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The Tax Institute

# Taxation *in* Australia

**Capping superannuation not straightforward**
*Kym Bailey, CTA*

**Asset protection post-Permewan**
*Caite Brewer and Pip Coore*

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### Invitation to write

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# Tax News – at a glance

by TaxCounsel Pty Ltd

# March – what happened in tax?

The following points highlight important federal tax developments that occurred during March 2023. A selection of the developments is considered in more detail in the "Tax News – the details" column on page 497 (at the item number indicated).

## Superannuation rate change

In a joint media release on 28 February 2023, the Treasurer and the Assistant Treasurer announced a change to the taxation of the income of superannuation funds in the accumulation phase. **See item 1.**

## Working from home deductions

The Commissioner has issued a practical compliance guideline that outlines a revised fixed-rate method for calculating the work-related additional running expenses incurred on or after 1 July 2022 as a result of working from home (PCG 2023/1). **See item 2.**

## Decision impact statement: Landcom

The Commissioner has released a decision impact statement in relation to the decision of the Full Federal Court in the *Landcom* case (*FCT v Landcom* [2022] FCAFC 204). **See item 3.**

## Suppression order refusal upheld

The Full Federal Court (Thawley, Stewart and Abraham JJ) has unanimously dismissed an appeal from an interlocutory decision of Bromwich J in which his Honour refused to make suppression orders in respect of the entirety of affidavits (which had been relied on by the Deputy Commissioner of Taxation in an ex parte application for freezing orders) and granted access to the affidavits to a journalist (*Lee v DCT* [2023] FCAFC 22. **See item 4.**

## Alternative assessments for same income

In a unanimous decision, the Full Federal Court (Logan, Bromwich and Hespe JJ) has affirmed a decision of Greenwood J at first instance in which his Honour rejected a claim for declaratory relief where assessments had been issued to different taxpayers in respect of the same amount (*Hyder v FCT* [2023] FCAFC 29).

## NSW taxi licence Financial Assistance Scheme

The Commissioner has released a factsheet that explains the tax implications for New South Wales taxi licence owners who apply for a payment under the Point to Point Financial Assistance Scheme from the NSW Government under the *Point to Point Transport (Taxis and Hire Vehicles) Amendment Act 2022* (NSW).

## Electric vehicles: FBT

Another factsheet issued by the Commissioner outlines how an employer's FBT obligations are determined where an employee is provided with an electric vehicle and associated items for their private use.

## Managed investment schemes

In a media release on 8 March 2023, the Assistant Treasurer announced that the government is taking further steps to ensure that there are strong investor protections in place across the financial sector and, to this end, was tasking the Treasury to review the managed investment schemes (MISs) regulatory framework. However, the review will not consider issues relating to the tax treatment of MISs and investors.

## Singapore hub settlement

A settlement has been reached between the ATO and Ampol Ltd which covers the transfer pricing outcomes of refined products and crude oil between Ampol Singapore and Ampol Australia, as well as how Australia's controlled foreign companies regime will apply to the profits of Ampol Singapore.

In a media release, the ATO said that the Tax Avoidance Taskforce has had a focus on offshore procurement hubs for a number of years. Broadly, under these models, an offshore entity of the multinational group (the procurement hub) is used to procure goods from third-party suppliers and in turn on-sell those goods to the Australian arm of the group. The procurement hub is typically located in a low or no tax jurisdiction.

President's Report

by Marg Marshall, CTA

# Necessary reform for our future

Tax reform is a necessary step for all of us, including those in the tax profession and those in the wider community.

In the lead-up to another Federal Budget, it's important for us to take a moment to reflect on our goals for the profession and for the tax system we all work with.

An efficient, fair and sustainable tax system is important for all of us – not just for practitioners, regulators and government, but also for every one of your clients, from individual taxpayers, to small business owners, to large corporates.

The Institute has been advocating for tax reform on a number of fronts in recent years. We are frequently featured in the media educating the public on the importance of holistic, meaningful reform. We also consult with government and regulators on issues of concern as they arise, through our submissions and work on various committees.

Some of the key issues we have been working to address recently include the superannuation system, FBT, digital activity statements, and the impact of the tax system on cost-of-living pressures. In these activities, we represent you and your interests within our system. You can follow our progress in our Advocacy Tracker, which is published on our website, and each week in the *TaxVine* newsletter. If an issue arises that you have a particular interest or expertise in, I also encourage you to reach out to our team and get involved in our advocacy work.

On a wider scale, we continue to advocate for overall system reform. In 2021, under Peter Godber's Presidency, with significant steering from Andrew Mills, CTA (Life), and with contributions from many of our talented members, we developed the *Case for Change* report, laying out an expansive discussion around tax reform. In that report, we highlighted the issues within our tax system and raised numerous options for reform, some of which have since taken centre stage within the profession.

There are a multitude of options when it comes to tax reform and each needs to be considered for its merits, drawbacks and knock-on effects in other areas of the system. That is half (or perhaps more than half) the reason that holistic tax reform has not yet been tackled seriously – reforming the system can quickly become as complex as the system itself. It is also, however, incredibly necessary.

As a profession and as a wider community, we have been aware of the overwhelming complexity of our tax system, at least since the *Australia's Future Tax System Review Final Report* in 2009 (the Henry review). And since that time, the complexity has only increased as additional measures are introduced to "paper over" cracks in a creaky old system.

The upcoming Federal Budget is an opportunity to set a holistic vision for the tax system to take steps towards true tax reform. We can't and don't expect the system to be overhauled in a single Budget, but we do hope to see the conversation opened on the national stage in a sincere, organised and proactive step towards a long-term vision of reform.

Genuine reform will address the complexity in our tax system, create an environment of certainty for taxpayers, and facilitate compliance with fair, simple tax obligations. It is also a good step for regulators, especially the ATO, which will be able to free up resources for other priorities once the system no longer needs constant bandaids to continue functioning.

But again, it's not just tax practitioners and regulators who benefit from tax reform – it touches everyone. Tax is a lever which allows us to influence important issues today, such as investment in environmental sustainability, Australia's skilled labour shortage, and repaying the national debt while maintaining economic stability.

Setting a vision for tax reform and then following through with genuine action are vital, both for the health of our economy and community today, and for future generations who deserve a resilient and efficient tax system.

## CEO's Report

by Giles Hurst

# Investing in your tax career

CEO Giles Hurst reflects on the importance of investing in yourself and your career each and every day.

As I'm sure all of you reading this know, one of the first things they teach you when it comes to managing your personal finances is the power of compound interest. Earning interest on your interest means that, over time, your initial investment grows faster and stronger than it might otherwise. Small investments building over time can become significant gains.

This is a lesson that applies to many facets of life.

In her report this month, Marg has detailed how we are investing in the future of reform in our tax system and how we hope that, in the upcoming Federal Budget, the government will invest in a vision for reform as well. Tax reform is not a task that can be achieved piecemeal, but the work of beginning that conversation has required many investments over the last few years. We continue to invest time, effort and resources into this important shared goal for all of us. Our current engagement with the federal government is sure to pay dividends in lower compliance costs, reduced work time, and better client outcomes.

But while we have one eye on the future of our tax system, it's also imperative to have your own career progression in mind. One of our guiding purposes at The Tax Institute is to support our members throughout their career, from the early days of finding your feet, to mentoring others who seek to follow in your professional footsteps. We facilitate investment into your career and celebrate the benefits with you.

A membership with us is an upfront investment that opens doors and creates opportunity. Above and beyond that, the time and engagement that you put into your membership partly determines how much value you get back from it.

An investment of time and effort into education or upskilling may build to expertise as a subject-matter expert in the future. An investment in your connections may pay off through the next big job opportunity.

Your daily practice, I'm sure, is also an opportunity to make small investments in your knowledge and skills. We support that day-to-day growth by providing you timely resources on emerging issues, regular news updates through *TaxVine*, and a wealth of historical analysis and information in our Tax Knowledge Exchange database.

Personally, I take an approach of aiming to learn something new every day. Often, it's just something small and sometimes completely unrelated to my larger goals in life and career. But the cumulative effect of those learnings and the daily habit of making small increases in my knowledge add up to a sense of continued growth that is very satisfying.

The sooner you start making investments – whether that is in terms of time, resources, money or effort – the more you will eventually benefit from the compounding effect of skills that grow, little by little, each day. I hope that your membership thus far has allowed you opportunity to invest in yourself, and to see that effort pay off as you meet career goals, big and small.

What investments are you making today that will pay off tomorrow, next year, or perhaps even many years into the future? As always, if there are ways that we can better support you or new avenues we haven't yet explored, we are receptive to your ideas and feedback. Please don't hesitate to reach out.

Senior Tax Counsel's Report

by Julie Abdalla, FTI

# The new working from home rate

With the ATO recently releasing the new working from home rate, we examine how it applies an administrative solution to a longstanding gap in the legislation on working from home expenses.

In April 2020, the ATO announced that taxpayers could use a new temporary rate (the shortcut method) for determining their claim in respect of working from home. This method was initially proposed to be available for the period 1 March 2020 to 30 June 2020. As the COVID-19 pandemic extended beyond what was initially anticipated, the shortcut method was extended to 30 June 2021 and then until 30 June 2022.

The ATO was clear in its communications from the beginning that this method was only a "temporary" concession, arising from sudden changes to working arrangements as a result of the COVID-19 pandemic. Since then, and in light of changed working arrangements, taxpayers and practitioners have been eagerly awaiting any indication from the ATO as to whether taxpayers would have to revert to using the existing fixed rate method, or if a new method would be developed that better reflects the current environment.

On 16 February 2023, the ATO released finalised guidance on the working from home rate that taxpayers can use to calculate their home office expenses. This is contained in PCG 2023/1.

## What has changed?

PCG 2023/1 introduces a revised fixed rate method (RFRM) that taxpayers can use to calculate their working from home claim from 1 July 2022 onwards. Similar to the shortcut method and the previous fixed rate method, the RFRM is an administrative concession. These rates (and methods) are not prescribed in the legislation, unlike the cents per kilometre method which requires the Commissioner to determine this rate with regard to the average operating costs of cars covered by the rate in Subdiv 28-C of the *Income Tax Assessment Act 1997* (Cth).

The Commissioner has acknowledged the difficulties that taxpayers may have in determining their working from home claim using the actual cost method and has exercised his general powers of administration in providing this concession. In many cases, this is of significant benefit to taxpayers, such as by reducing the highly onerous record-keeping requirements otherwise associated with working from home claims. However, it can create some challenges for taxpayers who choose to use it in determining their working from home claim.

## What happens in the event of a dispute?

In the event that a taxpayer lodges an objection in respect of their working from home claim, they will be unable to rely on the RFRM. Rather, they will be required to use the actual cost method. In this event, the taxpayer is unlikely to have retained all of the appropriate records that the actual cost method requires to enable them to claim the relevant expenses.

From a policy perspective, the RFRM is (and previous shortcut and fixed rate methods were) trying to bridge a gap in the legislation through an administrative solution. As we can see from the above example, it is an imperfect solution. A problem that has existed for two decades requires a permanent, robust solution.

## A proposed solution

Taxpayers should not be worse off as a result of using an administrative concession provided by the Commissioner than if they had relied on a legislative provision. Enshrining this method in legislation (similar to that in Subdiv 28-C) would provide certainty for taxpayers that they can continue to access the concessional methodology on objection. It would also ensure that the rate is representative of the actual costs taxpayers are incurring and provide transparency of how the Commissioner will adjust the rate so it continues to be an accurate reflection of these costs.

The Commissioner is aware of this issue, which was raised in The Tax Institute's submission on the draft version of PCG 2023/1. However, a legislative fix requires action by the government to ensure that taxpayers rights are preserved and that there is greater transparency of Australia's tax measures.

We continue to educate and advocate for our members and the broader tax community on this and other policy topics. Let us know in The Tax Institute's Community your thoughts about a legislative fix for working from home expenses.

# Tax News – the details

by TaxCounsel Pty Ltd

# March – what happened in tax?

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

## Government initiatives

### 1. Superannuation rate change

In a joint media release on 28 February 2023, the Treasurer and the Assistant Treasurer announced a change to the taxation of the income of superannuation funds in the accumulation phase.

The change is to apply from 1 July 2025 and will affect individuals whose total superannuation balances (TSBs) at the end of an income year exceed $3m. These individuals are to be subject to an additional tax of 15% on the earnings on any balance that exceeds the $3m threshold.

The extra tax is to only apply to the proportion of earnings corresponding to balances above $3m. This means that earnings corresponding to funds below $3m will continue to be taxed at 15% or less. Earnings are to be calculated with reference to the difference in TSBs at the start and end of the financial year, adjusted for withdrawals and contributions. Negative earnings will be able to be carried forward and offset against the tax in future years' tax liabilities.

The Treasury has released a document, *Better targeted superannuation concessions*, which explains the proposed change and contains several examples, including the following:

**Example 1**

Warren is 52 with $4m in superannuation at 30 June 2025. He makes no contributions or withdrawals. By 30 June 2026, his balance has grown to $4.5m.

This means that Warren's calculated earnings are: $4.5m – $4m = $500,000.

His proportion of earnings corresponding to funds above $3m is: ($4.5m – $3m) ÷ $4.5 m = 33%.

Therefore, the extra tax liability for 2025–26 is: 15% × $500,000 × 33% = $24,750.

**Example 2**

Dave is 70 and has two APRA-regulated funds and one SMSF. At 30 June 2025, his TSBs across all funds was $7m.

**Example 2 (cont)**

During 2025–26, he withdraws $400,000 from his SMSF and makes no contributions. At 30 June 2026, his TSBs across all funds is $6m.

This means that Dave's calculated earnings are: $6m – $7m + $400,000 = –$600,000. His proportion of earnings corresponding to funds above $3m is: ($6m – $3m) ÷ $6m = 50%.

The earnings loss attributable to the excess balance is $300,000. Dave can carry forward the $300,000 to offset future excess balance earnings.

At 30 June 2027, Dave's funds make earnings on his excess superannuation balance of $650,000. He carries forward the earnings losses attributable to his excess balance at 30 June 2026 of $300,000 and is only liable to pay the tax on $350,000 of earnings. This means his tax liability for 2026–27 is: 15% × $350,000 = $52,500.

## The Commissioner's perspective

### 2. Working from home deductions

The Commissioner has issued a practical compliance guideline that outlines a revised fixed-rate method for calculating the work-related additional running expenses incurred on or after 1 July 2022 as a result of working from home (PCG 2023/1).

A taxpayer can rely on PCG 2023/1 to calculate their deduction for additional running expenses using the method outlined in the guideline if they are:

- working from home while carrying out their employment duties or carrying on their business on or after 1 July 2022;
- incurring additional running expenses of the kind outlined below which are deductible under the general deduction provision (s 8-1 of the *Income Tax Assessment Act 1997* (Cth) (ITAA97)) as a result of working from home; and
- keeping and retaining relevant records in respect of the time that they spend working from home and for the additional running expenses (covered by the rate per hour) that they are incurring.

The taxpayer does not need to have a separate home office or dedicated work area set aside in their home in order to rely on PCG 2023/1.

PCG 2023/1 does not cover occupancy expenses such as rent, mortgage interest, property insurance and land tax. For the Commissioner's views on the deductibility of these expenses, reference may be made to TR 93/30.

#### Revised fixed-rate method

The revised fixed-rate method apportions the following additional running expenses that the taxpayer incurs on a fair and reasonable basis by using a fixed rate of 67c per hour for each hour that the taxpayer worked from home during the income year:

- energy expenses (electricity and gas) for lighting, heating, cooling and electronic items used while working from home;
- internet expenses;
- mobile and home phone expenses; and
- stationery and computer consumables.

The rate per hour calculates the total of the taxpayer's deductible expenses for energy, internet, mobile and home phone, and stationery and computer consumables for the income year.

This means that a taxpayer cannot claim an additional separate deduction for any of these expenses. For example, if the taxpayer were to use their mobile phone when they are working from home and when they are working from somewhere other than their home, the taxpayer's total deduction for mobile phone expenses for the income year will be covered by the hourly rate of 67c per hour.

A taxpayer can also claim a deduction for the work-related decline in value of any depreciating assets that the taxpayer used to work from home during the income year and any other running expenses that the taxpayer incurred which are not covered by the rate per hour.

### ATO compliance approach

The Commissioner will not apply compliance resources to review a taxpayer's deduction for working from home expenses if the taxpayer meets the criteria outlined in PCG 2023/1 and uses the revised fixed-rate method outlined in the guideline to calculate the additional running expenses that they incur as a result of working from home.

PCG 2023/1 does not apply if the taxpayer claims a separate deduction for any of the expenses listed above. Also, if a taxpayer does not use the revised fixed-rate method, the taxpayer will need to use the actual expenses method to claim a deduction for the additional expenses that they incur as a result of working from home.

PCG 2023/1 gives a number of illustrative examples, including the following (example numbers in the guideline are retained):

**Example 1**

Gerry is employed as a bookkeeper. He goes into the office to work three days a week and works from home two days a week. When he is working from home, Gerry uses his employer-provided laptop, his home internet connection, and his personal mobile phone. He also turns on the light and the air conditioning or the ceiling fan in the room in which he is working. The cost of the chair and desk that Gerry uses was reimbursed by his employer.

As Gerry uses his employer-provided laptop, he is not entitled to claim a decline-in-value deduction for it. Gerry also cannot claim a decline-in-value deduction for the chair and desk he uses at home.

During the income year, Gerry keeps and retains all relevant records. Based on his record of hours, Gerry

**Example 1 (cont)**

worked from home for 768 hours during the income year.

As Gerry meets all of the relevant criteria, he decides to calculate his working from home expenses using the revised fixed-rate method. He calculates his deduction as:

768 hours × 67c per hour = $514.

No additional amount is added to the hourly rate as Gerry is not entitled to a decline-in-value deduction for any of the depreciating assets that he uses when he works from home.

In his tax return for the income year, Gerry claims a deduction of $514 for his working from home expenses.

**Example 5. Incurring additional running expenses**

Pierre runs a plumbing business. When he gets home each day, he sends out invoices to his clients, calls clients, orders or purchases parts that he will need for certain jobs he has booked in, checks his bank account for client payments, and emails a reminder to clients whose payments are overdue. He does this work using his computer, his home internet connection, and his mobile phone. Pierre's mobile phone bill is in his name so he has incurred the expense. However, his electricity bills are in his partner's name and the internet bill is in his and his partner's name. All of Pierre's household expenditure is paid from a joint bank account, so Pierre is considered to have incurred the electricity and internet expenses as well.

If Pierre meets the other requirements set out in PCG 2023/1, he can rely on the guideline to calculate his additional running expenses.

If a taxpayer lodges an objection in relation to their working from home expenses for whatever reason, they cannot rely on using the revised fixed-rate method in PCG 2023/1 to determine whether they are entitled to a deduction for their expenses. Only the actual expenses that they incurred as a result of working from home and for which they have adequate records will be allowed as a deduction.

It should be noted that, if more than one taxpayer in the household is working from home at the same time, each taxpayer can rely on PCG 2023/1 only if each of those taxpayers meets all of the requirements set out in the guideline.

Also, taxpayers working in the same household at the same time can choose which method they will use to calculate their expenses, that is, revised fixed rate or actual expenses.

## 3. Decision impact statement: Landcom

The Commissioner has released a decision impact statement in relation to the decision of the Full Federal Court in the *Landcom* case (*FCT v Landcom*[1]).

That case concerned the application of the GST margin scheme to disposals of land by Landcom (a New South

Wales state-owned corporation that develops and sells real property) of the freehold interests in a number of lots of land which it intended to sell in a single transaction. In a private ruling, the Commissioner ruled that, for the purposes of item 4 of the table in s 75-10(3) of the *A New Tax System (Goods and Services Tax) Act 1999* (Cth) (GSTA99), Landcom's supply of multiple freehold interests was a single supply of land.

On the question of the operation of the margin scheme, the Full Federal Court agreed with Thawley J that the better construction of Div 75 GSTA99, when viewed in light of its objects, was that the provisions of the Division should be applied separately to each individual interest that is supplied. This was the case even if supply of the interest formed part of a larger supply of land, as occurred in the present case.

The decision impact statement states that the Commissioner will administer the law in accordance with the conclusions of the Full Federal Court and Thawley J. The statement goes on to state that, in many cases, this will not change the overall outcome for non-government taxpayers as the final GST outcome will be largely the same whether liabilities and entitlements are determined collectively or individually for each interest. However, this will not necessarily be the case for government entities. For supplies by such entities, each interest supplied will need to be considered separately when determining whether the supply is a supply of unimproved land to which s 38-445 GSTA99 (grants of freehold and similar interests by governments) or item 4 of the table in s 75-10(3) GSTA99 may apply.

## Recent case decisions

### 4. Suppression order refusal upheld

The Full Federal Court (Thawley, Stewart and Abraham JJ) has unanimously dismissed an appeal from an interlocutory decision of Bromwich J in which his Honour refused to make suppression orders in respect of the entirety of affidavits (which had been relied on by the Deputy Commissioner of Taxation in an ex parte application for freezing orders) and granted access to the affidavits to a journalist (*Lee v DCT*[2]).

On 15 July 2021, the Commissioner commenced proceedings seeking judgment against a Mr Phillip Lee in the amount of almost $280m, plus general interest charge. The originating application also contained claims for interlocutory relief which included a claim for freezing orders over certain assets of Mr Lee and seven other respondents, who were the appellants in the proceedings before the Full Federal Court. The originating application and claims for interlocutory relief were supported by two affidavits of Mr Yi Deng, an ATO officer.

On 27 September 2021, *The Age* made a request for access to Mr Deng's affidavits. Access was not immediately granted, with Bromwich J deciding to ascertain the position of the parties before deciding whether or not to grant access. Motivated at least in part by *The Age's* application for access, the appellants filed an interlocutory application on 2 December 2021 seeking a number of orders, including that:

- the court's file in the matter be marked suppressed; and
- the information not be published if it relates to the matter and is information that: comprises evidence or information about evidence; was obtained by the process of discovery; was produced under a subpoena; or was lodged with or filed in the court.

Bromwich J refused to make the wide-ranging orders which were sought and granted access to the affidavits. The access orders were stayed pending resolution of the appeal proceedings before the Full Federal Court.

The Full Federal Court in a joint judgment granted the appellants leave to appeal from the decision of Bromwich J and dismissed the appeal. In dismissing the appeal, the Full Court considered a number of issues, including issues arising under Div 355 of Sch 1 to the *Taxation Administration Act 1953* (Cth) (confidentiality of taxpayer information).

As to the application for a suppression order, the Full Court said that there was no proper basis on which it could be concluded that the entirety of the evidence should be the subject of a suppression order because there was no proper basis to conclude that such an order was "necessary to prevent prejudice to the proper administration of justice".[3] No specific material was identified which would cause any harm. The existence of the freezing orders had been published in the media. All of the harm identified by the appellants was caused by the freezing orders and the media articles.

The Full Court said that none of this was altered by adding to the relevant considerations the fact that Div 355 of Sch 1 contains a statutory regime aimed at preserving the secrecy of "protected information", and that those provisions operated according to their terms and did not directly address the present circumstances. The terms of that regime could not dictate the answer in a separate statutory regime. That was not to say that the existence of the regime was irrelevant when considering whether a suppression order is "necessary" in any given case. The existence of the regime, and its application (or non-application), was a part of what falls to be considered when deciding whether a suppression order is "necessary to prevent prejudice to the proper administration of justice".

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#### References

1 [2022] FCAFC 204.

2 [2023] FCAFC 22.

3 See s 37AG of the *Federal Court of Australia Act 1976* (Cth).

# Tax Forum Season

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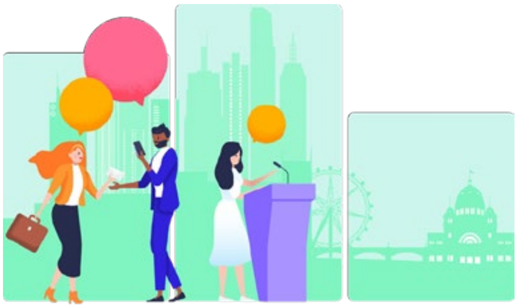

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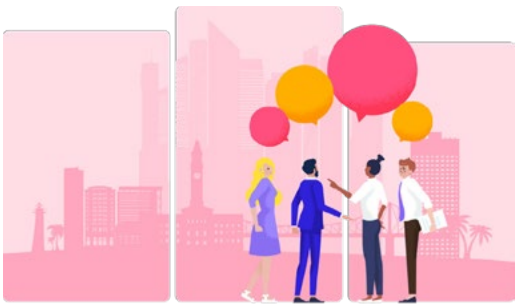

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The Tax Institute

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# Tax Tips

by TaxCounsel Pty Ltd

# Tax agents: what can they do?

A recent decision of the NSW Supreme Court highlights a potential limitation on the scope of a tax agent's activities.

## Background

The *Tax Agent Services Act 2009* (Cth) (TASA09) created a regulatory regime that governs the registration and activities of tax agents.[1]

In very broad terms, the TASA09 operates by imposing civil penalties where an entity other than a registered tax agent provides a service that they know, or ought reasonably to know, is a "tax agent service" and charges or receives a fee for providing the service (s 50-5 TASA09).

There is an effective exclusion from this prohibition if a tax agent service is not the preparation or lodgment of a return and is provided as part of a legal service.

For what constitutes a tax agent service and a taxation law for the purpose of the TASA09, see under "TASA09 provision" below.

From the perspective of state and territory laws, those laws which govern the carrying on of a legal practice will potentially become relevant.

## A recent case

In his recent judgment in *Galea v Camilleri; The Estate of Patricia Camilleri* (*Estate of Patricia Camilleri*),[2] Meek J of the NSW Supreme Court considered the question of the operation of the *Legal Profession Uniform Law (NSW)* (Uniform Law) in relation to the giving of advice by a registered tax agent who was not a registered legal practitioner. The advice given related to the operation of the *Duties Act 1997* (NSW) (the Duties Act).

More particularly, the issues for decision arose in relation to the administration of the estate of the late Patricia Camilleri (the deceased) who died on 21 October 2014. The beneficiaries of the estate were the deceased's children. Specifically, the issues involved a claim by some of the beneficiaries against the executor of the estate (who was one of the children) alleging wrongdoing in the administration of the estate.

Since early 2014, about seven months prior to the deceased's death, the family had engaged in various pieces of litigation impacting on the deceased's estate, including the present litigation which alleged maladministration of the deceased's estate by the executor.

Apart from the family members, various other professional persons were involved in the present proceedings either by providing services in respect of the estate, giving evidence, or otherwise being referred to in evidence. Importantly, for present purposes, those persons included Christopher Batten (Mr Batten) who was a director and principal of MGS Private Pty Ltd (MGS) and an accountant/chartered tax adviser/registered tax agent who gave "revenue" advice in relation to the deceased's estate and the executor.

The deceased left a will dated 20 September 2010 and a codicil dated 15 November 2013, probate of which was granted to the executor on 14 August 2015.

The deceased's estate was, for probate purposes, valued in excess of $23m. A significant majority of the deceased's estate was comprised of 12 pieces of real property, seven of which were specifically gifted to various of the deceased's children and five of which fell into residue which passed to such of her children who survived her in equal shares.

The plaintiffs' claims were somewhat complex but, for present purposes, it may be said that the claims included a claim that the executor should not have paid Mr Batten for some or all of the work he did because that work was in the nature of legal work and was, therefore, irrecoverable by him.

## Mr Batten

Mr Batten was called to give evidence but was not a party to the proceedings and so did not have the rights of a party to the proceedings.

When Mr Batten was called to give evidence, he appeared represented by senior counsel and sought a certificate pursuant to s 128 of the *Evidence Act 1995* (NSW) (privilege in respect of self-incrimination in other proceedings). Meek J was willing to grant Mr Batten a certificate and Mr Batten proceeded to be cross-examined. His Honour said that the context of Mr Batten giving evidence was that there were allegations that he was impermissibly conducting legal work.

On 19 May 2018, Mr Batten provided advice in relation to CGT arising from the sale of certain properties, or the transfer of the properties, to the beneficiaries in specie and also the consequences of any duty under the Duties Act if certain of the properties were transferred to the beneficiaries in specie.

Mr Batten gave further advice in respect of transfer duty and corresponded with the ATO in relation to CGT issues and the obtaining of private rulings from the ATO.

MGS sent invoices to the executor for the work done by Mr Batten.

## The prohibition on "engaging in legal practice"

As indicated, one complaint of the plaintiffs was that some or all of the work that Mr Batten (a tax agent but not a registered legal practitioner) did was in the nature of legal work and, so, s 10 of the Uniform Law was contravened.

The plaintiffs submitted that Mr Batten was not a legal practitioner and therefore, pursuant to s 10(2) of the Uniform Law,[3] he was not entitled to recover for that work. It was submitted that the estate should not have paid for the work and that it was entitled to a reimbursement.[4]

So far as is relevant, s 10 of the Uniform Law provides:

> **"10 Prohibition on engaging in legal practice by unqualified entities**
>
> (1) An entity must not engage in legal practice in this jurisdiction, unless it is a qualified entity.
>
> Penalty: 250 penalty units or imprisonment for 2 years, or both.
>
> (2) An entity is not entitled to recover any amount, and must repay any amount received, in respect of anything the entity did in contravention of subsection (1). Any amount so received may be recovered as a debt by the person who paid it."

The concept of "legal practice" for this purpose is not defined.

## What work was disputed?

Meek J said that, in essence, the issue relating to legal practice was whether work carried out by an accountant or registered tax agent, in relation to the Duties Act (which is not a "taxation law" as defined[5]), might involve someone in the position of Mr Batten impermissibly "engaging in legal practice" such as to contravene s 10 of the Uniform Law.

His Honour went on to say that, for the plaintiffs to succeed in relation to this issue, there needed to be a determination as to whether the estate should not have paid for the work performed by Mr Batten on the basis that his work in relation to advising in respect of the application for exemption under the Duties Act involved Mr Batten impermissibly "engaging in legal practice".

## Engaging in legal practice

Meek J said that he was not provided with specific submissions by reference to case law as to what was meant by "engaging in legal practice" and, in particular, whether work in relation to the Duties Act was such "engagement". His Honour went on:[6]

> "There are decisions of Courts in NSW (and, indeed, other jurisdictions) dealing with the meaning of various antecedent forms of the phrase 'engage in legal practice' in s 10 *Uniform Law* as well as NSW decisions dealing with s 10 *Uniform Law* itself. Those decisions emphasise that:
>
> (1) the expression 'engage in legal practice' means 'engage in legal practice as a legal practitioner' (*Felman v Law Institute of Victoria* [1998] 4 VR 324 … at 352 per Kenny JA (Winneke P and Brooking JA agreeing); *Council of the New South Wales Bar Association v Dwyer* [2015] NSWCA 302 at [12] per Emmett JA (Basten and Ward JJA – as their Honours then were – agreeing));
>
> (2) what constitutes engaging in legal practice is a question of fact to be determined objectively in each case (*Council of the Law Society of New South Wales v Australian Injury Helpline Ltd* … [2008] NSWSC 627 … at [55] per Adams J; *Overdean Developments Pty Ltd v Garslev Holdings Pty Ltd (No. 3)* [2021] NSWSC 1482 at [792] per Williams J; *Vaughan v Legal Services Board* [2008] VSC 200 at [5] per Pagone J);
>
> (3) there is no bright line in separating the permissible legal work from the impermissible legal practice (*Council of the Law Society of New South Wales v Australian Injury Helpline Ltd* at [55]); and
>
> (4) some activities (such as the giving of advice) regularly performed by legal practitioners are also frequently lawfully performed by persons who are not legal practitioners (including, e.g., accountants, financial advisors and tax agents etc) (*Kekatos v The Council of the Law Society of New South Wales* [1999] NSWCA 288 at [18] per Giles JA (Handley and Powell JJA agreeing); *Felman v Law Institute of Victoria* at 350).
>
> It is evident by reference to the above decisions that what I have described as the preliminary question is a contestable issue."

It will be seen that point (4) above is particularly important. The passage from the judgment of Giles JA in the *Kekatos* case referred to by Meek J is as follows:[7]

> "In the present case, it must therefore be asked whether, so far as the provisions of Pt 3A of the Act involved acting as a solicitor, Mr Kekatos did things which, although not required to be done by a solicitor, were usually done by a solicitor, and did those things in such a way as to lead to the reasonable inference that he was a solicitor. The cautionary qualification in *Felman v Law Institute of Victoria* must be remembered, and in … *Law Society of New South Wales v Seymour* [[1999] NSWCA 117] Fitzgerald JA, with whom Priestley and Stein JJA agreed, said –
>
>> 'While some activities regularly performed by solicitors are also frequently lawfully performed by persons who are not solicitors, for example, by accountants, merchant bankers, financial advisers, etc. other activities regularly performed by solicitors, including activities which may be lawfully performed by a person who is not a legal practitioner with a current practising certificate, might seldom, if ever, be performed by any person who is not a solicitor. Although activities which fall into either category are material, an affirmative answer to the second question drawn from [*Re Sanderson; Ex parte Law Institute (Vic)*] [1927] VicLawRp 57 … will likely be difficult to arrive at if the only relevant activities are in the first category and are limited in their number and nature. There is no policy justification for including activities which may be lawfully carried out by any person who does not act as though he or she has a status which he

> or she does not possess within the monopoly of legal practitioners with practising certificates.
>
> …
>
> The inference required by the second question based on *Sanderson* [1927] VicLawRp 57 … must be considered by reference to a reasonable person with knowledge of the material activities, which will include any statement by which the person performing the activities misrepresents that he or she is a solicitor or explains that he or she is not a solicitor. The reasonable person to be considered is a person dealing with the person alleged to have acted as a solicitor. When activities may lawfully be carried out by a person who is not a solicitor, his or her knowledge that the person with whom he or she is dealing is aware that he or she is not a solicitor, even if not based on his or her acknowledgment of the true position, makes it difficult, if not impossible, to be satisfied that the only reasonable inference open is that he or she acted as a solicitor."

Meek J said that, where findings may affect, even indirectly, non-parties' interests or for the taking of an account or the making of an inquiry in proceedings for the administration of the estate of a deceased person, notice should be given to such person pursuant to the court rules so as to permit the person to have an opportunity to intervene in the proceedings to seek to protect their interests.

His Honour said that there were no particular submissions made by reference to statutory construction principles and any relevant case law regarding whether the sort of work carried out by Mr Batten in relation to advising in respect of the application for exemption under the Duties Act involved Mr Batten impermissibly "engaging in legal practice".

## Invoice 1720

In relation to one invoice issued by MGS (invoice 1720), Meek J said that he considered there was "at least a tenable argument" that the eighth and ninth items arguably fell within permissible work pursuant to a "tax agent service".[8]

Those two items were as follows:

| | |
|---|---|
| "Service | 11/08/2019 – Drafting application for a private ruling from the ATO in relation to the disposal of the property at 19 Holbeche Road, Arndell Park, New South Wales |
| Service | 05/09/2019 – Meeting with John Camilleri and Amanda Fisher in relation to the Estaqte [sic] of the Late Patricia Camilleri" |

However, in light of the fact that:

1. Mr Batten was not joined to the proceedings;
2. there was a contestable issue regarding whether Mr Batten's work and advice in respect of the application for exemption under the Duties Act involved him impermissibly "engaging in legal practice"; and
3. no express submissions were made,

Meek J said that he expressly refrained from making any determination in relation to whether the executor, by reason of s 10 of the Uniform Law, impermissibly paid monies from the estate to discharge Mr Batten's invoice 1720.

With respect, Meek J's reference to the eighth and ninth items of invoice 1720 is a little puzzling. Neither of these items appear to have reference to the issues that arose in relation to the Duties Act. There were several items in the invoice which did refer to the Duties Act.[9]

## Observations

The decision of Meek J in the *Estate of Patricia Camilleri* case raises an issue of considerable importance in relation to the carrying on of a tax and accounting practice where advice is given in relation to state or territory revenue laws (for example, land tax or stamp duty legislation) and the practice does not include a legal practitioner.

It is not known whether the litigation in the *Estate of Patricia Camilleri* case will proceed further, but if it does not, the uncertainty as to the extent to which a registered tax agent may give advice on state or territory taxation issues will remain. The observations in the cases referred to above under the heading "Engaging in legal practice" should be noted.

At a practical level, an important issue may arise for registered tax agents out of the terms of their professional indemnity insurance cover. For example, if the terms of the policy contain an exclusion in respect of the provision of legal advice, this may create some problems. And if the exclusion was qualified so that it only applied to legal services provided other than in the course of rendering a tax agent service as defined in the TASA09, this would create difficulties in the kind of case considered in the *Estate of Patricia Camilleri* case.

It is suggested that the issues raised by the *Estate of Patricia Camilleri* case should be addressed. This could be done, for example, by an appropriate definition of what constitutes legal practice for the purposes of s 10 of the Uniform Law.

Failing that, practitioners will need to rely on the observations made in other cases dealing with "the engaging in legal practice" concept (see above).

There is, it is submitted, an issue as to the overlap of the legal service concept and the tax agent service concept. The provisions of the TASA09 envisage that a tax agent service can be a legal service; as noted at the beginning of this article, there is a specific provision which effectively excludes certain legal services from the operation of the Act.

But what is the situation of a tax agent who is not a registered legal practitioner but does work that would be both a tax agent service and a legal service? It is submitted that the TASA09 indicates an intention to cover the circumstances in which a tax agent service may be provided, and to this extent, the operation of the legal services regime would be displaced.[10] The determination of the scope of the operation of the definition of "tax agent service" will, of course, be of critical importance.

## TASA09 provision

The following provision of the TASA09 is particularly relevant to this article:

> "**90-5 Meaning of tax agent service**
>
> (1) A ***tax agent service*** is any service:
>
> (a) that relates to:
>
> (i) ascertaining liabilities, obligations or entitlements of an entity that arise, or could arise, under a taxation law; or
>
> (ii) advising an entity about liabilities, obligations or entitlements of the entity or another entity that arise, or could arise, under a taxation law; or
>
> (iii) representing an entity in their dealings with the Commissioner; and
>
> (b) that is provided in circumstances where the entity can reasonably be expected to rely on the service for either or both of the following purposes:
>
> (i) to satisfy liabilities or obligations that arise, or could arise, under a taxation law;
>
> (ii) to claim entitlements that arise, or could arise, under a taxation law.
>
> (2) A service specified in the regulations for the purposes of this subsection is not a ***tax agent service***.
>
> Note: For specification by class, see subsection 13(3) of the *Legislation Act 2003*."

For the purposes of this definition, the expression "taxation law" has the meaning it has for the purposes of the *Income Tax Assessment Act 1997* (Cth) (ITAA97). That definition is in s 995-1 ITAA97 and is as follows:

> "'***taxation law'*** means:
>
> (a) an Act of which the Commissioner has the general administration (including a part of an Act to the extent to which the Commissioner has the general administration of the Act); or
>
> (b) legislative instruments made under such an Act (including such a part of an Act); or
>
> (c) the *Tax Agent Services Act 2009* or regulations made under that Act."

**TaxCounsel Pty Ltd**

### References

1 The Act also provides for the registration of other types of entity, including a BAS agent but, for present purposes, the discussion is confined to tax agents.

2 [2023] NSWSC 206.

3 This is applicable by force of s 4 of the *Legal Profession Uniform Law Application Act 2014* (NSW)).

4 There was also an issue as to whether the executor had used estate funds to pay the estate's lawyers, accountants and a taxation specialist for work that was in fact for the executor in his personal capacity and/or another beneficiary and not for the estate. This issue is not relevant for present purposes.

5 With respect it is not at all clear what his Honour meant to convey by this point.

6 [2023] NSWSC 206 at [957] and [958].

7 *Kekatos v The Council of the Law Society of New South Wales* [1999] NSWCA 288 at [18] per Giles JA.

8 It is not at all clear why Meek J referred to the tax agent service in this context.

9 These are items 2, 7 and 11.

10 See s 109 of the *Commonwealth of Australia Constitution Act*.

Mid Market Focus

by Guy Brandon, CTA, HLB Mann Judd

# Connected entities/ aggregated turnover: traps

With more complicated structures, advisers must be across a client's whole group of entities to determine whether concessional tax provisions are available to the client(s) they are advising.

## Introduction

With a number of concessional tax provisions based on the level of aggregated turnover,[1] it is critical to determine the annual turnover[2] of entities and whether the annual turnovers of other entities are also included.

## This article

This article is not meant to be a complete review of annual turnover, aggregated turnover, connected entities,[3] affiliates,[4] and other impacted provisions. It has been drafted to highlight some of the issues that may cause some of the concessional tax provisions to be inapplicable.

## Concessional tax treatments

The provisions where concessional treatment requires consideration of aggregated turnover are:

- Div 83A of the *Income Tax Assessment Act 1997* (Cth) (ITAA97): employee share schemes;
- Div 152 ITAA97: small business relief;
- Div 230 ITAA97: taxation of financial arrangements;
- Div 328 ITAA97: small business entities;
- Div 355 ITAA97: research and development;
- Div 716 ITAA97: miscellaneous special rules;
- Div 995 ITAA97: definitions;[5] and
- s 23AA of the *Income Tax Rates Act 1986* (Cth): meaning of base rate entity.

## Unit trusts

There are a number of situations where a unit trust is used in practice, including:

- holding property (where a gain would not be assessed as a balancing adjustment[6]) and therefore having the possibility of accessing a discount capital gain;[7] and
- in substitution of a company so that the initial taxing point is at the equity holders' level. This is more likely when unrelated family groups are investing.

## Timing of connected entities and aggregated turnover

If, on a review of a group, it is determined that an entity is a connected entity, it is already too late to deal with the results for the year under review (and the year in which you are actually conducting the review). This is caused by s 328-115 ITAA97:

> "(1) Your ***aggregated turnover*** for an income year is the sum of the relevant annual turnovers …
>
> (2) The relevant annual turnovers are:
>
> …
>
> (b) the annual turnover for the income year of any entity (a ***relevant entity***) that is connected with you at any time during the income year …"

If an entity is connected with another entity, *if for only a moment* during an income year, their annual turnovers are aggregated.

Furthermore, according to the definition of "corporate tax rate for imputation purposes" in s 995-1 ITAA97 there is possibly an impact on the subsequent year as the corporate tax rate for imputation purposes is based on an entity's aggregated turnover for the previous income year.

## Indirect control of an entity

Section 328-125(7) ITAA97 can be problematical when entities (or their advisers) are not fully aware (eg for reasons of confidentiality) of the respective ownership in a chain of entities.

Section 328-125(7) is effectively a "look-through" provision.

Certain entities are excluded from s 328-125(7),[8] most notably, listed public companies. That is, the kind of entities listed in s 328-125(8) effectively break the indirect control chain (though downstream entities may still be connected via direct control). Therefore, if a listed public company has multiple operating subsidiaries, the annual turnover of those subsidiaries will not be included.

However, if a listed public company is the head of a tax consolidated group, it is submitted that s 328-125(8) is effectively circumvented as the annual turnover of the members of the tax consolidated group will be included in the annual turnover of the head company.[9]

## Determining connected entities/ aggregated turnover

The following example illustrates some of the potential problems when using a unit trust and determining connected entities/aggregated turnover.

The relevant "players" are:

- A Smith (AS) (directly related to B Smith);
- B Smith (BS) (directly related to A Smith);

- A Smith Family Trust (ASFT);
- B Smith Family Trust (BSFT);
- AS & BS Unit Trust (AS&BSUT);
- ABC Pty Ltd;
- XYZ Ltd (listed company and head of a consolidatable group[10]);
- MNO Pty Ltd (wholly owned subsidiary of XYZ Ltd); and
- other shareholders in the above companies (unrelated to AS and BS).

The period under review is 1 July 2020 to 30 June 2023. See Table 1 for relevant details regarding the above entities.

On balance and on closer examination of the fact pattern in this example, the position is taken that ABC Pty Ltd is *connected with* XYZ Ltd pursuant to s 328-125 for the financial years ending:

- 30 June 2021;
- 30 June 2022; and
- 30 June 2023.

**Table 1. Details**

| Entity | Relevant details |
|---|---|
| AS | XYZ Ltd<br>• AS owns 51% of XYZ Ltd at a point in 2020–21;<br>• AS owns 50.01% of XYZ Ltd at a point in 2021–22; and<br>• AS owns 45% of XYZ Ltd at a point in 2022–23 (refer AS&BSUT below for additional information).<br>ASFT: AS is the appointor and guardian. |
| ASFT | AS&BSUT: ASFT owns 50% of AS&BSUT. |
| AS&BSUT | ABC Pty Ltd:<br>• AS&BSUT owns 55% of ABC Pty Ltd at a point in 2020–21;<br>• AS&BSUT owns 50% of ABC Pty Ltd at a point in 2021–22; and<br>• AS&BSUT owns 45% of ABC Pty Ltd at a point in 2022–23.<br>XYZ Ltd:<br>• AS&BSUT owns 5% of XYZ Ltd at a point in 2020–21;<br>• AS&BSUT owns 5% of XYZ Ltd at a point in 2021–22; and<br>• AS&BSUT owns 5% of XYZ Ltd at a point in 2022–23. |
| ABC Pty Ltd | Annual turnover = $6m.<br>Has been successful in its registration for the R&D tax incentive. |
| XYZ Ltd | Annual turnover = $3m.<br>Head company of tax consolidated group. |
| MNO Pty Ltd | Annual turnover = $42m. |

## How are the entities connected?

In summary:

- AS controls directly or indirectly (by the successive application of the indirect control of the entity provisions in s 328-125(7)) ABC Pty Ltd and XYZ Ltd;
- whether BS is, or is not, an affiliate of AS is not relevant when determining control in these circumstances;
- as AS controls ABC Pty Ltd and XYZ Ltd, those two companies are connected;
- as XYZ Ltd had chosen to consolidate, AS would not indirectly control MNO Pty Ltd, but note that MNO Pty Ltd's annual turnover would be effectively included with XYZ Ltd due to the single entity rule; and
- if XYZ Ltd had not chosen to consolidate, AS would not indirectly control MNO Pty Ltd. ABC Pty Ltd and MNO Pty Ltd would not be connected entities and MNO Pty Ltd's annual turnover would not be aggregated with ABC Pty Ltd.

In more detail:

- FY2021:
  - AS directly controls XYZ Ltd; and
  - AS indirectly controls ABC Pty Ltd ultimately via AS&BSUT;
- FY2022:
  - AS directly controls XYZ Ltd; and
  - AS indirectly controls ABC Pty Ltd ultimately via AS&BSUT; and
- FY2023:
  - AS directly controls XYZ Ltd;* and
  - AS indirectly controls ABC Pty Ltd ultimately via AS&BSUT.**

* As the control percentage is at least 40% but less than 50%, the Commissioner *may* determine that the first entity (AS) does not control the other entity (XYZ Ltd) if the Commissioner determines that the other entity (XYZ Ltd) is controlled by an entity other than, or by entities that do not include, the first entity (AS) or any of its affiliates. This cannot be self-assessed and an application for a private binding ruling would need to be lodged and be favourable.

** As the control percentage is at least 40% but less than 50%, the Commissioner *may* determine that the first entity (relevantly AS&BSUT) does not control the other entity (ABC Pty Ltd) if the Commissioner thinks that the other entity (ABC Pty Ltd) is controlled by an entity other than, or by entities that do not include, the first entity (AS&BSUT) or any of its affiliates. This cannot be self-assessed and an application for a private binding ruling would need to be lodged and be favourable. Again, refer to whether the Commissioner may determine that an entity does not control another entity.

## Commissioner may determine that an entity does not control another entity[11]

If the control percentage referred to in s 328-125(2)[12] or (4)[13] is at least 40% but less than 50%, the Commissioner may determine that the first entity does not control the other entity if the Commissioner determines that the other entity is controlled by an entity other than, or by entities that do not include, the first entity or any of its affiliates.

In a recent private binding ruling,[14] the Commissioner noted the following when making a determination on s 328-125(6):

> "… it is important to distinguish between control of an entity and responsibilities a person may have to carry out certain functions in relation to the conduct of an entity's business …
>
> [Regardless of the duties/powers of an employee], this certainly does not mean that employees have 'control' of the nature as referred to in paragraph 328-125(2)(a).
>
> … [having] considerable autonomy in making significant business decisions, however these are not relevant 'control' of the entity for the purpose of subsection 328-125(6).
>
> … [even if an individual] is the main person for running the day-to-day management of the Trust, either in the capacity of a director of the trustee company, or shareholder of the trustee company, or director of the unitholding company, is not a relevant factor for consideration under subsection 328-125(6).
>
> …
>
> The word 'controlled' in subsection 328-125(6) takes its meaning principally from its context within Subdivision 328-C and more specifically, subsections 328-125(2) to 328-125(5). These provisions indicate that control of rights to economic benefits in the form of income and capital distributions as well as voting rights, together being the usual indicia of ownership of business entities, is the relevant type of control.
>
> As paragraph 328-125(2)(a) is the relevant provision for unit trusts, the term 'control' for the Trust should take its meaning from that provision. That is, control rights to economic benefits – rights to distributions of income or capital of the Trust – are the relevant factors for consideration when determining whether or not the Trust is controlled by a third entity/entities.
>
> …
>
> In the ordinary case, a relevant determination may be made under subsection 328-125(6) in favour of an applicant entity where:
>
> - it has more than a 40% control percentage interest in a unit trust, but
> - a third entity has a more than 50% control percentage interest in the unit trust.
>
> In such a case, it is clear that this third entity 'controls' the trust given its entitlement to more than 50% of the distribution of trust income and capital.
>
> However, in [a] case [where] both entities have 45% control rights to the distributions of income and capital of the Trust. Therefore, [one entity] does not have more control (than [the other entity]) or actual control of the Trust."

From further reading of the edited version of this private binding ruling, the Commissioner appears only to entertain a different control (if no party has more than 50% control) where there are "means other than formal ownership of interests carrying requisite control percentages. For example, there may be clear evidence of legally enforceable arrangements that might practically affect a third-party unitholder's rights to distributions of income or capital". This may be by way of an equity holders' agreement.

## What does this mean?

For FY2021 and FY2022:

- ABC Pty Ltd, being connected with XYZ Ltd, would have an aggregated turnover in excess of $50m (noting XYZ Ltd being the head of a tax consolidated group and MNO Pty Ltd's annual turnover being included due to the single entity rule);
- ABC Pty Ltd would not be a base rate entity and would have a corporate tax rate of 30%; and
- for FY2022 and FY2023, ABC Pty Ltd would have a corporate tax rate for imputation purposes of 30% (as it is based on, inter alia, the previous year's aggregated turnover).

The FY2021 tax return (including the R&D schedule) will have to be lodged based on ABC Pty Ltd being connected with XYZ Ltd, or if previously incorrectly lodged with no consideration to connected entities, an amendment would need to be made.

The FY2022 tax return (including the R&D schedule) will have to be lodged based on ABC Pty Ltd being connected with XYZ Ltd.

In respect of the R&D tax incentive for FY2022, the non-refundable R&D tax offset rate will be 38.5% (for R&D expenditure up to 2% R&D intensity). This may be increased by an additional 8 percentage points for R&D expenditure above 2% R&D intensity.

For FY2023, to the extent that the Commissioner has not made a determination that ABC Pty Ltd and XYZ Ltd are not connected (on a review of the control provisions):

- ABC Pty Ltd, being connected with XYZ Ltd, would have an aggregated turnover in excess of $50m; and
- ABC Pty Ltd would not be a base rate entity and would have a corporate tax rate of 30%.

For FY2023 and FY2024, ABC Pty Ltd would have a corporate tax rate for imputation purposes of 30% (as it is based on, inter alia, the previous year's aggregated turnover).

The FY2023 tax return (including the R&D schedule) will have to be lodged similarly to FY2022 to the extent that the Commissioner has not made a determination that ABC

Pty Ltd and XYZ Ltd are not connected (on a review of the control provisions).

## Caveat

Even if the Commissioner did exercise his discretion or the equity did not result in direct or indirect control of an entity, a review would need to be had as to who were affiliates of the group. This may be more difficult to determine due to the perceived greater subjectivity in its determination.

## In summary

When dealing with complex groups and there is a belief that one or more of the concessional tax treatments requires a review of aggregated turnover, all entities (and their advisers) need to come together to determine who the connected entities (and affiliates) are, and whether there is a need to restructure for the future, having regard to the integrity and anti-avoidance provisions.

**Guy Brandon, CTA**
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References

1 S 328-120 ITAA97.
2 S 328-120 ITAA97.
3 S 328-125 ITAA97.
4 S 328-130 ITAA97.
5 Including the definitions of "corporate tax rate" and "corporate tax rate for imputation purposes".
6 S 40-285 ITAA97.
7 Subdiv 115-A ITAA97.
8 S 328-125(8) ITAA97.
9 S 701-1 ITAA97 (single entity rule).
10 S 703-10 ITAA97 compared to a consolidated group; s 703-5 ITAA97.
11 S 328-125(6) ITAA97.
12 Direct control of an entity other than a discretionary trust.
13 Direct control of a discretionary trust.
14 PBR 1052037970093 (edited version).

Higher Education

# Providing sound client advice

The dux of Advanced Superannuation for Study Period 1 2022 shares how online learning can make upskilling manageable with family and work commitments.

**Renae Wilson**
Technical Services Supervisor
Politis Investment Strategies, NSW

## Provide a brief background of your tax career.

I started my career as a trainee accountant in 2003. I worked as an accountant for 16 years before I made a career change into financial planning. My accounting career involved working with small businesses and self-managed superannuation funds. I have been a financial planner for around three and a half years now and am enjoying the different aspects that financial planning offers.

## Why did you choose to study with The Tax Institute Higher Education?

I attended a superannuation conference run by The Tax Institute a couple of years ago and enjoyed the way it was presented. When I looked into further studies, I found that The Tax Institute's online learning suited my family and work commitments.

## What was the reason for undertaking the Advanced Superannuation subject?

I chose the Advanced Superannuation subject because it would deepen my knowledge and be beneficial in my role as a financial planner and Technical Services Supervisor.

## What skill or knowledge areas have you gained from the Advanced Superannuation subject?

The Advanced Superannuation subject deepened my knowledge of superannuation, and provided new knowledge in areas that I previously had not had a lot of experience with, such as death benefits.

## How have you applied the skill or knowledge learned to your current role?

As a financial planner, superannuation is an area that is applicable to so many. Helping clients to navigate all areas of their superannuation funds, including how death benefits and reversionary pensions work for their circumstances.

## How did you juggle study, work and other commitments?

I was very lucky to have a great support system in place. I had a set time for studying but also time to relax and spend time with family.

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

I am awaiting the results of my last subject within the Graduate Diploma of Applied Tax Law. Then I will have a well-earned study break!

## What advice do you have for other tax professionals considering the Graduate Diploma of Applied Tax Law?

If you are considering the Graduate Diploma, I highly recommend it – it is a very practical qualification that you can utilise in any tax advice role.



# Capping superannuation not straightforward

by Kym Bailey, CTA, Technical Services Manager, JBWere

This article discusses why, in the author's opinion, the introduction of further capping of superannuation tax concessions should be via the tightening of the existing capping measures, not the introduction of yet another layer of tax that is levied on a notional earnings amount. The proposed earnings surcharge that will apply an additional 15% tax to earnings of member balances above $3m has prioritised simplicity over good policy design. Although the earnings surcharge is assumed to affect a low number of people at introduction, over time, many more superannuation members will be scooped up due to the non-indexation of the reference threshold for implementation against continued indexation of other superannuation thresholds. The design of the formula for calculating the affected earnings introduces the taxing of unrealised capital gains which may be the trailblazer for further application across other entities. As it stands, a small number of superannuants are being used for beta testing of this potentially new way of taxing.

## Background

The Federal Budget is in structural deficit to the tune of 2% of GDP, and while we would expect the government to focus on reforms that contribute to improving the sustainability of the tax and transfer system, it would appear that superannuation has been singled out as a "target" for tax reform.

From a purely political perspective, the reduction of superannuation tax concessions is clearly more achievable than increasing existing taxes (such as the GST) or introducing new taxes (such as death duties), or even broaching the level of tax support provided under the main residence exemption and its intersection with aged pension and aged care eligibility.

The International Monetary Fund's review of Australia in January 2023 noted the cost of providing tax concessions for the main residence as one (quantifiable) item that could be reviewed to make the tax system more efficient and equitable.[1]

Reviewing tax exemptions could help make the tax system more efficient and equitable. The CGT exemption for the sale of main residences, costing around 2.5% of GDP annually in foregone revenues, could be restricted. More broadly, the planned publication of additional information on the distributional features of the tax system will be helpful in identifying areas where the tax system can be further strengthened.

The latest superannuation announcement is presented as "new thinking". However, we already have superannuation capping. Since 1 July 2017, the potential to capitalise a superannuation balance has been limited by the restriction on the amount of contribution that can be made via the total superannuation balance (TSB).[2] In addition, there is a limit on the level of capital that can be housed in the tax-free retirement phase via the transfer balance cap (TBC).[3] The TBC also acts as a break on the level of death benefits that can remain in a superannuation fund following the passing of a member.

This significant structural reform is only in its fourth year and therefore has not had the chance to mature and deliver on the policy objectives that led to the change.[4] For now, members with a TSB that is greater than $1.7m cannot contribute to superannuation, so the capital in their member balance will only increase from positive investment performance. A break has been put on the voluntary expansion of larger balances.

When a member passes away, all of their superannuation must be paid from the fund into a non-superannuation structure such as to an individual or to the member's estate.[5] The only exception is where a spouse is paid a death benefit pension. The deceased's superannuation, up to the beneficiary's personal TBC, can remain in superannuation if the beneficiary is their spouse. Importantly, this is not an additional pension allowed to be paid; in most cases, it results in the survivor commuting their pension back to accumulation phase in order to have the "space" in their TBC to take on the death benefit pension.[6]

It is only a matter of time before large member balances will be a thing of the past.

## Superannuation capping speculation narrowed

The speculation following various announcements by the Treasurer in respect of capping superannuation tax concessions has been truncated by the Prime Minister's announcement on the form that the cap will take.

The Prime Minister announced that the current government will legislate a cap of $3m for superannuation balances entitled to tax at the rate of 15%. Earnings on balances above that level will be taxed at 30%. Following the announcement, Treasury has released a factsheet entitled *Better targeted superannuation concessions*[7] to put some substance behind the announcement.

## Capping at $3m

The target of the increase in the tax rate on earnings from member balances above $3m (a non-indexed threshold) is aimed at the individual rather than fund based. Only the ATO has a full picture of a member's TSB and therefore it is in the best position to determine if additional tax is to be applied to a particular member balance.

The method of assessing an individual for the additional tax is likely to be similar in form to the current Div 293 ITAA97 tax which applies an additional 15% tax on superannuation contributions of individuals with incomes above $250,000. Under Div 293, the ATO matches up an individual's tax return against the contribution data from all of their superannuation balances to determine whether additional tax is to be applied. Once the ATO issues a determination, the personal income tax is re-assessed. The individual can request the additional tax to be "released" from their superannuation balance(s) or simply pay the tax from non-superannuation sources.

The proposed "Div 293-styled system" would appear to be the "simplest" method of targeting individuals with balances of more than $3m as, by and large, the technology is in place. The difference is that it will not result in a re-assessment of personal income tax as it is intended to be an absolute tax, regardless of personal tax positions.

The alternative of stratifying the flat tax system in superannuation would require systems changes that may be hardest felt by Australian Prudential Regulation Authority (APRA) funds which, reportedly, are not as likely to be impacted as the self-managed superannuation fund (SMSF) sector as balances tend to be lower than the announced $3m cap.

## A new Division in the ITAA97?

If we assume that the ITAA97 will be amended by adding a new Division to enact this change, how could it operate?

The ATO already collates individual balances for the purposes of calculating the TSB. The TSB is the threshold that determines whether a person can make non-concessional contributions to superannuation. It is determined annually and holds for the entire year.

In order to determine the level of earnings subject to the new tax, Treasury has published a formula for its calculation that simply determines the change in the member's TSB between the start and end of the period and then adds back any drawings and minuses after-tax contributions (see Diagram 1).

The problem with this simplicity is that it will capture unrealised capital gains and then, on realisation in a later period, capture a gain on the same holding. It appears that this was deliberate by Treasury and not likely to change given it is pursuing simplicity over fairness.

## Case study

An individual superannuation fund member has a TSB of $10m which includes $2m in the retirement phase and the remainder in the accumulation phase. The member draws $100,000 per annum as their pension. For the sake of simplicity, this is a sole member fund. The retirement phase is tax-free and therefore 20% of the earnings for this member's TSB is tax-free and 80% is taxed at 15%. The earnings for the year are $500,000, so the tax paid at fund level would be $60,000 (assume that no capital gains or franking credits are included).

The member's end of year TSB is $11,000,000 due to appreciation in assets.

Using the notional earnings formula, the closing TSB of $11m is deducted from the opening TSB of $10m, and the pension drawings are added back ($100,000). The result is assessable earnings of $1.1m.

Under the proposed new tax arrangement, this member is (personally) liable for additional tax of 15% on the proportion of their notional earnings from the 70% of capital which is above $3m (TSB ~ $10.1m – $3m = 70%).

Following the lodgment of the annual member statements, the ATO systems detect that additional tax is payable.

Part c) of the Treasury formula would see the additional tax calculated at $115,500. That is, notional earnings of $1,100,000 x 70% = $770,000 x 15% ~10.5%. However, this is somewhat "smoking mirrors". The fund only earned $500,000 in taxable earnings so the effective tax rate on actual earnings is 35.1%. This is due to unrealised gains being taxed in the earnings surcharge, whereas they are

**Diagram 1. Calculation method**[8]

**a) The below formula will be used for calculating earnings in a financial year:**

$$Earnings = TSB_{Current\ Financial\ Year} - TSB_{Previous\ Financial\ Year} + Withdrawals - Net\ Contributions$$

**b) The proportion of earnings corresponding to funds above $3 million is calculated as:**

$$Proportion\ of\ Earnings = \frac{TSB_{Current\ Financial\ Year} - \$3\text{ million}}{TSB_{Previous\ Financial\ Year}}$$

**c) The tax liability is calculated as follows:**

$$Tax\ Liability = 15\text{ per cent} \times Earnings \times Proportion\ of\ Earnings$$

not included in the first tax round against fund income of $500,000.

## Taxing unrealised capital gains plus realised capital gains

Funds that do not deploy tax effect accounting are at a real disadvantage under this proposed earnings surcharge. Tax will be levied annually on asset price uplift and then again on disposal.

The Treasury factsheet stated that unrealised losses will be captured to offset the year-on-year movement. This presumes that all funds utilise tax effect accounting and, more or less, it "all comes out in the wash".

Remembering that this formula for the calculation of notional earnings relies on movements between the member's TSB, balance sheet movements will be important.

The choice to pay the earnings surcharge personally or via the member balance will impact on the TSB and, therefore, considered choice is likely to be warranted.

Take the example in the case study above. The superannuation fund member has an additional $115,500 in income tax to pay. If they release it from the fund, their TSB is reduced accordingly. On the other hand, if liquidity is an issue in the fund, or the portfolio construction limits raising this level of cash, the member could elect to pay the tax personally and thereby their ending TSB will be higher. This is the starting point for the next year's assessment and could result in a lower notional earnings assessment.

## Case study extended

The TSB at the end of the case study period was $11m.

The earnings surcharge is due in the following year. The superannuation fund member has the option to release the amount from superannuation or to pay it personally. While, traditionally, capital was always retained in the superannuation environment, the new earnings surcharge is cause for re-assessment. However, only momentarily.

If the member releases the surcharge tax, their TSB will reduce accordingly to $10,884,500.

All things being equal, if no transactions occur, apart from the earnings surcharge tax release, the potential for higher earnings surcharge is in play at least in this year.

This may be a strategy option going forward whereby the source for the payment of the earnings surcharge is re-assessed annually depending on the likely earnings within the fund.

## Other options to further cap superannuation

### Prioritising simplicity

The logical (and obvious) "quick and actionable" additional cap on superannuation balances could come from a freezing of the TBC. The movement in inflation in recent times will see the TBC index to $1.9m from the current level of $1.7m, commencing 1 July 2023.

It should be noted that TBC indexation is in line with most superannuation thresholds which are indexed according to movements in the CPI or average weekly ordinary time earnings. For the TBC to index, the CPI movement must see an uplift of at least $100,000 from the base level in December 2016.[9]

The consequence of freezing this indexation round would be that less capital can be deployed into the tax-free retirement phase. However, potentially more impactful (from a longer-term tax revenue perspective), an index of the TBC leads to an index of the TSB.

The ability to make an after-tax contribution to superannuation requires a person's TSB to be less than the general TBC.[10] In practice, less after-tax capital would be able to be deployed into superannuation if the TBC and, accordingly, the TSB remain at the current level of $1.7m.

The current indexation round demonstrates that perhaps the original $100,000 indexation level is too generous. The TBC commenced at $1.6m in the 2018 financial year and remained static until the 2022 financial year when it moved to $1.7m. If no freezing is enacted, it will jump up to $1.9m and so on, in line with inflationary pressures.

The 2017 changes to superannuation were designed to reduce superannuation tax concessions. However, if further capping is deemed necessary, this would be the logical place to start: tighten up the thresholds.

> "The 2017 changes were designed to reduce superannuation tax concessions; if more is needed, tighten these."

A review of TBC indexation would also provide the opportunity for a review of the concept of partial indexation, which is an overly complicated process to limit the benefits of indexation for individuals who hold a *personal* TBC but have not fully utilised it. That is, if an individual has some unused cap percentage, they can access a proportionate level of general TBC indexation which, following the first indexation round, has resulted in there being several hundred individual TBCs. Unless the partial indexation provision is abolished, individual TBCs will grow exponentially over time.

If, going forward, the TBC is subject to indexation, it must be uniform for all superannuants or we will end up with the same highly specialised advice area that was required to navigate the reasonable benefit limit (RBL)[11] system (which was the previous capping mechanism for superannuation). A "perfect case" of allowing the "perfect to be the enemy of the good".

### Reintroduce end benefit tax

An obvious, but seemingly not countenanced, option for reducing superannuation tax concessions is a re-introduction of end benefit tax for individuals over age 60. This generous tax concession could be curbed, and in many ways, seems "fairer" than introducing additional tax on earnings on capital above certain levels. The tax system has various measures available to ensure that low-income earners are not disadvantaged by the taxing of superannuation benefits, and it would lead to minimal structural adjustment to the current system. While not a capping mechanism, it is another way to extract more tax from the superannuation system.

The only revised process would be the requirement for superannuation funds to provide members with annual PAYG summary statements.

## Inherent issues in the proposed earnings surcharge approach

### No threshold indexation

The Treasury information sheet made it clear that the threshold amount of $3m for the cut-in for liability to pay the earnings surcharge will not be indexed. With the level of the TSB indexing to $1.9m from 1 July 2023, it is likely that the thresholds will intersect in due course. When this occurs, we have the quandary whereby an individual may be permitted to make non-concessional contributions. However, if they do, they could be putting their member balance into surcharge territory.

### Younger members trapped

As superannuation law restricts member access until certain "trigger events", members that are younger than age 60 may be caught in the earnings surcharge net without any choice to limit the impact. Release events are most commonly associated with a member's retirement, disability or death. The new earnings surcharge information sheet does not indicate that a window will be provided to enable balance sheet re-arrangement for those impacted. This appears to be an unfair impost given that existing superannuation balances have been built based on the law as it stands. Future decisions will be based on the understanding that balances above $3m will have an additional tax applied to the notional earnings. However, the investment decisions made prior to this were based on the understanding that tax on superannuation balance earnings was a flat 15%, applied at fund level only.

### Disparity between member data held by the ATO

Although APRA superannuation funds utilise tax effect accounting and member balances are represented on realisable value on a daily basis, they do not currently report individual pension drawings to the ATO. This represents imperfect data in order for the ATO to be able to "simply" calculate the notional earnings.

Individual member data is more granular for SMSF members. However, unrealised gains are not carved out in the member statements. Funds with members caught in the earnings surcharge net will be required to deploy tax effect accounting in order to provide a modicum of fairness to the "new" ability to tax unrealised capital gains.

## Recent structural change not mature

The 2017 changes to superannuation were designed to reduce the tax concessions associated with superannuation. However, they need time to work through the system. At this point, a superannuation fund member has a limit on what can be held in the tax-free pension phase, with the remainder of their superannuation being held in the accumulation phase and taxed at 15%.

On the death of a superannuant, the fund must cash out the member balance. Where the deceased has a spouse, all but the pension pot is required to be removed from superannuation, so it is only a matter of time before the large non-pension balances are removed permanently from the superannuation environment.

The compulsory transfer of accumulation superannuation out of the fund on death leads to CGT (at fund level) being incurred and, where the beneficiary is a "non-tax dependant" (an adult child, for example), the taxable component of the superannuation is subject to tax at 15% plus Medicare levy (at beneficiary level). This death tax has been a feature of superannuation for many years however, the 2017 changes have ensured that there are few strategies available to limit the impact.

In summary, if the 2017 changes were left to run their course, overall:

- significant exit tax will be paid following the death of a person or the last member of a couple; and
- superannuation will be capped to just the amount that can be housed in the pension balance.

## Conclusion

Budget speculation is always fraught. However, as the Prime Minister and Treasurer have ruled it in, it is appropriate to consider the implications should superannuation capping become law.

The fairest outcome will be achieved if responsible reforms to the superannuation system acknowledge that people have made investment decisions based on the policy settings that were designed and implemented over the last 30 years.

Long-term investment vehicles such as superannuation often favour asset allocation based on longer holding periods, which can result in the deployment of capital into illiquid assets. As such, changes that increase the level of tax outlays could result in changes to asset allocation.

Capital gains are significant in many superannuation funds and the use of a simple formula to calculate the notional earnings that are subject to the new tax will result in taxing gains along the way and on disposal unless the fund utilises tax effect accounting. For smaller firms, or for firms with a limited number of larger member balance funds, this impost may cause unnecessary disruption and would be a typical example of the private sector assisting public policy implementation.

The simplicity of the formula could remain if the ATO harvested more granular information from SMSF annual returns by adding one or two new labels, and the formula allowed for unrealised gains to be excluded. Superannuation fund administration systems have the functionality to prove the difference between taxable income and accounting income, so the data is ready to be reported.

The reality is that this new tax will result in an effective rate of tax that is more than 30% without unrealised gains being excluded.

More broadly, younger superannuation fund members who are impacted by this new tax should be given a window to restructure their superannuation to below the $3m cap if they choose to deploy the capital elsewhere prior to 1 July 2025 when the measure commences. This earnings surcharge imposition appears to be based on the presumption that members can rearrange their investment vehicles without limitation. However, superannuation is preserved until at least age 60.

The lack in indexation of the earnings surcharge threshold of $3m is also not in step with the fact that contribution caps and the TSB are indexed in line with movements in wages and inflation. At the current pace of inflation, the TSB could breach the $3m threshold in a relatively short period of time. When this occurs, you have the discombobulation of being permitted to add capital to superannuation under the TSB threshold, but earnings from it will be subject to a surcharge tax.

## Final thoughts

Anyone who has been involved in superannuation as a practitioner or an adviser since the commencement of the modern system in 1993 will have a sense of déjà vu when talking about limiting the tax concessions available to superannuation. The RBL system was not unlike the current TBC system in that it limited concessions based on a capital value and provided better tax treatment for individuals who preferred to draw their superannuation as a pension rather than as a lump sum.

The RBL system ran from 1990 to 2007, making it the longest period for the capping iterations in superannuation. However, a move to cap the concessions in 1994 led to grandfathering and a transitional system that was inordinately complex.

A 10-year (complexity) respite was enjoyed between 2007 and 2017 when "Simple Super" introduced a raft of easing of the law across superannuation, including transferring the superannuation tax laws into the ITAA97[12] and abolishing RBLs.

The changes stripped away complexity and, while the changes were generous in removing all end benefit tax (from taxed benefits), the revised system also significantly lowered the level of contribution caps and introduced excess contributions tax.

At the time, many thought that it was "too good to be true" and "couldn't last". It was reckless law-making and unfortunately resulted in a reasonably harsh crackdown from July 2017. It did, however, set the stage for reducing contribution caps, rather than the previous system that saw them significantly increase in age bands, as well as embedding a preference for not taxing end benefits. Tax-free superannuation drawings for individuals over age 60 seem like a generous tax concession, but one that seems to be off limits in the current debate.

If the next Federal Budget includes further superannuation capping, this will see the change timeline further reduced. As it stands, the timeline for structural changes to superannuation has been 17 years (RBLs), then 10 years (Simple Super), and now possibly five years (Super17). In the author's opinion, this pace of change is too fast and will significantly undermine confidence in our superannuation system.

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# Asset protection post-Permewan

by Caite Brewer, Barrister, and Pip Coore, Barrister, Hemmant's List

Gift and loan back arrangements are a popular strategy for estate planning and asset protection. The recent Supreme Court of Queensland decision of *Re Permewan No. 2* brings into question whether gift and loan back strategies are effective. *Re Permewan No. 2* concerned the validity and enforceability of gift and loan back transactions where the sole purpose was to defeat a family provision application under s 41 of the *Succession Act 1981* (Qld). This article outlines: the background to *Re Permewan* and *Re Permewan No. 2*; the reasons why the gift and loan back arrangement in *Re Permewan No. 2* was invalid and unenforceable; the impact that *Re Permewan No. 2* has on earlier gift and loan back cases such as *Atia v Nusbaum*; and the impact that *Re Permewan No. 2* will have on gift and loan back arrangements moving forward. The authors also provide some key takeaways for estate planning practitioners on asset protection.

## Background to Re Permewan

Before discussing *Re Permewan No. 2*,[1] it is useful to outline the background of the case and to consider *Re Permewan*.[2]

Prudence Veronica Permewan (the deceased) died on 21 September 2019. She was survived by her three children:

- John Scott Permewan (Scott);
- Donna Frater (Donna); and
- Marla Hurlimann (Marla).

Under the terms of her last will dated 29 November 2017 (the will), the deceased:

- appointed Scott as sole executor and trustee;
- gifted her shares in a company called Zalerina Pty Ltd (Zalerina) to Scott; and
- gifted the rest of her estate (which were her shares in Orion Investments Pty Ltd (Orion)) to the Lotus Trust. The Lotus Trust was a discretionary trust previously established in 2011 by a deed of settlement.

The deceased made no provision for Donna and Marla under the will.

At the date of her death, the deceased had the following assets:

- her Burpengary residence, worth approximately $725,000;
- the shareholding in Orion, worth approximately $1,310,636; and
- a loan to Orion of $876,229.62.

Probate of the will was granted to Scott as executor on 29 January 2020.

### The effect of the will

The trustee of the Lotus Trust was Zalerina. Prior to the deceased's death, Scott held two shares in Zalerina and the deceased held 10. As Scott received the deceased's 10 shares in Zalerina under the will, on her death, he became the controlling mind of the company and therefore had sole control of the Lotus Trust's assets. Scott was also the sole director of Orion. The shares in Orion were gifted to the Lotus Trust (as part of the residue), which Scott had sole control of.

Therefore, the effect of the will was that it transferred the deceased's entire estate to both Scott and Zalerina (as trustee of the Lotus Trust). As a result, Scott had full control of the deceased's estate because he controlled Zalerina.

### The gift and loan back transactions

Before her death, the deceased entered into six transactions, herein referred to collectively as "the transactions":

1. a statutory declaration signed by the deceased and witnessed by Brett Hart, a partner of the firm Cleary Hoare. The statutory declaration was written in the following terms:

   "1. It is my intention that all payments whether in cash, by cheque or Bearer Promissory Notes or otherwise, that I make from myself to the trustee of the Lotus Trust being a trust constituted by Deed dated 14 February 2011 are by way of gift unless otherwise recorded in writing"

2. a document headed "Bearer Promissory Note". This document (the promissory note) contained three parts, each signed by the deceased :

   a. a promise by the deceased to pay the bearer of the note the sum of $3m;

   b. a receipt given by Zalerina as trustee of the Lotus Trust (at the time), recording it as having received the promissory note from the deceased as a gift; and

   c. a further receipt given by the deceased. This recorded her as having received the promissory note back from Zalerina as a loan and having cancelled the note because of the merger of the right to be paid and the obligation to pay;

3. a resolution by Zalerina, as trustee of the Lotus Trust, signed by the deceased as the sole director of Zalerina:
   a. noting the promissory note had been received from the deceased by way of a gift;
   b. resolving:
      i. to acknowledge receipt of the promissory note by execution of it;
      ii. to lend the money gifted by the promissory note to the deceased;
      iii. that such loan be repayable on demand and secured by way of mortgage over real property; and
      iv. to execute a loan agreement and mortgage security documents to effect these resolutions;
4. a loan agreement entered into between the deceased and Zalerina, signed by the deceased on behalf of herself and Zalerina. Zalerina, as trustee of the Lotus Trust, loaned the deceased $3m. The loan was secured by a mortgage over the deceased's home at Burpengary and a security interest over all of her shares in Orion;
5. a security deed, again, signed by the deceased on behalf of herself and Zalerina as the secured party; and
6. a deed of assignment, again, signed by the deceased on behalf of herself and Zalerina. The deed assigned a debt of $876,229.62 that Orion owed, from the deceased to Zalerina as trustee of the Lotus Trust.

One form of the last four documents mentioned were dated 18 April 2018, indicating that was the date the deceased signed those documents.

The result of the transactions was that the deceased, who before these transactions had assets worth approximately $3m, had a debt of that amount to the Lotus Trust secured over her assets.

### The family provision proceedings

As the deceased's entire estate was either gifted to Scott, or to Zalerina as trustee of the Lotus Trust, Donna and Marla commenced proceedings pursuant to Pt 4 of the *Succession Act 1981* (Qld) for further provision out of the estate on 12 June 2020.

It was through these proceedings that Donna and Marla became aware that the deceased's estate was essentially worthless, with a $3m debt owing to the Lotus Trust secured over the deceased's assets.

As Scott was not willing to investigate the transactions, on 29 March 2021, Donna filed an application in the Supreme Court of Queensland. That application was heard by Davis J on 27 April 2021.

## The removal application

At the hearing before Davis J in *Re Permewan*,[3] Donna (with the support of Marla) argued that there should be an inquiry into the validity of the transactions, which effectively stripped the deceased's estate of its value. Donna submitted that:

- the document styled "Promissory Note" was not a promissory note as defined by s 89 of the *Bills of Exchange Act 1909* (Cth). Therefore, it did not have the legal effect of a promissory note;
- no gift had been perfected and there was no consideration supporting a promise to pay $3m to the Lotus Trust; and
- the transactions were a sham.

Although it was unnecessary for his Honour to consider the strength or otherwise of Donna's assertions, Scott seemed to accept that it was a live issue and submitted that it ought to be litigated in the family provision proceedings.

> "Re Permewan No. 2 brings into question whether gift and loan back strategies are effective."

Donna argued that she should not have to pursue the family provision proceedings when the composition of the estate was in question, only to learn that there was effectively no fund on which any order could operate.

Donna submitted that the trustee and executor needed to undertake an inquiry and, because of the obvious conflict of interest, Scott should not be undertaking that inquiry as he was the executor and trustee but he had the sole interest in the deceased's entire estate.

Accordingly, Donna sought the following orders in the proceedings before Davis J:

1. a revocation of probate of the will issued to Scott as executor on 29 January 2020;
2. the removal of Scott as executor; and
3. the appointment of Mr Myles Murphy (a solicitor) as the administrator of the estate.

### Davis J's conclusion

Ultimately, Davis J concluded that the proper administration of the estate would be frustrated if Scott remained as executor in circumstances where, among other things:

- he had a clear interest in defending the validity of the transactions; and
- there was evidence that Scott had deep-seated animosity towards Donna and an intention to run the estate dry in defending any action she brought. This animosity was on display in the transcript of a telephone conversation between Scott and Marla on or about 21 November

2019. That conversation involved Scott using some very "colourful" language and is extracted at para 33 of Davis J's judgment.

At the conclusion of the judgment, Davis J ordered, among other things, that Scott was to be removed as executor and that Mr Murphy was to be appointed as independent administrator (the administrator).

The deceased's shares in Zalerina were then to be held by the administrator rather than by Scott.

### Scott's actions post-decision

One week after Davis J's orders, Scott, as the principal of the Lotus Trust, executed a deed of change of trustee. This deed appointed another company that Scott controlled, Zerelda Pty Ltd, as trustee of the Lotus Trust in place of Zalerina.

In *Re Permewan No. 2* (outlined in more detail below), Cooper J found that the only inference to draw from Scott's actions was that he sought to regain control of the trustee and, through that, control of the Lotus Trust assets.

On 27 January 2022, Zerelda commenced proceedings (the enforcement proceedings), seeking:

- against the administrator:
  - repayment of the $3m loan, together with interest;
  - recovery of possession of the deceased's former residence in Burpengary; and
  - an order pursuant to s 175 of the *Corporations Act 2001* (Cth) that the register of members of Orion record that the shares in Orion held by the administrator be conveyed to Zerelda; and
- against Orion, recovery of the debt the subject of the deed of assignment between the deceased and the Lotus Trust.

The enforcement proceedings were stayed until the conclusion of the administrator's decision.

## Re Permewan No. 2

### Invalidity of the transactions

In *Re Permewan No. 2*,[4] the administrator sought declarations as to the validity and enforceability of the transactions.

Cooper J found that the purported effect of the transactions was as follows:

- the deceased gifted, through the provision of the promissory note, $3m to the Lotus Trust;
- the Lotus Trust loaned $3m to the deceased;
- to secure the loan, the deceased mortgaged or otherwise charged her assets; and
- the consequences would be that the deceased's financial position changed from having had assets worth approximately $3m before the transactions to having a debt of $3m to the Lotus Trust secured over her assets.

His Honour found that, if the promissory note was to be called on, the deceased would have had to liquidate all of her assets. Because of the obligation to pay capital gains tax on the realisation of those assets, the assets would have in fact equated to less than $3m when liquidated. Therefore, the deceased did not have the $3m that she purported to gift to the Lotus Trust.

The administrator, in seeking determination of the enforceability or otherwise of the transactions, pleaded:

- by allowing the trustee of the Lotus Trust to enforce the transactions, the sole purpose of the transactions was to strip the estate of any assets, thereby preventing Donna and Marla from successfully bringing a family provision application;
- Scott had evinced an intention to effect the deceased's intentions as to her estate and the purpose of the transactions, being to prevent Donna and Marla from successfully bringing a family provision application;
- if the deceased's intentions were to enter into the transactions for the purpose of stripping the estate and precluding Donna and Marla from successfully bringing a family provision application, her actions were not in good faith;
- if Scott sought to implement and give effect to the transactions for the same purpose as the deceased, his actions were not in good faith; and
- if the transactions were entered into for the aforementioned purpose, they are void as contrary to the public policy underpinning Pt 4 of the *Succession Act 1981* (Qld).

Donna subsequently filed a response to the administrator's points of claim, adopting the bases on which the administrator disputed the validity of the transactions. Donna also alleged that the transactions were a sham because the deceased and Zalerina (as trustee of the Lotus Trust) never intended to give effect to the documents recording the transactions. Marla subsequently adopted the same position as Donna.

In his affidavit, Mr Hart (the solicitor who witnessed the deceased's statutory declaration) gave evidence about various meetings that he had had with the deceased and:

- Scott and their accountants on 12 October 2017;
- another solicitor of Cleary Hoare at the time, Catherine Da Silva (Catherine) on 29 November 2017; and
- Catherine and the deceased's accountant on 18 April 2018.

In cross-examination, Mr Hart gave evidence that the deceased's intention and purpose in entering into the transactions was based on his discussion with her at these meetings, that is:

- the purpose of the gift and loan back scheme that Mr Hart proposed to the deceased was to ensure there was so little, if anything, left in her estate on or after her death that any family provision application by her daughters would be futile;

- her control of the Lotus Trust ensured that there was no prospect that the loan to her from the Lotus Trust would be called on during her lifetime;
- the prospect of the liability to pay the money under the promissory note would only arise if the trustee of the Lotus Trust called on it;
- the deceased did not have $3m in cash and would have to liquidate all of her assets to satisfy a call on the promissory note; and
- the deceased did not wish to sell those assets and had no intention of selling those assets.

At para 19 of his affidavit, Mr Hart deposed to the deceased's instructions on 18 April 2018 to date and deliver the documents recording the transactions, both in her personal capacity and in her capacity as the sole director of Zalerina.

In cross-examination, Mr Hart gave evidence, among other things, that:

- his understanding was that delivery required only the process undertaken at the 18 April 2018 meeting. Thus, Mr Hart only considered that he needed to explain the promissory note to the deceased, take her through it to explain the different capacities in which she had signed, explain its effect, and ask the deceased at each stage "is that okay?", with the deceased responding "yes"; and
- although the deceased instructed him and Catherine to date the documents at the meeting on 18 April 2018, he
  - did not date the documents at that meeting;
  - did not see anyone date the documents at that meeting; or
  - could not say when the documents were dated.

After the evidence was heard, but prior to the delivery of closing addresses, Scott and Zerelda conceded that the court could not find that the promissory note had been delivered and, therefore, the promissory note remained "inchoate and incomplete". On the basis of that limited concession, Cooper J made declarations by consent that the transactions were invalid and unenforceable at law.

## Consideration of other grounds of validity

Having conceded the unenforceability of the transactions on that limited basis, Scott and Zerelda submitted that it was not necessary for the court to consider other grounds on which the administrator, Donna and Marla relied on asserting that the transactions were invalid. Cooper J disagreed and discussed the findings that his Honour would have made had the transactions not been unenforceable on the limited basis of the concession made by Scott and Zerelda.

At para 65 of his judgment, Cooper J stated:

> "… I am confident that the Administrator was almost certain to have succeeded on his application, and both Donna and Marla were almost certain to have succeeded on their cross-applications, in obtaining declarations that the Transactions were invalid and unenforceable at law for reasons other than the matter the subject of the concession made by Scott and Zerelda."

His Honour considered that the transactions would have been invalid and unenforceable for two reasons:

1. they were contrary to the public policy underpinning Pt 4 of the *Succession Act 1981* (Qld) (as submitted by the administrator, and as adopted by Donna and Marla); and
2. they constituted a sham (as submitted by Donna and Marla).

## Invalidity as contrary to public policy

Cooper J quoted the decision of *Barns v Barns*[5] when considering the public policy ground. In *Barns*, the public policy of s 41 of the *Succession Act 1981* (Qld) was said to be "the making of provision for the maintenance of members of a family who are found to be in need of such maintenance when the family tie has been broken by death. That policy is of public, as well as private importance".

Contrary to Scott and Zerelda's submission that the transactions constituted an inter vivos gift of the deceased's property, Cooper J found that the transactions were testamentary in nature. This was because the deceased did not divest herself of all of her assets before she died and had no intention of disposing of her property during her lifetime. At para 74 of his judgment, Cooper J found:

> "The documents which recorded the Transactions were executed contemporaneously with [the deceased's] will and the Transactions were only ever intended by her to take effect upon her death. [The deceased] never intended that the Lotus Trust, which she controlled, would call on the promissory note or attempt to enforce the loan while she was alive. If that occurred, she would have been placed in the position of having to sell her assets to meet her obligations and she never intended to do so."

Cooper J considered that the transactions were "illusory" because the deceased appeared, "contrary to the reality, to have parted with her property", and that the dealings with the property were instead in a "testamentary fashion". Given the sole purpose of that conduct was to ensure that there was so little, if anything, left in the deceased's estate to defeat any family provision application by Donna and Marla, at para 77, Cooper J said:

> "In those circumstances, I am confident that the Administrator was almost certain to have succeeded on his application on the basis that enforcement of the Transactions would be contrary to public policy."

## Invalidity as a consequence of sham

In relation to the cross-applications by Donna and Marla that the transactions were invalid on the basis that they constituted a sham, Cooper J quoted Kiefel J (as her Honour then was) in *Raftland Pty Ltd v FCT*.[6] In that case, her Honour stated that "[c]ritical to the characterisation of a transaction as a sham is that the parties do not intend to give effect to the ostensible transaction". In that decision, her Honour quoted Lockhart J in *Sharrment Pty Ltd v Official Trustee in Bankruptcy*,[7] who stated that "[a] 'sham' is therefore for the purposes of Australian law, something that is intended to be mistaken for something else or that is not really what it purports to be. It is a spurious imitation, a counterfeit, a disguise or a false front".

At para 80, Cooper J considered the transactions met the description of a "sham". That is because, contrary to the terms of the promissory note, the deceased never intended to pay the Lotus Trust the $3m, nor did the Lotus Trust (being under the deceased's control) ever have an intention of receiving or enforcing the $3m. Furthermore, the Lotus Trust never had any expectation that it would have $3m (with the deceased's property representing that amount) for it to be in a position to lend that amount back to the deceased.

In those circumstances, at para 81, Cooper J said:

> "… I am confident that Donna and Marla were almost certain to have succeeded on their cross-applications on the basis the Transactions were shams, as well as on the basis of the public policy ground."

### Costs

In relation to costs, Cooper J found that Scott and Zerelda were to pay to each of the administrator, Donna and Marla's costs of and incidental to:

- the removal application before Davis J (which were presently reserved);
- the administrator's application; and
- the cross-applications brought by Donna and Marla,

on the indemnity basis.

In relation to the enforcement proceedings, his Honour ordered that:

- the plaintiff's claim was dismissed; and
- the plaintiff (Zerelda) pay the first defendant (the administrator) and the second defendant (Orion) the costs of and incidental to the claim to be assessed on the indemnity basis.

## What does Re Permewan No. 2 mean for earlier gift and loan back cases?

Before *Re Permewan No. 2*, the leading case in relation to gift and loan back arrangements was arguably *Atia v Nusbaum*[8] which was a decision by Boddice J in the Queensland Supreme Court.

A brief summary of that case is as follows:

- Violet Nusbaum (Mrs Nusbaum) had one child, Aaron Atia (Dr Atia), who she raised on her own;
- Dr Atia practiced medicine. He entered into a gift and loan back arrangement with his mother;
- when Mrs Nusbaum subsequently called in the debt, Dr Atia argued that the loan and mortgage were not intended to be binding and were only a pretence to protect against situations where Dr Atia was sued in his professional capacity as a surgeon;
- Dr Atia argued that his mother was only calling in the debt secured by the mortgage because he had married his girlfriend against his mother's express wishes;
- the court found that all aspects of the legal documentation, including a deed of gift, loan agreement and registered mortgage, had been validly prepared and executed. The court found that there was no mistake or sham involved; and
- as a result, Mrs Nusbaum was able to call on the debt.

In the authors' opinion, the main difference between *Atia v Nusbaum* and *Re Permewan No. 2* is that, in *Atia*, the money actually changed hands, whereas in *Re Permewan No. 2*, no money (or property) changed hands. It was merely an illusory or documentary transaction.

It must be remembered that *Re Permewan No. 2* was ultimately a costs decision and that Cooper J's reasons are not binding on Supreme Court judges. In the authors' view, the judgment does, however, demonstrate how a court is likely to view gift and loan back arrangements that are designed for the purposes of avoiding a family provision application or are a sham.

## Estate planning strategies post-Permewan

Are gift and loan back strategies dead in the water? What could Prudence, the deceased, have done in her circumstances to prevent a family provision application?

The only way to actually prevent a family provision application from succeeding is to ensure that there are no assets in your name when you die. This does not work in New South Wales where notional estate provisions apply. Contrary to the mistaken belief of some, a testamentary discretionary trust in your will does not defeat a family provision application.

In the authors' opinion, Prudence could have actually transferred all of her assets to the Lotus Trust while she was alive (with or without a loan back). This would have incurred stamp duty and capital gains tax. The authors believe that there is no way around this. Anything short of an actual transfer is likely to attract the potential for a finding of a sham or that the agreement is against public policy.

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This article is an edited and updated version of "Asset protection post-Permewan" presented at The Tax Institute's Private Business Tax Retreat held in Surfers Paradise on 16 to 17 February 2023.


References

1 [2022] QSC 114.

2 [2021] QSC 151.

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4 [2022] QSC 114.

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8 [2011] QSC 44.

A Matter of Trusts

by James Gao, Sladen Legal

# Small business CGT: who's in and who's out?

Family businesses often operate via a multitude of trusts and entities. How do we determine which entities are included when assessing the availability of the small business CGT concessions?

## Introduction

This article uses a case study to explore the application of the "connected with" and "affiliate" rules in the context of trusts. These rules are in Subdiv 328-C of the *Income Tax Assessment Act 1997* (Cth) and all references to legislation in this article are to this Act.

The case study involves a unit trust selling a post-CGT asset. Broadly, to access the small business CGT concessions found in Div 152, four basic conditions must be satisfied:

1. a CGT event must happen in relation to an asset;
2. the CGT event must result in a capital gain;
3. the taxpayer must satisfy the CGT small business entity (CGT SBE) test or the maximum net asset value (MNAV) test; and
4. the asset must be an active asset and satisfy the active asset test.

In this context, the "connected with" and "affiliate" rules are relevant for the third and fourth conditions listed above. Beyond the small business CGT concessions, the "connected with" and "affiliate" rules are used when determining the availability of several concessions, such as the simpler depreciation rules, the small business income tax offset, and many more listed in s 328-10.

## Case study

The AB Unit Trust is a fixed unit trust that owns post-CGT land (the land) that it uses in its business. The A Family Trust and the B Family Trust each own 50% of the units in the AB Unit Trust. Both the A Family Trust and the B Family Trust are discretionary trusts.

The A Family Trust's beneficiaries are Adam and Abigail, who are spouses, and the A Family Trust has a corporate trustee, with Adam and Abigail as directors and equal shareholders. Each year, the A Family Trust distributes 50% of its income to Adam and 50% to Abigail. The A Family Trust also owns 100% of the shares in the A PrivateCo.

The B Family Trust's beneficiaries are Ben, Benson and Becca, who are father, son and daughter, respectively, and the B Family Trust has a corporate trustee, with Ben, Benson and Becca as directors and equal shareholders. Benson and Becca are adults and Ben is the sole appointor of the B Family Trust.

In most years, the B Family Trust distributes its income equally to Ben, Benson and Becca. However, three years ago, there was an emergency involving Benson that resulted in the B Family Trust distributing 100% of its income that year to Benson.

Becca has her own business, conducted by the Becca Trust, where she is the trustee and there is a broad class of beneficiaries. Generally, Becca is the only person who receives over 40% of the distributions from the Becca Trust. However, three years ago, the Becca Trust also distributed 45% of its income to Benson for his emergency.

See Diagram 1 for the group structure.

The AB Unit Trust wishes to sell the land to an unrelated third-party buyer. The land is a CGT asset and has always been an active asset of the AB Unit Trust's business. The sale will result in a capital gain.

As three of the four conditions necessary for the small business CGT concessions are satisfied, the next step is for the AB Unit Trust to determine whether it passes the CGT SBE test or the MNAV test.

## CGT SBE and MNAV

The CGT SBE test is satisfied when an entity carries on a business and has one of the following:

- an "aggregated turnover" of under \$2m in the previous income year;
- a likely "aggregated turnover" of under \$2m in the current income year; or
- an "aggregated turnover" of under \$2m in the current income year.

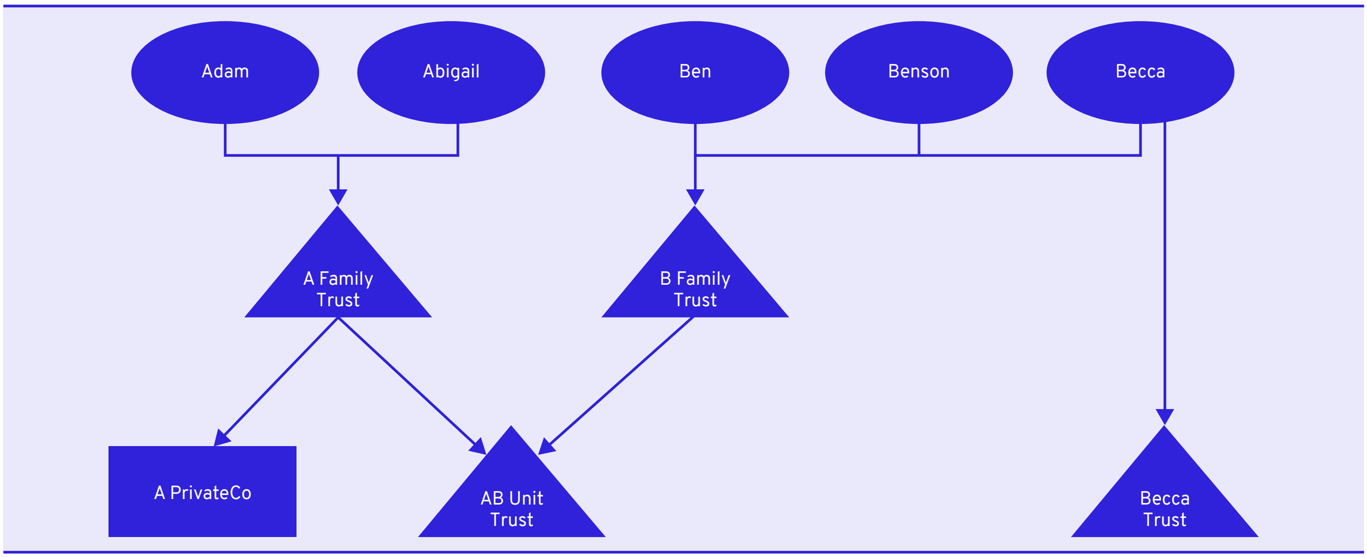
Broadly, "aggregated turnover" is the sum of the ordinary business income of the taxpayer and the ordinary business income of any entity that is "connected with" or is an "affiliate" of the taxpayer.

The MNAV test is satisfied when, just before the CGT event, the following amounts added together do not exceed \$6m:

- the net value of the CGT assets of the taxpayer;
- the net value of the CGT assets of entities "connected with" the taxpayer; and
- the net value of the CGT assets of the taxpayer's "affiliates" and entities "connected with" those "affiliates".

As we can see, both tests require the examination of entities "connected with" the taxpayer and "affiliates" of the

**Diagram 1. Group structure**




taxpayer to determine the availability of the small business CGT concessions.

## Connected entity rules

Under s 328-125, whether an entity is "connected with" another entity depends on control. Section 328-125(1) explains that this connection can be established by either one entity controlling the other or by two entities being controlled by the same third entity.

Section 328-125(2) contains rules for establishing direct control of entities other than discretionary trusts. This includes entities like companies and fixed unit trusts. Broadly, this subsection looks at "control percentage", which can be based on entitlement to distributions of income or capital of the taxpayer and their affiliates. For companies, the control percentage can also be based on the voting power of the taxpayer and their affiliates. The necessary control percentage is 40%.

In s 328-125(3) and (4), there are two rules for establishing the control of discretionary trusts. Under s 328-125(3), control is established when the trustee of the discretionary trust "acts, or could reasonably be expected to act, in accordance with the directions or wishes" of the taxpayer, its affiliates, or both.

Section 328-125(4) also looks at "control percentage" but, unlike s 328-125(2), the control percentage in s 328-125(4) is based on past distributions. Control is established if, in any of the previous four income years, the trustee distributed at least 40% of either the income or capital of the trust to the taxpayer, their affiliates, or both.

Section 328-125(5) excludes an exempt entity or a deductible gift recipient from the application of s 328-125(4).

Section 328-125(6) applies in relation to s 328-125(2) and (4) and confers the Commissioner with the discretion to ignore a taxpayer's interest when the control percentage is greater than 40% but less than 50%. The Commissioner can exercise this discretion if he believes that the entity is controlled by an entity other than the taxpayer.

Section 328-125(7) contains an indirect control test which operates to ensure that, if the first entity controls the second entity and the second entity controls the third entity, then the first entity controls the third entity.

## Affiliate rules

Section 328-130 defines an "affiliate" as:

> "(1) An individual or a company is an ***affiliate*** of yours if the individual or company acts, or could reasonably be expected to act, in accordance with your directions or wishes, or in concert with you, in relation to the affairs of the * business of the individual or company.
>
> (2) However, an individual or a company is not your ***affiliate*** merely because of the nature of the business relationship you and the individual or company share."

As the definition indicates, only individuals or companies can be affiliates.

## Analysis of the case study

### AB Unit Trust

The AB Unit Trust is selling the land. To determine the availability of the small business CGT concessions, we examine whether the other entities are "connected with" the AB Unit Trust or are "affiliates" of the AB Unit Trust.

### A Family Trust and B Family Trust

The A Family Trust and the B Family Trust are both connected to the AB Unit Trust under s 328-125(2)(a). This is because both family trusts own 50% of the units in the AB Unit Trust. As the AB Unit Trust is a fixed unit trust, unless its trust deed expresses to the contrary, each family trust should be entitled to 50% of the AB Unit

Trust's distributions. This gives each family trust a control percentage of 50%, passing the 40% threshold in s 328-125(2)(a). Under s 328-125(1)(a), because both family trusts control the AB Unit Trust, both family trusts are "connected with" the AB Unit Trust.

## Adam and Abigail

As Adam and Abigail are beneficiaries of the A Family Trust and both receive 50% of the A Family Trust's income every year, they both control the A Family Trust by way of having 50% control percentage under s 328-125(4). Under s 328-125(7), because Adam and Abigail control the A Family Trust, and the A Family Trust controls the AB Unit Trust, Adam and Abigail are taken to indirectly control the AB Unit Trust. This results in both Adam and Abigail being "connected with" the AB Unit Trust.

Conversely, it is unlikely that control will be established via s 328-125(3). This is because the corporate trustee has Adam and Abigail as directors and equal shareholders, so it cannot be said that the trustee "acts, or could reasonably be expected to act, in accordance with the directions or wishes" of either Adam or Abigail. This conclusion could be changed if Adam and Abigail were affiliates of each other but, under s 328-130(2), Adam and Abigail are not affiliates merely because of the business relationship that they share. Additionally, outside of the context of certain passively held assets (s 152-47), being married also does not, by itself, deem Adam and Abigail as affiliates of each other.

## A PrivateCo

The A PrivateCo is "connected with" the AB Unit Trust under s 328-125(1)(b) and (2)(b). Under s 328-125(2)(b), the A PrivateCo is controlled by the A Family Trust because the A Family Trust has 100% of the voting power in the A PrivateCo. As the A Family Trust controls both the A PrivateCo and the AB Unit Trust, the A PrivateCo and the AB Unit Trust are "connected with" each other under s 328-125(1)(b).

## Ben, Benson and Becca

Under s 328-125(4), between Ben, Benson and Becca, only Benson controls the B Family Trust, which makes Benson indirectly control the AB Unit Trust under s 328-125(7) and therefore "connected with" the AB Unit Trust.

Benson controls the B Family Trust due to its past distributions, which are as follows:

- one year ago: 33% to Ben, Benson and Becca equally;
- two years ago: 33% to Ben, Benson and Becca equally;
- three years ago: 100% to Benson; and
- four years ago: 33% to Ben, Benson and Becca equally.

Under s 328-125(4), Ben and Becca each have a control percentage of 33%, which is less than the 40% threshold needed to establish control. Benson has a control percentage of 100% due to the distribution from three years ago. This results in Benson controlling the B Family Trust.

Ben's status as the appointor of the B Family Trust does not, by itself, make him control the B Family Trust. ATO ID 2008/139, now withdrawn, used to state that an appointor with the power to remove and replace a trustee of a discretionary trust controls the trust for the purposes of s 328-125(3). ATO ID 2008/139 was withdrawn on 3 October 2014, and since then, it is accepted that holding the office of the appointor, by itself, is not sufficient to conclude that the individual controls the trust.

## Becca Trust

There is uncertainty on whether the Becca Trust is "connected with" the AB Unit Trust due to the Commissioner's discretion under s 328-125(6). Three years ago, the Becca Trust distributed 45% of its income to Benson, giving Benson a control percentage of 45% under s 328-125(4). As Benson's control percentage is between 40% and 50%, the Commissioner has the discretion to disregard Benson's control if the Commissioner thinks that the Becca Trust is controlled by another entity.

Facts that support the Commissioner making such a determination include the fact that Becca is the sole trustee of the Becca Trust, Becca is generally the only person who receives over 40% distributions from the Becca Trust, and Benson not being involved in the business of the Becca Trust.

These facts are also relevant to s 328-125(3), which examines whether the trustee, Becca, "acts, or could reasonably be expected to act, in accordance with" Benson's wishes. Paragraph 2.53 of the explanatory memorandum to the Tax Laws Amendment (Small Business) Bill 2007 listed the following relevant factors:

- "the way in which the trustee acted in the past;
- the relationship between the entities and the trustee;
- the amount of any property or services transferred to the trust by the entity; and
- any arrangement or understanding between the entities and a person or persons who have benefited under the trust in the past."

Becca and Benson are siblings and both trustees of the B Family Trust. We would need more information on how Becca has acted in the past, whether Benson transferred anything to the Becca Trust, and whether there were any arrangements in place.

If the discretion is not exercised under s 328-125(6) or control is established under s 328-125(3), Benson controls both the B Family Trust and the Becca Trust. Under s 328-125(1)(b), the two trusts will be "connected with" each other because Benson controls both.

If the discretion is exercised and Benson does not control the Becca Trust, the Becca Trust will not be "connected with" the AB Unit Trust.

# Result

Each entity's connection to the AB Unit Trust and the relevant s 328-125 subsection are summarised in Table 1.

**Table 1. Connection to AB Unit Trust**

| Entity | Connection with the AB Unit Trust (and relevant s 328-125 subsection) |
|---|---|
| A Family Trust | • Controls AB Unit Trust under s 328-125(2)(a)<br>• Connected under s 328-125(1)(a) |
| Adam and Abigail | • Controls A Family Trust under s 328-125(4)<br>• Controls AB Unit Trust under s 328-125(7)<br>• Connected under s 328-125(1)(a) |
| A PrivateCo | • Controlled by A Family Trust under s 328-125(2)(b)<br>• Connected to AB Unit Trust under s 328-125(1)(b) |
| B Family Trust | • Controls AB Unit Trust under s 328-125(2)(a)<br>• Connected under s 328-125(1)(a) |
| Ben | • No control of B Family Trust |
| Benson | • Controls B Family Trust under s 328-125(4)<br>• Controls AB Unit Trust under s 328-125(7)<br>• Connected under s 328-125(1)(a) |
| Becca | • No control of B Family Trust |
| Becca Trust | • Controlled by Benson under s 328-125(4)<br>• Connected to AB Unit Trust under s 328-125(1)(b)<br>• Uncertainty due to discretion in s 328-125(6) |

For the MNAV test, the entities that are "connected with" or the "affiliates" of the AB Unit Trust will have the net value of their assets included when calculating the AB Unit Trust's MNAV. The values must be market values "just before the CGT event" (s 152-15). Certain assets, such as assets maintained for personal use, are also excluded.

For the CGT SBE test, the entities that are "connected with" or "affiliates" of the AB Unit Trust will have their annual turnover included in the aggregated turnover of the AB Unit Trust. This includes the total ordinary income derived by each of the entities in the ordinary course of carrying on a business in that income year. In ss 328-115 and 328-120, there are also additional rules on what is included and excluded.

## Conclusion

The "connected with" and "affiliate" rules involve careful analysis of group structures. They are integral to determining the eligibility of various small business concessions available to entities. This article serves as a case study and has been necessarily simplified to highlight the application of these specific rules. In practice, there will often be other necessary considerations that call for professional assistance, such as the following:

- Is the active asset test satisfied?
- Do all units in a unit trust carry equal distribution or voting rights?
- What are the market values of each connected entity's assets just before the sale for the purposes of the MNAV test?
- Are the liabilities in relation to the CGT assets for the MNAV test?
- Are there any assets used solely for personal use and enjoyment?
- Are the distributions in the four income years before the sale income or capital?
- What happens if the trust makes a loss?
- How do the individuals get the gain out of the trust?
- Would it be prudent for the parties to sell the units of the unit trust itself instead of the assets of the unit trust?
- Would it be prudent for the parties to restructure the group prior to selling the asset?

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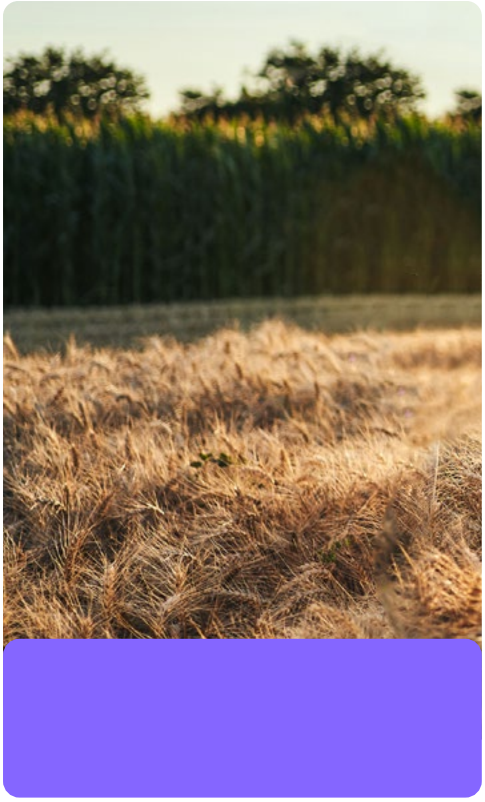

# Superannuation

by William Fettes and Daniel Butler, CTA, DBA Lawyers

# All SMSF members should have an EPoA

All SMSF members must have an appropriately drafted EPoA in place that works hand in hand with their intended succession plans and the relevant SMSF deed and related documents.

It is not an exaggeration to say that being a member of an SMSF without an appropriately drafted enduring power of attorney (EPoA) is courting with disaster.

Indeed, the various potential pitfalls and problems that can arise for SMSFs where the fund member(s) does not have an EPoA mean that a person who is unwilling to have an EPoA should probably be strongly cautioned against having an SMSF in the first place.

It is thus vital that all SMSF members have an EPoA in place to deal with the situation of them potentially losing legal capacity or being unable to act in the future.

Outlined below are some of the key points in relation to the fundamental importance of EPoAs.

## Meeting the trustee–member rules on loss of capacity

To meet the definition of an SMSF in s 17A of the *Superannuation Industry (Supervision) Act 1993* (Cth) (SISA), all fund members must generally be trustees of the fund (or directors of a body corporate that is trustee) and vice versa.

Naturally, this compliance requirement can create serious difficulties where a trustee/director is unable to act at the trustee level due to mental incapacity. For example, it is very common for private company constitutions to contain a provision along the following lines:

> The office of a director will be vacated if the director is mentally incapacitated or becomes of unsound mind, loses legal capacity or becomes, or whose estate becomes, liable to be dealt with in any way under the law relating to mental health.

This type of provision found in many constitutions means that a fund may cease to meet the definition of an SMSF six months after a director/member loses legal capacity (ie after the grace period in s 17A(4) SISA has elapsed) if there are no pre-existing EPoA arrangements in place for the incapacitated member.

More specifically, under a special exception in s 17A(3)(b) SISA, funds can continue to meet the definition of an SMSF where a member's attorney under an EPoA is appointed as a trustee or director in the member's place.

Accordingly, having an EPoA in place can be of vital importance in relation to maintaining a fund's compliance status where a member loses legal capacity.

## Passing control to a trusted person

Under superannuation law, a fund member's loss of mental capacity does not automatically pass control of their SMSF to any particular person.

Unfortunately, many SMSF members do not fully understand how succession to control of their fund works, and thus, they do not plan for it appropriately. Accordingly, it is often the case that control passes haphazardly or by default, ie to the remaining trustee/director (if any) who retains legal capacity.

This can create difficulties, for example, in a blended family situation as the person who has lost capacity may have wanted their children from a previous relationship to have a say in relation to their SMSF. However, if the children were not already admitted to the fund and appointed at the trustee-level, they may only have very limited avenues to influence what happens with decision-making for the fund.

Similarly, if there is no surviving director or trustee with legal capacity (eg in relation to a sole member fund), control of the fund may be put in limbo for a prolonged period due to the absence of proper prior planning.

An EPoA is usually extremely helpful in this regard because (subject to the SMSF deed, the company constitution and the EPoA instrument) it may allow the attorney to "stand in the shoes" of the incapacitated member in relation to helping to achieve an intended structure for the fund/trustee that is aligned to the member's succession planning objectives.

It must be noted that, where a member's attorney is not already occupying a co-trustee/director role, they do not generally become trustees or directors automatically on the member's loss of capacity. Rather, the attorney can help to facilitate the intended outcome in conjunction with other steps being taken, such as:

- in the case of a fund with individual trustees, changing the fund's trustee subject to the terms of the SMSF trust deed; or
- in the case of a fund with a corporate trustee, appointing new director(s) subject to the company's shareholdings and the terms of the constitution.

Thus, it is important that the relevant SMSF deed and company constitution are reviewed, and if relevant updated, to ensure that they are appropriate to enable correct appointments by the member's attorney.

If an automatic succession mechanism is desired to appoint the member's attorney, the inclusion of successor director provisions in the company's constitution can be used to provide a smooth pathway for succession to control to occur in the event of the member losing legal capacity.

## Trusted person

Of course, it should go without saying that the choice of appointing an attorney under an EPoA is a critical one and only the right "trusted" person should be chosen to act in this role.

Although a member may have some flexibility to substitute their nominated attorney for a different choice prior to losing legal capacity, it is likely to be difficult and costly to dislodge a nominated attorney once a member is incapacitated.

## When an SMSF member loses legal capacity without an EPoA

Where a fund member loses legal capacity without an EPoA in place, the situation of taking control of the SMSF is far less straightforward. For example, it may be necessary for a family member or other interested party to apply to a tribunal in the relevant jurisdiction to become an administrator of the member's living estate, eg in Victoria via the Guardianship List of the Victorian Civil and Administrative Tribunal.[1]

Unfortunately, the process of making such an application has some issues. One issue is that there is no guarantee as to who the tribunal will select to be the member's administrator/LPR. For instance, the application could involve a contested process and, even if it is not contested, the tribunal may decide to appoint an independent administrator for various reasons.

Another issue is the additional cost and time associated with this process. For example, it should be borne in mind that the process of obtaining administrator status and then having the administrator appointed at the trustee level could easily exceed the six-month grace period allowed for in s 17A(4) SISA for failing to meet the trustee–member rules. This may result in the fund facing compliance difficulties even where the parties take prompt action after the member's loss of capacity.

Further, if the application is being made to the NSW Trustee & Guardian pursuant to the "managed persons" regime in New South Wales, the situation is even more complex. Financial managers are subject to strict oversight by the NSW Trustee & Guardian and generally have more limits placed on them than administrators. For instance, the standard directions and authority given to a financial manager may not cover dealings with the managed person's SMSF. Thus, additional authorities may be required to take action in respect of an SMSF and expert advice is likely required to address the issue.

For these reasons and others, attorneys appointed under an EPoA during the member's lifetime will provide greater certainty than the situation of needing to appoint an administrator/LPR after a member has already lost legal capacity.

## Conclusion

It is absolutely vital that all SMSF members have an appropriately drafted EPoA in place that works hand in hand with their intended succession plans and the relevant SMSF deed and related documents. Without one, when an SMSF member loses legal capacity, the member's loved ones may well find themselves embroiled in a protracted and costly process (with no guarantee of the ultimate outcome) to have an administrator appointed with a view to assuming control of the fund and to help ensure the fund's complying status.

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### Reference

1 It should be noted that, in many cases, an "administrator" is another type of "legal personal representative" (LPR) who can play a similar role to an attorney.

## Successful Succession

by Tim Donlan, ATI, Donlan Lawyers, and Archana Manapakkam, Velocity Legal

# Secret trusts: less secrecy, more certainty

A recent SA case highlights the obstacles that may arise where a party seeks to assert that an executor holds assets of an estate on the terms of a secret trust.

### Introduction

The concept of the "secret trust" in relation to a will has been known for a long time. Given their secret nature, the number of estates involving secret trusts that are administered without controversy is unknown. However, many such trusts often give rise to disputed legal proceedings that would be better avoided.

Some willmakers, whether due to apathy or anxiety, like to keep their testamentary intentions a little "loose". Solicitors are regularly faced with instructions that reflect a "they know what I want them to do with that" type approach.

Sometimes willmakers wish to maintain a level of privacy in relation to their testamentary affairs. Rather than specifying the intended distribution of their estate via their will, they prefer to leave their estate to a nominated executor on the basis that they will distribute the estate on the death of the willmaker to persons not otherwise mentioned in the will in accordance with previously agreed arrangements for distribution. This is known as a "secret trust".

This type of secret trust arrangement differs from, and should not be confused with, a delegation of willmaking power where a willmaker delegates the responsibility of determining who should benefit from their estate to another person. In general, a person cannot delegate the power to make a will on their behalf.[1] The courts have identified exceptions to that rule against delegation of testamentary power in some circumstances, including where a willmaker provides a power to confer a benefit on anybody (including the executor[2]) or where the willmaker confers the power on the executor to confer benefits on only a limited class of persons who are able to be identified with sufficient certainty.[3]

Most states and territories in Australia have now abolished the rule against delegation of testamentary power by statute.[4] However, it still continues to apply in South Australia and Western Australia.

### Secret trusts

For a secret trust to be valid, there are three specific requirements that must be met: the willmaker must intend to establish a trust; the intention of the willmaker must be conveyed to the trustee (usually an executor); and the trustee must agree to accept the duty and act as trustee as requested by the willmaker.

There are two types of secret trusts, "fully secret trusts" and "half secret trusts". A fully secret trust is one where there is no mention at all of the trust in the will. The agreement between the willmaker and the trustee is made outside of the will. The will merely leaves a gift to the trustee on a fully secret understanding that it will be gifted to the ultimate beneficiary by the trustee in due course.

In the case of a half secret trust, the willmaker leaves the gift to the trustee "to hold upon the terms of a trust", such terms not being specified in the will.

A difference between the two types of secret trust is how they are communicated. In the case of a half secret trust, the intention of the willmaker is conveyed to the trustee *before* the will is made. With a full secret trust, that merely appears in the will as a gift to the intended trustee, and the intention of the willmaker (and the satisfaction of the three certainties identified above) can occur at any time *before or after* the making of the will prior to the willmaker's death.

It is not difficult to envisage problems arising with respect to secret trusts. At a simple level, an alleged trustee of a full secret trust may simply "forget" or deny the existence or terms of any agreed trust relationship with the willmaker.[5] In those situations, the credibility of the relevant witnesses will be highly influential for a court when determining the existence or terms of the secret trust. If a trustee of a fully secret trust dies before the willmaker, the existence of the trust will also be difficulty to establish.[6]

The existence of a half secret trust will be more difficult to deny by a trustee. While the terms of the trust may be subject to dispute, the existence of a trust of some sort will usually be evident from direct references to it in the will. If a trustee of a half secret trust disclaims their role as trustee or dies before the willmaker, then, assuming the terms of the trust can be determined, the courts will be able to appoint a replacement trustee to administer the trust.[7]

### Burke v Public Trustee for South Australia

In *Burke v Public Trustee for South Australia*,[8] the Court of Appeal of the Supreme Court of South Australia was called on to consider, on an application for advice and directions, as to whether the Public Trustee as the administrator of a deceased estate would be justified in distributing the estate of a deceased on the basis of a half secret trust.

## Facts

Lady Edith Badger OAM died at the age of 100, a widow with no children or grandchildren. She left a will dated 16 July 2012 (the 2012 will) which appointed Mr Richard Burke as her sole executor and trustee, and gifted the whole of her estate to him "to distribute the same as he shall know to be in accordance with my wishes".

A month or so later, Mr Burke also died, without having obtained a grant of probate in Lady Badger's estate. He was survived by Mrs Carolyn Burke, his wife and the sole executor and beneficiary of his estate. Mrs Burke did not obtain a grant of probate in either estate but rather, on her request, the Public Trustee obtained a grant of letters of administration with the will of each estate annexed.

As might be anticipated, an issue (and later, a dispute) arose as to the proper interpretation of the will and the existence and terms of any half secret trust. The Public Trustee argued that it would be justified in administering the estate in accordance with a letter of wishes left by the deceased as to the distribution of her estate that had been made prior to the execution of the will in 2012. The objects of the trust were those set out in a letter of Lady Badger's wishes dated 15 August 2008 (the 2008 letter of wishes). Notably, neither Mr Burke nor Mrs Burke were included as intended beneficiaries in that letter, and so stood to receive nothing on distribution of the estate if it contained the terms of the secret trust.

Lady Badger had made an earlier will in 2007. The terms of the 2008 letter of wishes referred to the 2007 will in stating:

> "For the help and guidance of my executors and trustees, I have enumerated below the actions I request my executors and trustees take during the administration of the trusts of my will dated the 23rd day of April 2007. The purposes of my request is not to fetter the discretion given to my executors and trustees but afford them guidance in the way I wish them to exercise their discretion."

The terms of the 2008 letter of wishes were complex and explicit. They were effectively set out in a format that one would typically see in a will. The overriding motivation of secrecy was highly evident as opposed to any demonstrable motivation of simplicity or a delegation of willmaking authority. The terms of the letter of wishes included specific gifts of money, the establishment of separate trusts for income to certain beneficiaries, the establishment of scholarships, and the division of the residuary estate between various charitable organisations.[9]

The terms of the 2007 will and the 2008 will were largely similar, save for the appointment of executors. In the 2007 will, the willmaker had named a solicitor and Mr Burke as executors. In the 2012 will, Lady Badger named only Mr Burke as her executor. The solicitor named in the 2007 will, Mr Tarca, had prepared the 2008 letter of wishes, as well as a letter of wishes in 2007. Both the 2007 letter of wishes and the 2008 letter of wishes referred to the 2007 will. There was no separate letter of wishes that referred to the 2012 will.

The issues to be resolved by the court, on an application for advice and directions, were whether the 2008 letter of wishes was intended to apply to the 2012 will. If it did, the terms of the 2008 letter of wishes would determine the terms of the half secret trust and distribution of the estate. Alternatively, if it did not apply to the 2012 will, there may not have been any effective disposal of the residuary estate under the 2012 will and it was considered whether the estate would then need to be distributed on the basis of an intestacy.[10]

Mrs Burke somewhat belatedly contended that the terms of the half secret trust had been changed from those expressed in the 2008 letter of wishes. She alleged that, although the precise terms were not known to her, the updated terms of the half secret trust were intended by the willmaker to benefit Mr Burke and that Mr Burke was entitled to be gifted the entire estate of Lady Badger. That being the case, as his executor and the beneficiary of his estate, she would in turn receive his interest in it.

Obvious limitations when assessing the merits of Mrs Burke's claims of amended terms of the half secret trust was Mr Burke's death and the inability to lead any evidence in that regard. The evidence led by Mrs Burke was limited. It had to be considered as part of the argument as to her application to be joined in the application for advice and directions, rather than being considered as to any final factual determination as to the existence of any later half secret trust. She led evidence as to what Mr Burke said Lady Badger had told him about changing the half secret trust to benefit him. The weight to be afforded that evidence and its reliability were carefully considered by the court. There was also evidence of changed funeral and burial arrangements, as well as an expression of gifts to certain beneficiaries that were alleged to be inconsistent with the terms of the 2008 letter of wishes.

The primary judge at first instance determined and gave advice to the Public Trustee that it would be justified in administering the estate on the basis of the half secret trust as described in the 2008 letter of wishes. On appeal to the Court of Appeal, the majority refused the appeal and determined that the primary judge had not erred in providing the advice that it did, nor in refusing the joinder in the proceedings of Mrs Burke.

## Conclusion

The use of secret trusts as an estate planning tool is probably best avoided. The position of trustee of a secret trust, particularly for a professional adviser such as an accountant or a solicitor, is not a desirable one. The costs of adducing evidence to support the existence of the trust and its terms will typically be significant, if indeed satisfactory evidence can be obtained at all. At a minimum, a proper recording of the terms of the trust should be made. Ironically, as in the case of Lady Badger, the objective of a willmaker to maintain secrecy will foreseeably lead to greater scrutiny and publicity of the testator's dispositions than may have arisen if the terms of the will itself were more transparent.

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## References

1 *Lutheran Church of Australia South Australia District Incorporated v Farmers' Co-Operative Executors and Trustees Ltd* [1970] HCA 12.

2 *Tatham v Huxtable* [1950] HCA 56.

3 *Tatham v Huxtable* [1950] HCA 56. For example, where a testator leaves a gift to an executor "to divide between the children of the testator", this would arguably be sufficient not to offend the rule.

4 S 33R of the *Succession Act 1981* (Qld); s 48 of the *Wills Act 1997* (Vic); s 14A of the *Wills Act 1968* (ACT); s 43 of the *Wills Act 2000* (NT); s 58 of the *Wills Act 2008* (Tas); s 44 of the *Succession Act 2006* (NSW).

5 *Duggan v White* [2018] NSWSC 364.

6 *Re Maddock; Llewelyn v Washington* [1902] 2 Ch 220 at 231 per Cozens-Hardy LJ.

7 *Ledgerwood v Perpetual Trustee Co Ltd* (1997) 41 NSWLR 532 at 532–536 per Young J.

8 *Burke v Public Trustee for South Australia* [2022] SASCA 64.

9 The provision in the letter of wishes regarding the division of the residuary estate was expressed to be: "… without any obligation to ensure equality amongst those organisations, institutions and charities to which payments are made." As a division at the discretion of the trustee (executor) between certain identifiable objects if expressed in the will that would arguably not offend the rule of delegation of testamentary power.

10 There were no surviving relatives of Lady Badger and therefor the estate would vest in the Crown.

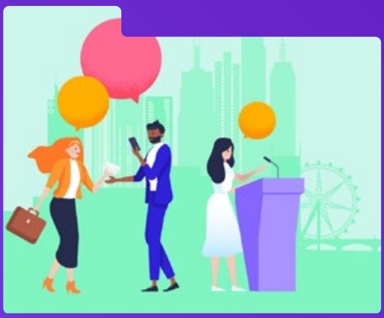
# Events Calendar

## Upcoming months

MAY
**3–4**
Wed–Thu

VIC

### VIC Tax Forum



12 CPD hours

MAY
**17–18**
Wed–Thu

NSW

### NSW Tax Forum

14 CPD hours

MAY
**24–25**
Wed–Thu

QLD

### QLD Tax Forum

12 CPD hours

JUNE
**1–2**
Thu–Fri

Online

### Trusts Intensive

8 CPD hours

For more information on upcoming events, visit taxinstitute.com.au/events.

# Cumulative Index

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# Giving back to the profession

The Tax Institute would like to thank the following presenters from our February/March 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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