase ($100,000) + subdivision cost for lot 2 ($30,000) + selling costs ($10,000) = $140,000
>
> Sale price of lot 2 = $400,000
>
> Gross capital gain = $400,000 – $140,000 = $260,000

Since A and B held the property as individuals (s 115-10(a) ITAA97) for more than 12 months prior to the CGT event (s 115-25 ITAA97), they are eligible for the 50% CGT discount under s 115-100(a)(i) ITAA97. This reduces the capital gain to $130,000. As A and B are joint tenants, the net capital gain is divided equally between them, so each will declare $65,000 as their share of the capital gain (s 108-7 ITAA97).

GST implications of the sale of the land

As previously established, A and B are not carrying on a business. Consequently, the condition outlined in s 9-5(b) GST Act is not met and the sale is not a taxable supply. As a result, no GST is applicable.

Scenario 2

In this scenario, A and B demolished the existing main residence, subdivided the land into two equal lots, and constructed houses on both lots 1 and 2. They retained lot 1 as their principal residence and opted to sell lot 2 for a profit. Construction was completed on 1 July 2023, and A and B moved into lot 1. Lot 2 was subsequently advertised for sale on 1 September 2023, with the contract exchanged on 31 December 2023 and settlement scheduled for 1 March 2024. The sale price for lot 2 was $1,400,000, and the development costs for each lot amounted to $400,000 (excluding GST).

GST implications of the sale

The GST implications of the sale of lot 2 must first be considered. The sale is made for a consideration of $1,400,000, which exceeds the $75,000 registration threshold. According to paras 262 to 266 of MT 2006/1, the ATO considers the construction of the new residential premises on lot 2 for sale as part of an enterprise for GST purposes. Given that the conditions for making a taxable supply are satisfied, the sale of lot 2 will be subject to GST. Under s 40-65(2) GST Act, the sale of new residential premises is not treated as input taxed. Consequently, GST will be applicable to the sale of lot 2.

Assuming that A and B have agreed with the buyer to apply the margin scheme as per s 75-5 GST Act and all of the conditions of eligibility for the margin scheme have been met, GST will be calculated on the margin only. Additionally, A and B can claim input tax credits for the development costs. For GST purposes, lot 2 is considered to be acquired at the time the subdivision is registered and the title for lot 2 is created, as outlined in para 51 of GSTR 2006/8. The acquisition cost of lot 2 is determined based on its market value at the time of subdivision.

GST is calculated as follows:

Sale price = $1,400,000

Less acquisition cost of lot 2 = $400,000

Margin = $1,000,000

GST on margin (1/11th of margin) = $100,000

Input tax credits on development costs = $40,000

Therefore, the net GST amount payable after accounting for input tax credits is:

Net amount for GST purposes = $100,000 (GST on margin) – $40,000 (input tax credits) = $60,000

Assessability under ordinary income

Next, we determine whether lot 2 has been disposed of as part of a profit-making scheme. The ATO considers that even a one-off transaction of constructing a dwelling for resale is part of a profit-making scheme. In this case, any net profit derived from such a profit-making scheme will be taxed as ordinary income under s 6-5 ITAA97, as it is treated on revenue account. Concurrently, any capital gain resulting from the transaction will be subject to the CGT provisions, as it is treated on capital account. Section 118-20 ITAA97 contains anti-overlap provisions to ensure that the profit from the transactions is not taxed twice.

Based on the facts, it is evident that the sale of lot 2 constitutes a profit-making scheme. The net profit is determined as the gross sale proceeds less the development costs incurred. Development costs are included in the net profit calculation rather than being deducted separately. According to paras 58 and 59 of GSTR 2006/8, the ATO will accept the cost to be apportioned between each lot on either an area basis or a market value basis.

Under s 6-5 ITAA97, the net profit (excluding GST) is calculated as follows:

Sale proceeds for lot 2 = $1,400,000 – $100,000 (net amount for GST purposes) = $1,300,000

Less acquisition cost of lot 2 = $400,000

Less development costs = $400,000

Net profit = $1,300,000 – $400,000 – $400,000 = $500,000

The capital gain is calculated as follows:

Consideration received (capital proceeds excl GST) = $1,300,000

Cost of lot 2 (s 112-25(3) ITAA97) = $100,000

Development costs (excl GST) = $400,000

Cost base = $100,000 + $400,000 = $500,000

Capital gain = $1,300,000 – $500,000 = $800,000

Capital gain reduced by net profit = $800,000 – $500,000 = $300,000

Less 50% general CGT discount = $150,000

Net profit

A and B will each declare $250,000 as assessable income under s 6-5 ITAA97 in the 2024 income tax year.

Net capital gain

A and B will each declare $75,000 as a net capital gain in the 2024 income tax year.

Scenario 3

The original purchase details of the property remain consistent with those in previous scenarios. Subdivision was completed on 1 July 2016, and construction of both lot 1 and lot 2 was finalised on 1 July 2017, at which point A and B moved into lot 1. Lot 2 was subsequently advertised for lease on 1 September 2017, with tenants occupying the premises from 31 December 2017. The property was leased until 30 June 2023, after which A and B decided to sell lot 2. The property was advertised for sale, with the contract exchanged on 5 September 2023 and settled on 31 October 2023. Lot 2 was sold for $1,400,000. The market value of each lot at the time of subdivision was $400,000. Construction costs for lot 2 amounted to $400,000, and the apportioned holding costs during the construction period were $50,000. The selling costs for lot 2 were $10,000.

Ordinary income or mere realisation of capital asset

Given the facts above and the intention of A and B, the disposal of lot 2, a long-term rental property, would not be considered a commercial venture but a mere realisation of a capital asset and will be treated on capital account. Consequently, normal CGT rules apply. On 5 September 2023, CGT event A1 occurred. The holding costs and construction costs attributable to lot 2 are included in its cost base.

The capital gain is calculated as follows:

Sale proceeds for lot 2 = $1,400,000

Total cost base = $100,000 (original apportioned cost for land) + $400,000 (construction cost) + $50,000 (holding cost) + $10,000 (selling cost) = $560,000

Gross gain = $1,400,000 – $560,000 = $840,000

Less 50% general CGT discount = $420,000.

A and B will equally declare $210,000 as a net capital gain in the 2024 income tax year.

GST implications of the sale

According to the ATO's decision impact statement on *Domestic Property Development Pty Ltd as trustee for the Dals Property Trust v FCT*,[1] if a newly constructed property is leased for less than five continuous years, it is classified as new residential premises under s 40-75 GST Act and is considered an input-taxed supply under that provision. However, since the property was leased continuously for over five years, it is treated as an input-taxed supply, resulting in no GST implications on sale. Additionally, as the property is considered a capital asset, it will not be included in the turnover calculation for GST purposes under s 188-25 GST Act. Therefore, A and B are not required to be registered for GST as none of the conditions under s 9-5 GST Act are met.

Scenario 4

In scenario 4, A and B acquired a property on 1 July 1970, using it as their main residence. At the time of acquisition, the land was valued at $100,000 and the building at $200,000. In 2019, A and B decided to demolish the existing residence, subdivide the land into two equal lots, and construct new houses on each lot. They planned to live in lot 1 and lease out lot 2 for a minimum of 10 years.

Subdivision was completed on 1 January 2020, with construction finishing on 1 July 2020. At the time of subdivision, lot 2 was valued at $30,000. The development costs for each lot amounted to $400,000, and the holding costs during the construction period apportioned to lot 2 were $50,000. A and B moved into lot 1 and began leasing lot 2 from 31 December 2020.

Deceased estate

On 1 July 2021, A passed away and, due to joint ownership, B acquired A's share of the property. Lot 2 continued to be leased and generated income. At the time of A's death, the market value of the land for lot 1 and lot 2 was $400,000 each, and the buildings were valued at $600,000 each.

B passed away on 1 July 2023 and the properties became part of B's estate. At the time of B's death, the market value of the land for lot 1 and lot 2 was $600,000 each, with the buildings still valued at $600,000 each.

> "… the subdivision of land into separate blocks does not itself trigger a CGT event."

The executor decided to sell both lot 1 and lot 2, with the contract exchanged on 1 September 2023 and settlement on 31 October 2023. Lot 1 and lot 2 were sold for $1,400,000 each, with selling costs of $10,000 per lot.

Pre-CGT status and CGT events

The original purchase of the property by A and B predates the introduction of CGT. Therefore, the pre-CGT status was maintained at the time of subdivision as no CGT event had occurred (s 112-25(2) ITAA97).

The determination of the status of a CGT asset only happens at the time of a CGT event. On A's death, A's share of lot 1 and lot 2 transferred to B under s 128-50(2) ITAA97. Despite the buildings on both lots being constructed post-1985, the land retains its pre-1985 status as s 108-70(2) ITAA97 does not apply due to the CGT event occurring because of death (TD 96/18). B is deemed to have acquired A's share on the date of A's death, thus becoming a post-1985 asset for B. The cost base for the share acquired from A includes the sum of the cost base for the land and building.

For the land, the cost base is $225,000, which includes A's share of the market value at the time of A's death ($200,000) and holding costs ($25,000). For the building, the cost base is the original cost of $200,000 ($400,000/2). Consequently, the cost base for B of A's share amounts to $425,000 for each lot.

For B's own share in lot 1 and lot 2, no determination is done as no CGT event to this share has happened.

On B's death, both lot 1 and lot 2 become part of B's estate, with CGT event A1 occurring due to the change in ownership to the legal personal representative (LPR) under s 104-10(2) ITAA97. However, any CGT gain or loss is disregarded (s 128-10 ITAA97).

Sale by the LPR

In light of the CGT event that has occurred, it is necessary to assess whether the building and land associated with the original shares in lot 1 and lot 2 held by B are considered separate assets. Given that the CGT event resulted from death, s 108-70 ITAA97 does not apply. Consequently, the building and land are regarded as a single asset. The LPR is deemed to have acquired lot 1 and lot 2 on the date of B's death, in accordance with s 128-15(2) ITAA97.

Regarding lot 1, no CGT implications arise as it was utilised as the main residence from 1970 until B's death. Additionally, the trustee's ownership interest ceased within two years of B's death, as stipulated by s 118-195 ITAA97. During the construction period, lot 1 will continue to be regarded as the main residence, given that the construction period was less than four years (s 118-150(4) ITAA97). Moreover, after the completion of construction, A and B resumed residence in the property and used it as their main residence for more than three months, as required by s 118-150(3) ITAA97.

Let us now consider the sale of lot 2.

To determine the cost base of lot 2 for the LPR, we must consider both B's original share and the share of A acquired by B on A's death.

The cost base for B's original share will be the sum of the cost base of each original asset (s 112-25(4)(b) ITAA97), ie the land and the building.

The land

The cost base for the land will be $325,000, comprised of the market value of the share held by B at the time of B's death (item 4 of s 128-15(4) ITAA97), ie $300,000, plus B's share of the holding cost, ie $25,000.

The building

The cost base for the building will be the original cost of B's share (item 1 of s 128-15(4) ITAA97), ie the development cost of $200,000 ($400,000/2).

So the cost base for the LPR of B's original share of lot 2 would be $525,000.

For the share of A acquired by B on A's death, this share is considered a post-1985 acquisition for B. Therefore, the cost base of this share is determined at the time of B's death, which we previously calculated as $425,000 for A's share.

Combining both components, the total cost base for lot 2 for the LPR is $525,000 (B's original share) plus $425,000 (A's share), resulting in a total cost base of $950,000.

Since lot 2 was not B's main residence at the time of B's death, s 118-195 ITAA97 does not apply, and the property is subject to CGT.

The gross capital gain for lot 2 is calculated as follows:

> Gross gain = $1,400,000 (sale price) – $950,000 (total cost base) – $10,000 (selling costs) = $440,000

Given that lot 2 was held for more than 12 months, the net capital gain for the LPR is half of the gross gain, ie $220,000.

GST implications of the sale

When assessing the GST implications of the sale of lot 2, we must first determine its classification under the GST Act. Lot 2 is categorised as "residential premises". Generally, residential premises are treated as input-taxed supplies, so GST does not apply unless the premises are classified as new residential premises.

Since A and B demolished the original building and constructed new premises on lot 2, and the property was rented out for less than five years from the time it was built, it qualifies as new residential premises under s 40-75(1)(c) GST Act.

Despite this, the sale is not considered a taxable supply because it was not made in the course or furtherance of an enterprise (s 9-5(2) GST Act). Proceeds from the sale of capital assets are excluded when calculating projected and current turnover to determine whether the GST registration threshold has been met. Consequently, the GST turnover threshold is not satisfied, and the trustee is not required to register for GST. Therefore, there are no GST implications of the sale of lot 2.

Conclusion

The tax implications associated with the subdivision of land and the construction of new dwellings are complex and heavily depend on the intent and actions of the taxpayer, both prior to and following the subdivision. The tax treatment of subdivided property under the ITAA97 can vary, potentially falling under the CGT provisions or ordinary income provisions based on the specific circumstances. Additionally, subdivision activities may give rise to GST liabilities, which could be mitigated through the application of the margin scheme if planned in advance.

Thus, while subdividing property can offer significant opportunities, it is crucial for taxpayers to seek comprehensive advice from their tax accountant before proceeding with any subdivision project. This ensures that all tax implications are properly considered and managed, aligning with regulatory requirements and optimising tax outcomes.

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Reference

1 [2022] AATA 4436.

A Matter of Trusts

by Phil Broderick, CTA, and
Terence Wong, Sladen Legal

Trusts and NALI/NALE: part 1

NALI/NALE has been a hot topic in recent years. Now the dust has settled, this two part article will examine the rules interactions with trusts.

Avoiding the non-arm's length income (NALI) taxing regime is like flying through gaps in spider webs – there are few viable routes and a slight mistake could mean the end – in that, for a self-managed superannuation fund (SMSF), an entire investment asset is forever "tainted" with NALI.

This article, over two parts, discusses how investments by SMSFs in trusts can trigger the NALI and the non-arm's length expenses (NALE) legislative provisions.

Historical context

Prior to 1 July 2007, the NALI rules were known as "special income" rules and were contained in s 273 of the *Income Tax Assessment Act 1936* (Cth) (ITAA36). These were redrafted into the current NALI provisions contained in s 295-550 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97).

Current NALI provisions

Under s 295-545 ITAA97, the non-arm's length component is taxed at the top marginal rate (currently at 45%).

The non-arm's length provisions are contained in s 295-550 ITAA97 (referred to in this article as "the NALI provisions").

There are known to be four types or subsets of NALI under s 295-550 as follows:

- **"general" NALI (which includes NALE) under s 295-550(1):** income from a scheme where the parties to that scheme were not dealing with each other at arm's length and where the amount derived was more than what a superannuation fund would have been expected to derive had the parties to the scheme been dealing with each other at arm's length;
- **"dividend" NALI under s 295-550(2) and (3):** this applies to dividends paid to a superannuation fund by a private company, unless the amount is consistent with arm's length dealings;
- **"non-fixed" trust NALI under s 295-550(4):** this applies to income derived by a superannuation fund as a beneficiary of a trust, other than in situations where the fund has a fixed entitlement to the income of the trust; and
- **"fixed" trust NALI under s 295-550(5):** this applies to distributions to a superannuation fund from a fixed trust that is not a result of arm's length dealings and the amount of income received by the fund is more than would otherwise have been received by the fund if the parties were dealing with each other at arm's length.

In the context of this article, NALI/NALE and trusts, the last two types of NALI noted above, will be examined.

Why is the fixed trust distinction important?

The initial key element for applying NALI to trusts is whether an SMSF holds a fixed trust entitlement to the trust's income or not. If the entitlement is not a fixed trust entitlement (eg a distribution from a family discretionary trust), s 295-550(4) provides that all income and capital gains derived by the SMSF will be deemed as NALI.

What is a fixed trust entitlement?

Legislation

Fixed entitlement is not asterisked as a defined term in s 295-550 ITAA97. However, the term "fixed entitlement" is defined in s 995-1(1) ITAA97 as:

> "an entity has a fixed entitlement to a share of the income or capital of a company, partnership or trust if the entity has a fixed entitlement to that share within the meaning of Division 272 in Schedule 2F to the Income Tax Assessment Act 1936 …"

Section 272-5(1) of Div 272 in Sch 2F ITAA36 provides as follows:

> **"272-5 Fixed entitlement to share of income or capital of a trust**
>
> (1) If, under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust, the beneficiary has a ***fixed entitlement*** to that share of the income or capital …"

Division 272 in Sch 2F ITAA36 requires a higher threshold to be a fixed trust,[1] such that most "standard" unit trusts would not create a fixed entitlement. This would obviously be problematic if such an approach was taken with the NALI rules.

Cases

The AAT decision in *The Trustee for MH Ghali Superannuation Fund and FCT*[2] (*Ghali*) discussed using the definition of "fixed entitlement" provided in Sch 2F ITAA36. However, in the ATO's decision impact statement on the *Ghali* decision, the Commissioner disagreed with the AAT's view in *Ghali* and noted his intention to continue with the argument that the Sch 2F definition does not apply to the NALI provisions and that the superannuation fund's entitlement to the distribution depends on the exercise of the trustee's or any other person's discretion.

ATO guidance

The ATO's views in relation to what generally constitutes a fixed trust for the ITAA97 are set out in PCG 2016/16. However, PCG 2016/16 states (at para 4) that it does not apply to the NALI rules. Rather, the Commissioner's view on what constitutes a fixed entitlement for the NALI rules is set out in TR 2006/7.[3]

TR 2006/7 considered the question of what constitutes a fixed entitlement in respect of the "special income" provisions of former s 273 ITAA36.

In TR 2006/7, the key determinant as to whether income is derived as a result of a fixed entitlement is whether "the entity's entitlement to the distribution does not depend on the exercise of the trustee's or any other person's discretion".[4]

In the explanatory reasons accompanying TR 2006/7, the ATO explained that:

> "209. To have an interest in the income of a trust estate, a person must have a right with respect to the income of the trust that is susceptible to measurement; a right merely to be considered as a potential recipient of income is not sufficient. An interest in the income of a trust estate will be vested in interest if it is bound to take effect in possession at some time and is not contingent upon any event occurring that may or may not take place. In contrast to a vested interest, a contingent interest will be one which gives no right at all unless or until some future event happens such as the exercise of a discretion by the trustee or some other person."

While there has been some uncertainty as to what constitutes a fixed entitlement for the purposes of s 295-550(5) ITAA97, broadly, the applicable test is whether the SMSF's entitlement to distribution depends on the exercise of the trustee's or any other person's discretion.

What types of trusts will be fixed for NALI purposes?

The devil is in the detail as the saying goes and therefore whether a particular trust creates a fixed entitlement for NALI purposes will depend on the drafting of the trust deed. However, at a high level, the principles set out in Table 1 can be applied.

Can a non-fixed trust be amended?

Provided the relevant trust deed grants the trustee the power to amend the trust deed to create "fixed entitlements", a trust deed could be amended to ensure that such fixed entitlements exist. While it may not fix non-fixed trust NALI from prior years, it should prevent non-fixed trust NALI going forward.

Fixed trust NALI provision

If it is established that a trust is a fixed trust for NALI purposes, although NALI will not be automatically attributed to its income (as compared to non-fixed trusts), if the unit trust conducts some dealings that are not at arm's length, then the fixed trust NALI provision may be enlivened.

Table 1. Examples of whether a trust is fixed or non-fixed

Type of trust	Fixed or non-fixed
Discretionary trust	Non-fixed
Non-unitised fixed trust	Fixed
Unit trust with only one class of units	Fixed
Unit trust with multiple classes of units but distributions paid proportionally to unitholders	Fixed
Unit trust with multiple classes of units but trustee has discretion to pay between classes	Non-fixed
Hybrid trust – trustee has discretion to distribute income but in default goes to unitholders	Non-fixed
Hybrid trust – income and capital gains must be paid to unitholders, "non-taxable amounts" can be paid to discretionary beneficiaries	Uncertain – this will depend on the terms of the trust deed

The fixed trust NALI provision is contained in s 295-550(5). Broadly, it applies where income is derived, the parties were not dealing at arm's length, and the superannuation fund derives income that is more than might have been expected had there been (commercial) arm's length dealings.[5]

Fixed trust NALE provision

In addition to the above NALI provision, from 1 July 2018, s 295-550(5) contains a NALE provision. This provision is triggered where income is derived, the parties were not dealing at arm's length, and the superannuation fund in acquiring the entitlement (ie purchasing the units in the fixed trust), or in gaining or producing the income from that entitlement, incurs an expenditure normally paid for but which is not paid by the superannuation fund or which is obtained at a discount to a commercial arm's length rate.[6]

For a fixed trust, NALE only applies to non-arm's length dealings at the unit/fixed entitlement level. This could include, for example, acquiring the units/trust entitlement for less than market value, using a non-commercial limited recourse borrowing arrangement loan to acquire units, or not incurring an acquisition cost from a related party provider when acquiring the units.

The fixed trust NALE rules do not apply to non-arm's length dealings within/at the unit trust/fixed trust level. This is because s 295-550(5)(a) would deal with non-arm's length dealings at the unit trust level.

It is important to note that NALE is not a separate taxing provision, it is a subset of the NALI provision. On triggering NALE, the income and/or capital gains are treated as NALI and are to be taxed at the higher rate.

Disproportionate NALI tax

Across the NALI provisions, including in relation to fixed trusts, a structural issue has persisted (even before the NALE changes) in that the NALI 45% tax rate is applied to all of the income tainted by NALI, rather than applying the 45% tax rate only to the excess NALI income.

The following are examples of this disproportionate NALI application:

- an SMSF invests in a unit trust with a fixed entitlement. The unit trust owns a property and engages a related party real estate agent to manage the property. The related party does not charge for those services. The value of those services would normally be $2,000 per annum. The unit trust derives $50,000 in net rent from that property and $150,000 of net rent from another property. NALI is triggered, resulting in the $200,000 which is taxed as NALI at the rate of 45% (ie $90,000 in tax). That is, a failure charge of $2,000 results in additional tax of $60,000;[7] and
- an SMSF acquires units in a unit trust. It uses the services of a related party lawyer. The lawyer does not charge for her services. The value of those services would normally be $3,000. The unit trust later distributes a net capital gain to the SMSF of $1m. NALI is triggered, resulting in the $1m which is taxed as NALI at the rate of 45% (ie $450,000 in tax). That is, a failure charge of $3,000 results in additional tax of $300,000.[8]

Coupled with the ATO's view that non-arm's length dealings generally cannot be rectified,[9] the above examples show how NALI can be a disproportionate penalty that is unfit for the mischief it seeks to penalise.

Next article

The next article in this series will consider the decision in *BPFN and FCT*[10] and the application of NALI to multi-entity trust groups ultimately owned by SMSFs.

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References

1 See *Colonial First State Investments Ltd v FCT* [2011] FCA 16.

2 [2012] AATA 527.

3 Discussed in more detail in P Martins and D Smedley, "ATO provides a 'safe harbour' for fixed trusts", (2017) 52(5) *Taxation in Australia* 266.

4 Which has since also been referred to in PBR 1012733720677.

5 S 295-550(5)(a) ITAA97.

6 S 295-550(5)(b) and (c) ITAA97.

7 That is, $90,000 NALI tax less normal SMSF tax (at 15%) of $30,000.

8 That is, $450,000 NALI tax less normal SMSF tax (at 15%) of $150,000.

9 See LCR 2021/2.

10 [2023] AATA 2330.

Superannuation

by Daniel Butler, CTA, and
William Fettes, DBA Lawyers

Division 296 tax and reversionary pensions

This month's column discusses whether existing pensions should be made non-reversionary in view of the potential impact of the proposed new 15% Div 296 tax.

Many advisers favour automatically reversionary pensions (ARPs) as a popular strategy for SMSF succession planning. Indeed, in recent times, ARPs have gained prominence and have often been seen as the default choice by many. For instance, some focus on the 12-month deferral of the transfer balance account (TBA) credit for the reversionary beneficiary, with the credit value being locked in at the time of death, as a distinct advantage. However, it is important to properly weigh up all of the key factors when formulating an SMSF succession plan that includes a death benefit pension. Naturally, this should include consideration of potential advantages and disadvantages, especially as we head towards 30 June 2025, with the new Div 296 tax on member balances that exceed $3m proposed to commence from 1 July 2025.

In this article, all legislative references are to the Treasury Laws Amendment (Better Targeted Superannuation Concessions and Other Measures) Bill 2023 (the Bill) unless otherwise stated.

Death benefit pensions under proposed Div 296 tax

Self-managed superannuation fund (SMSF) members and advisers should be aware that ARPs are not treated identically to non-reversionary pensions (eg a "fresh" death benefit pension paid to a surviving spouse) for the purposes of the recipient's adjusted total superannuation balance (TSB) under the Div 296 rules. Accordingly, different Div 296 tax outcomes can arise based on whether a pension is made reversionary or non-reversionary to a surviving spouse or other eligible beneficiary.

Pension capital

Under s 296-55(1)(d), the pension capital supporting a death benefit pension is not counted as part of the recipient's adjusted TSB for the first income year that the pension is payable to the beneficiary as a "retirement phase recipient". This is pursuant to the formula in s 296-45 for calculating an individual's adjusted TSB which subtracts certain "contributions" in a year. This means that:

- for an ARP, the pension capital is subtracted from the reversionary beneficiary's adjusted TSB in the income year of the primary pensioner's death (it, of course, counts for subsequent income years); and
- for a non-reversionary pension, the pension capital is subtracted from the recipient's adjusted TSB in the income year that the new death benefit pension is commenced.

Thus, the reversionary status of a pension can potentially result in a timing difference regarding when the value of the pension capital is tested for Div 296 tax purposes. For example, if a member dies part way through an income year (FY-1), and the trustee commences to pay a fresh death benefit pension to the deceased member's spouse in FY-2, the capital supporting the pension will not be counted for the spouse's adjusted TSB until the following income year. Naturally, this is subject to compliance with the ASAP compulsory cashing rule in reg 6.21 of the *Superannuation Industry (Supervision) Regulations 1994* (Cth) (SISR).

Pension payments

Under s 296-50(1)(d), pension payments in respect of a death benefit pension are included in the recipient's adjusted TSB for Div 296 purposes. This is pursuant to the formula in s 296-45 which adds back certain "withdrawals" in a year. This means that:

- for an ARP, the total amount of pension payments made for the pension in the income year of death (less any payments made to the primary pensioner pre-death) will be reflected in the recipient's adjusted TSB; and
- for a non-reversionary pension, there is no required minimum pension payments needed in the income year of death. Thus, the recipient's adjusted TSB will typically only need to include any pro-rated minimum payments for the newly commenced death benefit pension, ie subject to when the new pension is commenced (of course, this might occur in the following income year).

Example

Consider an SMSF with two members who are in a domestic relationship and who are 85 years of age. Each member has an account-based pension (ABP) with an account balance of $1.9m and an accumulation account with an account balance of $2.5m and no other superannuation entitlements. Both pensions are reversionary to the respective spouse.

In the event that one member dies during a year, the surviving spouse would have a raw TSB of around $6.3m (ie $4.4m + $1.9m). However, for the purposes of calculating the recipient's adjusted total TSB:

1. the capital supporting the reversionary pension is excluded in the income year that the pension reverts to the reversionary beneficiary. In the second year, the

capital supporting the ARP will, of course, be counted when calculating the surviving spouse's adjusted TSB, and there will be an increased exposure to Div 296 tax unless the situation is carefully managed; and

2. the required pension payments for the ARP under Sch 7 SISR that must be met in the income year of the deceased member's death (say 9% of $1.9m = $171,000) are included in spouse's adjusted TSB due to the "withdrawals" component that is added back pursuant to the formula in s 296-45.

The above position, based on having ARPs in place, may in fact be less favourable for Div 296 tax purposes than the outcome where non-reversionary pensions are in place as:

- the timing of when the capital supporting the fresh death benefit pension starts being counted in the recipient's adjusted TSB may occur in a subsequent income year; and
- there is no add-back mechanism in relation to unpaid pension payments for the ceasing pension in the income year of death (ie pursuant to the ATO's administrative concession).

Therefore, it is important that SMSF members and advisers recognise the importance of making the right decision regarding whether to make a pension reversionary as part of each member's SMSF succession plan.

Other considerations

Naturally, there are other considerations that should also be factored into the decision of whether a pension should be made reversionary, such as:

- implications under the Australian financial services licence regime, eg in relation to any situation which may require a statement of advice to be obtained. This may weigh in favour of a reversionary position;
- preserving grandfathering of more favourable eligibility testing rules for the Commonwealth Seniors Health Card and the age pension for pre-1 January 2015 ABPs. This may weigh in favour of a reversionary position;
- transfer balance cap optimisation. Where the value of the assets supporting the pension are expected to increase in the 12-month period after the deceased member's death, an ARP may provide an advantage as the recipient's TBA credit for the ARP is locked in, based on the (lower) market value of the pension capital at the time of death. However, in a declining market, the non-reversionary position may be more advantageous as the TBA credit value will reflect the current market value of the pension capital at the time the pension is commenced;
- strategic considerations in relation to insurance arrangements in an SMSF. In particular, where policy premiums (eg for a life policy) are being paid from a reversionary pension account, the policy proceeds paid to the fund and allocated to the reversionary pension account are not tested for transfer balance cap purposes (ie for the reversionary beneficiary) and will effectively take on the same proportion of taxable and tax-free components as the underlying pension interest. This favours a reversionary position; and
- extra paperwork requirements, eg in relation to valuations and interim accounts. Typically, an ARP requires additional accounts to be prepared to confirm the value of the pension as at the date of death, as well as on the 12-month anniversary of the deceased member's death, in addition to the usual 30 June requirements. In contrast, a non-reversionary pension may involve less work as interim accounts are focused on the value of the assets at the commencement of the pension. This favours a non-reversionary position.

The above factors give an overview of some of the key considerations in deciding whether to revert a pension or not. The authors emphasise that the above is also not an exhaustive list of all relevant considerations.

Conclusion

As can be seen from the above, the proposed new Div 296 tax is an additional factor that broadly weighs against ARPs, thereby providing a counter to the prevailing, popular view that ARPs are the default or "one-size-fits-all" solution.

Instead of starting from the position that ARPs are always or usually the preferred option, advisers should be aware of the potential advantages and disadvantages that can arise in different circumstances, including with respect to the proposed Div 296 tax.

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Alternative Assets Insights

by James Nickless, Hiral Mistry
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Australia's new thin capitalisation regime

From 1 July 2023, general investors will need to ensure that cross-border related party borrowings align with arm's length conditions under transfer pricing rules.

Overview

Major reforms to Australia's thin capitalisation regime (which mostly take effect for income years commencing on or after 1 July 2023) are now law following the enactment of the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024* on 8 April 2024.

In addition to introducing new earnings-based tests for most taxpayers, the amendments removed a key provision of the tax law that prevented the transfer pricing rules from applying to limit the amount of related party debt to an arm's length amount where the thin capitalisation rules applied.

For income years commencing on or after 1 July 2023, general class investors will need to ensure that the quantum of cross-border related party borrowings is consistent with arm's length conditions under the transfer pricing rules. This will be particularly important for taxpayers who are relying on the fixed ratio test or the group ratio test for the current income year and going forward as it could operate to permanently deny debt deductions.

In detail

Prior to the amendments made by the *Treasury Laws Amendment (Making Multinationals Pay Their Fair Share – Integrity and Transparency) Act 2024*, s 815-140 of the *Income Tax Assessment Act 1997* (Cth) prevented the transfer pricing rules from operating to alter the amount of cross-border related party debt that a taxpayer had where the thin capitalisation rules applied to the taxpayer. This meant that, in practice, the thin capitalisation rules set the maximum amount of debt a taxpayer could have, while the transfer pricing provisions set the arm's length pricing of that debt (albeit with regard to a hypothetical arm's length quantum of debt).

The amendments, which apply to income years commencing on or after 1 July 2023, remove the operation of s 815-140 for general class investors (that is, broadly, foreign controlled entities and outbound investors that are not financial entities or authorised deposit-taking institutions). This means that the transfer pricing provisions are required to be considered when determining the arm's length price and the quantum of the debt, and then the thin capitalisation rules apply to the remaining arm's length debt deductions (ie the 30% fixed ratio test is not a safe harbour/debt ceiling where cross-border loans subject to transfer pricing are involved).

This is a key consideration for taxpayers with cross-border related party borrowings who have focused primarily on the outcomes under the fixed ratio or group ratio test, given the rules may operate to deny deductions before applying the thin capitalisation tests. In instances where an entity has excess tax earnings before interest, taxes, depreciation and amortisation, or thinks it is able to carry forward denied debt deductions under the fixed ratio test, they may find that they have a *permanent denial* under the transfer pricing rules before even applying the thin capitalisation rules if the quantum of the loan is not arm's length.

Determining the arm's length debt amount

The ATO has indicated that it is working on releasing guidance on the new thin capitalisation rules, including updating its existing guidance in PCG 2017/4 to take into account these changes and the factors that are relevant to the assessment of risk on cross-border related party borrowings. While this represents one of the initial focus areas announced by the ATO in relation to the release of guidance, the timing of the release of any guidance is currently unknown. re applicable to the current income year for affected taxpayers, steps will be required now to assess and support

There is no universal list of factors that an independent party would consider when establishing the amount of debt that they would be willing to lend or borrow, and this will require consideration in light of the specific industry and circumstances of a taxpayer. Nonetheless, the authors expect that some of the key factors that may be relevant to the assessment of an arm's length quantum of debt may include:

- the general creditworthiness of the borrower, and the key financial metrics analysed by independent lenders or credit ratings agencies in assessing creditworthiness;
- the borrower's history of meeting (or failing to meet) previous debt payments, and forecast serviceability of the relevant related party debt arrangement;
- the purpose of the debt arrangement;
- the availability of collateral/security, including parent guarantees;
- the presence of senior ranking debt;
- any key covenants imposed under debt arrangements for the borrower or broader group;
- the availability of comparable debt observations among industry peers; and

- the "loan to value" or "debt to equity" ratio of the borrower after drawing the debt.

In addition to the above, a key consideration for taxpayers under the transfer pricing rules is to understand and assess the impact of the borrower's position as a member of the broader global multinational group. This is distinct from the operation of the "factual assumptions" that were required to be considered under the previous arm's length debt test provisions and has been a key focus area for the ATO, as well as recent case law, in relation to the arm's length pricing of related party debt arrangements. In this context, understanding the broader group's treasury policies and funding arrangements may be particularly instructive when establishing an arm's length quantum of debt going forward.

Consideration of any alternative funding options available to the borrower at the time of entering related party debt arrangements will also be critical to further support this assessment and the "options realistically available" to the borrower.

The takeaway

Following the repeal of s 815-140 for general class investors, taxpayers will need to consider the arm's length quantum of any cross-border related party debt arrangements in order to avoid potential permanent denial of deductions under Australia's transfer pricing rules.

The transfer pricing rules will apply prior to the application of the fixed ratio or group ratio test under the thin capitalisation rules. Given this will apply for the current income year for affected taxpayers, the authors recommend considering:

- available comparable data or observations considering the specific circumstances and industry of the Australian borrower, including the key terms and conditions and purpose of any cross-border related party debt arrangements;
- evidence of the options realistically available to the Australian borrower at the time of entering the related party debt arrangement (which may have been several years earlier) and intervening periods; and
- the broader funding practices and policies of the Australian borrower's broader global group.

Consideration of the above factors will be critical for any new related party debt arrangements, as well as existing related party debt held by a general class investor. Taxpayers with related party debt arrangements will also be required to consider the application of the debt deduction creation rules going forward, which can apply separate to the transfer pricing rules. Therefore, it is recommended that taxpayers with related party debt arrangements consider the potential application of the new thin capitalisation rules holistically and continue to monitor for the release of ATO guidance to further refine or support the positions adopted going forward.

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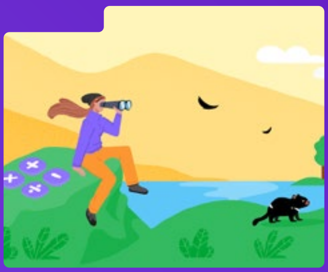
Events Calendar

Upcoming months

OCTOBER
17–18
Thu–Fri

TAS

Tasmanian Convention



12 CPD hours

OCTOBER
17–18
Thu–Fri

VIC

National GST Conference

13 CPD hours

OCTOBER
24–25
Thu–Fri

VIC

National Transfer Pricing Conference

10 CPD hours

OCTOBER/
NOVEMBER
31–1
Thu–Fri

NSW

National Superannuation Conference

12 CPD hours

NOVEMBER
21–22
Thu–Fri

WA

National Resources Tax Conference

10 CPD hours

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Cumulative Index

The following cumulative index is for volume 59, issues (1) to (4). Listed below are the pages for each issue:

Vol 59(1): pages 1 to 44
Vol 59(2): pages 45 to 82
Vol 59(3): pages 83 to 132
Vol 59(4): pages 133 to 174

Legislation

Rulings and other materials

Cases

Authors

Giving back to the profession

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