

eJournal of Tax Research

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In Memory of
JOHN RANERI
1957-2005

The logo for Atax UNSW Faculty of Law. It features the word "Atax" in a large, white, serif font with a blue swoosh underline. Below it, "UNSW" is written in a smaller, white, sans-serif font, and "Faculty of Law" is written in an even smaller, white, sans-serif font at the bottom.

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eJournal of Tax Research

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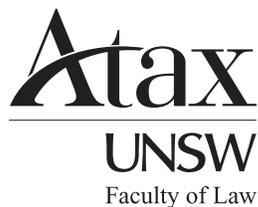
eJournal of Tax Research

EDITOR'S NOTE

The *eJournal of Tax Research* is a refereed journal that publishes original, scholarly works on all aspects of taxation. It aims to promote timely dissemination of research and public discussion of tax-related issues, from both theoretical and practical perspectives. It provides a channel for academics, researchers, practitioners, administrators, judges and policy makers to enhance their understanding and knowledge of taxation. The journal emphasises the interdisciplinary nature of taxation. To ensure the topicality of the journal, submissions will be refereed quickly.

SUBMISSION OF ORIGINAL MATERIAL

Submission of original contributions on any topic of tax interest is welcomed, and should be sent as an email attachment to the Production Editor at <ejtr@unsw.edu.au>. Submission of a manuscript is taken to imply that it is an unpublished work and has not already been submitted for publication elsewhere. Potential authors are requested to follow the "Notes to Authors", which is available from the journal's website.



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Preface – Editors’ Note

We have taken the unusual step of writing an editorial note for this edition of the *eJTR* because it is a commemorative issue to honour the contribution to Australian tax made by our late colleague John Raneri. John had a passion for tax law that was unmatched, he had an eye for detail that made him stand out amongst practitioners and academics and he was, simply, meticulous in his tax practice and research. As an academic, John was what we sometimes call ‘a black letter lawyer’. He had an eye for the technical detail of the legislation that few others have. This skill as well as John’s many other qualities are sadly missed at Atax.

The papers that have been chosen for this issue are selected by reason of the interest John would have shown in their topics were he still with us. He was an expert in (amongst other things) stamp duty; taxation of trusts; taxation of corporations; and the anti avoidance rules. These are all topics chosen for this issue of the *eJTR*. We trust our readers will enjoy them, we suspect our late friend would have done so. Each of the authors also had close contact with John and we thank them for these contributions in his memory.

On John’s passing we feel we could never improve the eulogy for John given by our friend and editorial board member, former Director of Atax Prof Bob Deutsch. Those moving, personal words are reproduced below with our thanks.

Michael Walpole
Binh Tran-Nam

Co-editors
eJTR

Eulogy

Farewell to my fallen friend

JOHN CHARLES RANERI

14 July 1957 – 20 July 2005

by Bob Deutsch

It was in 1990 that I was sitting in my office at the city law firm Mallesons Stephen Jacques overlooking the harbour when I was buzzed by my secretary – “there’s a fellow on the phone for you – the name’s Raneri, John Raneri and he says he knows you.” Well, I didn’t let on that I had absolutely no idea who he was, so John and I talked on the phone for 15 minutes about conferences we’d both attended and how he was now looking for a new professional challenge and would Mallesons be interested. So we arranged a meeting for the following week and when he arrived all my worst fears were realised – I thought his face might trigger my apparently failing memory but I was sure I’d never met him and still he acted like we knew each other well. Funny thing is - so did I!

Needless to say with such a formidable Curriculum Vitae we did employ John and we became the best of friends from that moment on.

Several years later, I think it was about 1995, we were both firmly entrenched at Atax and having our umpteenth coffee talking about pressing issues in international tax when somehow the topic came up about our meeting back in 1990. “You know” I said to him “when you rang in to Mallesons all those years ago I had absolutely no idea who you were.” “Well” said John with that combination beaming smile and raucous laugh that was his trademark, “I knew that but it was my best shot at getting an interview and I knew you’d be too polite to let on that you had no idea who I was”.

Well I am grateful to John that he persisted with his deception because it meant that for 15 years I had one of the finest friends anyone could ever ask for.

John’s professional career began back in 1982 when he took a position in the Tax Division of Arthur Andersen. This was followed by brief stints with Walker and Raphael, Ernst and Whinney and Coleman and Greig. While working hard as a junior tax lawyer John also managed to complete his Master of Laws (LLM) at Sydney University, graduating with High Distinctions in three of his five subjects and Distinctions in the other two.

His LLM thesis titled “The Prevention of Double Taxation under the CFC Regime – An Examination of the Main Relief Provisions”, while mandatory reading only for the

certifiably insane (like myself and about a third of today's audience) was a major paper which recognised many complex tax issues in the operation of Australia's international tax rules. Many of the issues John raised were specifically addressed in subsequent legislation that was passed by Parliament.

John then spent three years with Mallesons as a senior tax lawyer before joining us at Atax. Like myself, John had a need to combine his practical work with his passion for teaching. Perhaps this is one of the reasons we understood each other so well.

The years from 1994 up to April of 2000 were perhaps the best years of John's professional life. He was highly constructive in the development of the Atax program contributing significantly to the international tax profile of the organisation. His writing continued and he was a frequent contributor to seminars and professional discussions on diverse tax matters. At the same time he continued to assist his late father on a day per week basis in the development of his practice.

He imposed exacting standards on himself and this was exemplified by the high quality of his technical work. Never one to shirk responsibility, he always worked to achieve excellent materials for his many students, many of whom have rung me in the last few days to tell me of the high regard in which they held him.

Together with Roger Hamilton, John and I wrote for many years, the *Guidebook to Australian International Tax* – J.K. Rowling need have no fear of market erosion resulting from the widespread popularity of this book but nevertheless in its time this work was to be found in the tax libraries of most firms and universities throughout Australia and even overseas. John's contributions were a key component of its ongoing success.

He shared many special bonds with his colleagues at Atax. In the early frenetic years he worked closely with Yuri Grbich and Pat Gallagher and then later with Mike Walpole Chris Evans Steven Abadee Colin Fong Shirley Carlon Maurice Cashmere Wouter Scholtz Jacqui McManus and Binh Tran-Nam. He greatly valued his intellectual exchanges with them all and enjoyed the comradeship they provided in his work environment. His contact with more recent Atax recruits was regrettably more low-key as his debilitating illness prevented him spending much time at Atax beyond the immediate work requirements. On his behalf I would particularly like to thank Matthew Wallace, Garry Payne, Yuri and Maurice who helped me, without a word of complaint, to pick up the international and other tax teaching components when John fell ill.

John had a special affinity with the Atax administrative staff who especially admired his courage and resilience in the face of so many setbacks. I made sure that whenever I visited him in the last few difficult months their special prayers and thoughts were passed on to him. John and Maryse were always cognisant of the compassionate and caring way in which the University dealt with John's situation extending to him the flexibility his circumstances necessitated.

Many years ago John indicated to me that he would like to see a real Passover celebration one day. So when the opportunity arose this April to host the festival for our extended family at our home my wife, Linda suggested to me that we invite the Raneri's. Happily John, Maryse, Samantha, Alicia and Dominic were able to join us

and I have special memories of a wonderful night sharing religious practices and one filled with much joy, goodwill and laughter.

During the last troubled five years John bore his illness with unbelievable courage and dignity. Sometimes he pulled it off so well even I started to believe, albeit briefly, that meaningful recovery was possible. My extended family found it hard to believe how ill he was having regard to the way he behaved and looked at our Passover dinner.

I tried the other day to work out how many times John and I had sat together sipping coffee, hot chocolate and more recently just water - chewing the fat about a whole variety of topics – kids, wives, schools, money, religion, films and of course death and taxes – the list really was quite endless.

I think the total was around 500, sometimes in the city, sometimes in Randwick, sometimes Clovelly and more recently during his various convalescences in Burwood and Strathfield. With John I always felt relaxed and comfortable and discussion was always, well almost always, fun unless of course we talked of death and taxes.

I will miss our times together – even the sad ones because for me being with John was always a pleasure and if I could brighten his day just one iota, the trip even to far-flung Strathfield was always worth it.

John was a man of great love, courage, dignity and faith. He adored his family of whom we spoke many times. He told me just a few weeks ago that without Maryse he could never have survived even this far. His three children were a constant source of joy to him and he worried about their future- without saying it I knew he meant their future in his absence.

His mother, his late father and his brother Carl were always with him - if not physically, in spirit. And he made special mention of his sister-in-law Veronica. Just a few weeks ago when I saw him for the last time at his home he said to me if you ever need help professionally, make sure you get Veronica on your side!

I last tried to speak to John on the phone on the Friday before he died. He held the phone to his ear and he only had enough energy to say 3 words. He said to me “God bless you.” Even in his darkest hour John was a believer and he used what little energy he had left to bless me. I think that tells you everything you need to know about John Raneri.

My life was greatly enriched by John’s presence in it and it is greatly diminished by his absence from it. Tonight we will all say a prayer for my fallen friend – the language will be different but the message will be much the same. My message will be one of thanks – thanks for letting me be part of the life of such a wonderful human being - even if only for 15 short years.

FAREWELL MY FRIEND – I SO HOPE WE MEET AGAIN SOME SUNNY DAY!

July 2005

Refocusing on Fundamental Principles of Stamp Duty

Bill Cannon and Peter Edmundson*

Abstract

This article refocuses on the fundamental principles of Stamp Duty in the context of the rewrite of stamp duty and tax reform. The article traces the course of these changes through the States in Australia and carefully tracks changes to heads of duty such as lease duty, duty on hire of goods, duty on quoted marketable securities, on business assets etc. The article notes an increasing emphasis on dealings in land and the greater role of land rich duty in the tax base. It examines the constitutional validity of land rich duty as well as flagging the validity of anti-avoidance measures that purport to operate outside of the jurisdiction of a State. The article finally reflects on the pursuit of uniformity amongst the State jurisdictions and expresses the hope that a narrower tax base, a consequence of tax reform, may well return us to the process of consistency of application of duty across jurisdictions.

INTRODUCTION

In recent years there have been many significant changes to stamp duties in Australia. One fundamental transformation has been the change of emphasis from being a tax levied on certain instruments to a tax levied on certain transactions. To some extent this process was accelerated during the rewriting of stamp duty law conducted by some States and Territories in the last decade.¹ The more recent changes have involved the abolition of a number of duties as an indirect result of the introduction by the Commonwealth of the goods and services tax ("GST"). This has involved a significant change in the stamp duty tax base.

In the early stages of the Rewrite process, one of the authors of this article analysed some fundamental principles of stamp duty law and the potential effect of the Rewrite on these principles.² This article seeks to re-examine some of these basic issues in the light of the potential changes to the scope and significance of stamp duties and comment on where future issues may lie. What emerges is that the narrowing of the stamp duty base will increase the relative emphasis on the imposition of duty on dealings in land. This is likely to refocus attention on matters concerning indirect dealings in land. In particular, there is scope in the future for re-examination of the ability of the States and Territories to tax dealings in land-holding entities that are otherwise unconnected with the taxing jurisdiction. There will also be increased pressure on both general and specific anti-avoidance provisions in order to protect a narrowing tax base.

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¹ This process (the "Rewrite") flowed from the release in 1995 of an exposure draft published for discussion purposes by the revenue offices of a number of States and the Australian Capital Territory.

² WDM Cannon, (1996). "Fundamental Principles of Stamp Duty" 19(1) UNSWLJ 1.

Whether or not the pursuit of uniformity will be forgotten in this process remains to be seen. However, it is notable that the greatest steps toward uniformity have been made in relation to duties that are being abolished and there are still fundamental differences between the jurisdictions in relation to the taxation of dealings in land and the anti-avoidance mechanisms that support such taxation.

While some reference will be made to other States and Territories, for the sake of brevity when specific matters are discussed the main focus will be on the position in New South Wales.

THE REWRITE AND SUBSEQUENT CHANGES TO THE TAX BASE

The process of rewriting stamp duties laws undertaken by a number of jurisdictions gathered momentum in the mid-1990s. In 1995 an exposure draft was released by the various revenue offices of New South Wales, Victoria, South Australia, Tasmania and the Australian Capital Territory. This Rewrite exposure draft recognised that traditional stamp duties on instruments may be problematic in the context of the increasing volume of transactions undertaken without paper documentation. The benefits of moving toward a more uniform approach to duties was also apparent, although it was clear from the start that not all jurisdictions were keen to participate in the process.

Following release in 1997 of a second exposure draft of Rewrite Duties legislation in New South Wales, the *Duties Act 1997* (NSW) based on that exposure draft was introduced. Similar (but not identical) Duties Acts were subsequently enacted in the Australian Capital Territory, Victoria and Tasmania.³

Queensland also followed with its own version in 2001.⁴ Western Australia, South Australia and the Northern Territory did not enact new Duties Acts. Rather, they retained their existing stamp duty legislation, although they introduced a number of amendments, some of which had the aim of achieving consistency across the various jurisdictions.⁵

To some extent the Rewrite process was overtaken by the introduction of GST and the agreement between the Commonwealth and the States and Territories dealing with the narrowing of the stamp duty base by the abolition of duty on a number of dealings. The agreement between the Commonwealth and the States and Territories, in the form of the Intergovernmental Agreement on the Reform of Commonwealth-State Financial Relations (the "Intergovernmental Agreement"),⁶ provides for the distribution to the States of revenue raised by the Commonwealth from the collection of GST. It also has

³ *Duties Act 1999* (ACT); *Duties Act 2000* (Vic); *Duties Act 2001* (Tas).

⁴ *Duties Act 2001* (Qld).

⁵ Amendments made for the purpose of achieving consistency related principally to mortgage duty and hire of goods duty.

⁶ The text of the Intergovernmental Agreement can be found in Schedule 2 of the *A New Tax System (Commonwealth-State Financial Arrangements) Act 1999* (Cth). While this Act purports to give effect to the Intergovernmental Agreement (in fact it states that it is the "intention" of the Commonwealth to comply with, and give effect to, it: see section 10), there are significant doubts about its legal enforceability by any party: see generally Saunders, (2000) "Federal Fiscal Reform and the GST" 11 *Public Law Review* 99.

the aim of “the achievement of a new national tax system, including the elimination of a number of existing inefficient taxes which are impeding economic activity”.⁷

Under the Intergovernmental Agreement, the States and Territories agreed to abolish stamp duties on quoted marketable securities by 1 July 2001.⁸ All jurisdictions have abolished this duty and financial institutions duty (if previously imposed). It was also agreed that the tax, or similar taxes, would not be reintroduced in the future. Obligations in relation to some other heads of stamp duty are more vague. It was agreed that the Ministerial Council, a body formed to oversee the operation of the Intergovernmental Agreement,⁹ would:

by 2005 review the need for retention of stamp duty on non-residential conveyances; leases; mortgages, debentures, bonds and other loan securities; credit arrangements, instalment purchase arrangements and rental arrangements; and on cheques, bills of exchange, promissory notes; and unquoted marketable securities.¹⁰

The response of various governments to the “review” of these taxes has not been uniform. The Commonwealth has expressed the view that the States and Territories are obliged to abolish these taxes. It has stated:

The reason for agreeing to a review of these taxes, rather than setting a firm date for their abolition, reflected uncertainty in 1999 about when GST revenue would be sufficient to fund their abolition. It was understood that if GST revenue proved to be sufficient at the time of the review, the states would abolish these stamp duties.¹¹

At a meeting of the Ministerial Council on 23 March 2005, the Commonwealth proposed a timetable for the abolition of the various duties with almost all to be removed by 1 July 2006.¹² On 20 April 2005, all States and Territories except New South Wales and Western Australia made a “counter-offer” which proposed a slower and more flexible abolition of the taxes.¹³ The timetable differs for each jurisdiction but involves the removal by 2010-2011 of the taxes reviewed under the Intergovernmental Agreement.¹⁴ The one exception is the limited removal of duty on non-residential conveyances with the maintenance by the States and Territories of duty on the real property component of business sales.¹⁵ Some time after the announcements by other States and Territories, Western Australia agreed to abolish a

⁷ See clause 2(i) of the Intergovernmental Agreement.

⁸ See clause 5(vi) of the Intergovernmental Agreement. The States and Territories also agreed to abolish bed taxes and financial institutions duty by 1 July 2001 and debits tax by 1 July 2005.

⁹ See clauses 40 and 42 of the Intergovernmental Agreement. Membership of the Ministerial Council comprises the Treasurers of the Commonwealth, States and Territories (or their designated representatives): clause 41 of the Intergovernmental Agreement.

¹⁰ Clause 5(vii) of the Intergovernmental Agreement.

¹¹ Commonwealth of Australia, *2005-06 Budget Paper No 3: Federal Financial Relations 2005-06*, p 20.

¹² *Ibid* at 20-21.

¹³ New South Wales, *Budget Paper No 2 Budget Statement 2005-06*, p 8-11.

¹⁴ Australian Capital Territory, *2005-06 Budget Paper No. 3: Overview*, p79-81.

¹⁵ The Australian Capital Territory has stated that “[w]ith respect to stamp duty on business conveyances of real property, on both administrative and public policy grounds, all States have stated that they do not support having different treatment of residential and business property”: Australian Capital Territory, *2005-06 Budget Paper No. 3: Overview*, p 81. One must also assume that the effect on revenue is a consideration.

number of the “review” taxes.¹⁶ Finally, following intense and public political pressure,¹⁷ New South Wales announced the removal of a number of the taxes.¹⁸

Differences in terminology and application of various taxes make generalisations difficult. However, most jurisdictions have abolished or will abolish mortgage duty (see Table 1 below), duty on leases of real property (see Table 2 below), duty in relation to the hire of goods¹⁹ (see Table 3 below), duty on marketable securities that are not quoted on a recognised stock exchange (see Table 4 below), and duty on the conveyance of business assets other than real property (see Table 5 below). The abolition of various taxes on credit arrangements, bills of exchange, cheques and promissory notes has also been announced.²⁰

TABLE 1: CHANGES TO MORTGAGE DUTY

JURISDICTION	CHANGES
NSW	Mortgage duty will be phased out by being reduced by 50% from 1 January 2010 with complete abolition from 1 January 2011: see New South Wales, <i>Budget Paper No 2 Budget Statement 2006-07</i> , p 8-17.
VIC	Abolished in Victoria on 1 July 2004: <i>Duties Act 2000</i> (Vic) s148A.
QLD	Mortgage duty will be phased out by being reduced by 50% from 1 January 2008 with complete abolition from 1 January 2009: see Queensland Government, <i>State Budget 2005-06 Budget Strategy and Outlook Budget Paper No 2</i> , p81.
WA	Mortgage duty will be phased out by being reduced by 50% from 1 July 2006 with complete abolition from 1 July 2008: WA Office of State Revenue, <i>Circulars 83 & 84</i> , April 2006.
SA	Mortgage duty is being phased out by 1 July 2009 through a combination of reductions of the tax base and changes to the rate: see RevenueSA, <i>Stamp Duties Circular No 255: State Budget 2005-2006</i> .
TAS	Mortgage duty is to be reduced by 50% on 1 July 2006 and abolished completely on 1 July 2007: see Parliament of Tasmania, <i>Budget Overview 2005-06 Budget Paper No 1</i> , p119.
ACT	In the ACT duty is only charged on mortgages if it is chargeable under another head of duty (see <i>Duties Act 1999</i> (ACT) s174) and on 18 August 2003 the ACT Government formally abandoned its plans to introduce a comprehensive mortgage duty.
NT	The Northern Territory does not impose stamp duty on mortgages.

¹⁶ See Government of Western Australia Media Statement 21 March 2006 (Alan Carpenter MLA and Eric Ripper MLA).

¹⁷ This included television advertisements and full-page newspaper advertisements in which the Commonwealth accused New South Wales of “double taxation”: see, for example, Sydney Morning Herald, Friday March 31, 2006, p 6.

¹⁸ New South Wales, *Budget Paper No 2 Budget Statement, 2006-07*, p 8-17.

¹⁹ Including duty in relation to installment purchase arrangements.

²⁰ Queensland will abolish credit business duty on 1 January 2006: see Queensland Government, *State Budget 2005-06 Budget Strategy and Outlook Budget Paper No 2*, p81; the ACT will abolish duty on credit arrangements by 1 July 2007: Australian Capital Territory, *2005-06 Budget Paper No. 3: Overview*, p81; New South Wales will abolish duty on credit arrangements on 1 July 2007: New South Wales, *Budget Paper No 2 Budget Statement 2006-07*, p 8-17.

TABLE 2: CHANGES TO LEASE DUTY

JURISDICTION	CHANGES
NSW	Lease duty will be abolished from 1 January 2008: New South Wales, <i>Budget Paper No 2 Budget Statement 2006-07</i> , p 8-17.
VIC	Abolished from 26 April 2001: <i>State Taxation Acts (Taxation Reform Implementation) Act 2001</i> (Vic) ss5 and 15.
QLD	Lease duty abolished from 1 January 2006: see Queensland Government, <i>State Budget 2005-06 Budget Strategy and Outlook Budget Paper No 2</i> , p81.
WA	Lease duty was abolished from 1 January 2004.
SA	Lease duty abolished from 1 July 2004: see RevenueSA, <i>Stamp Duties Circular No 246: State Budget 2004-2005</i> .
TAS	Tasmania does not impose stamp duty on leases.
ACT	Lease duty will be abolished by 1 July 2009: Australian Capital Territory, <i>2005-06 Budget Paper No. 3: Overview</i> , p81.
NT	Duty on the grant or renewal of leases and franchises abolished from 1 July 2006. However, the transfer of rights under a lease or franchise arrangement may be dutiable as a conveyance until the abolition of duty on non-residential conveyances (other than land): Northern Territory, <i>Fiscal and Economic Outlook 2005-06 Budget Paper No.2</i> , p64.

TABLE 3: CHANGES TO DUTY IN RELATION TO HIRE OF GOODS

JURISDICTION	CHANGES
NSW	Duty on rental arrangements to be abolished from 1 January 2007: New South Wales, <i>Budget Paper No 2 Budget Statement 2006-07</i> , p 8-17.
VIC	Rental business duty to be abolished from 1 January 2007: Victoria, <i>2005-06 Strategy and Outlook Budget Paper No. 2</i> , p79.
QLD	Hire of goods duty will be abolished from 1 January 2007: see Queensland Government, <i>State Budget 2005-06 Budget Strategy and Outlook Budget Paper No 2</i> , p81.
WA	Hire of goods duty is to be abolished from 1 January 2007: WA Office of State Revenue, <i>Circular 84</i> , April 2006.
SA	Rental business duty to be phased out by being reduced by one third on 1 July 2007, one third again on 1 July 2008 and removed completely on 1 July 2009: see RevenueSA, <i>Stamp Duties Circular No 255: State Budget 2005-2006</i> .
TAS	Rental business duty was abolished on 1 July 2002: <i>Revenue Legislation (Miscellaneous Amendments) Act 2002</i> (Tas) s23.
ACT	Hire of goods duty will be abolished by 1 July 2007: Australian Capital Territory, <i>2005-06 Budget Paper No. 3: Overview</i> , p81.
NT	Hire of goods duty will be abolished from 1 July 2007. Northern Territory, <i>Fiscal and Economic Outlook 2005-06 Budget Paper No.2</i> , p64.

TABLE 4: CHANGES TO DUTY ON UNQUOTED MARKETABLE SECURITIES

JURISDICTION	CHANGES
NSW	To be abolished on 1 January 2009: New South Wales, <i>Budget Paper No 2 Budget Statement 2006-07</i> , p 8-17.
VIC	Abolished from July 2002: <i>Duties Act 2000</i> (Vic) s7 (3A).
QLD	To be abolished from 1 January 2007: see Queensland Government, <i>State Budget 2005-06 Budget Strategy and Outlook Budget Paper No 2</i> , p81.
WA	Duty on unquoted shares was abolished from 1 January 2004.
SA	To be halved by 1 July 2009 with complete abolition on 1 July 2010: see RevenueSA, <i>Stamp Duties Circular No 255: State Budget 2005-2006</i> .
TAS	Duty on marketable securities was abolished on 1 July 2002: <i>Revenue Legislation (Miscellaneous Amendments) Act 2002</i> (Tas) s5.
ACT	To be abolished by 1 July 2010: Australian Capital Territory, <i>2005-06 Budget Paper No. 3: Overview</i> , p81.
NT	Abolished from 1 July 2006. Northern Territory, <i>Fiscal and Economic Outlook 2005-06 Budget Paper No.2</i> , p64.

TABLE 5: CHANGES TO DUTY ON SALE OF BUSINESS ASSETS (OTHER THAN REAL PROPERTY)

JURISDICTION	CHANGES
NSW	Duty to be abolished on 1 July 2012: New South Wales, <i>Budget Paper No 2 Budget Statement 2006-07</i> , p 8-17.
VIC	Duty not charged on business assets (although attempts have been made to build the value of goodwill into the value of real property).
QLD	Duty to be reduced by 50% on 1 January 2010 and removed completely on 1 January 2011: see Queensland Government, <i>State Budget 2005-06 Budget Strategy and Outlook Budget Paper No 2</i> , p81.
WA	Duty on the sale of non-real business property will be abolished from 1 July 2010: WA Office of State Revenue, <i>Circular 84</i> , April 2006.
SA	Duty on non-realty conveyances will be reduced by 50% on 1 July 2009 and abolished completely on 1 July 2010: see RevenueSA, <i>Stamp Duties Circular No 255: State Budget 2005-2006</i> .
TAS	To be abolished on 1 July 2008: see Rental business duty was abolished on 1 July 2002: see Parliament of Tasmania, <i>Budget Overview 2005-06 Budget Paper No 1</i> , p111-112.
ACT	To be abolished by 1 July 2006: Australian Capital Territory, <i>2005-06 Budget Paper No. 3: Overview</i> , p81.
NT	To be abolished from 1 July 2009: Northern Territory, <i>Fiscal and Economic Outlook 2005-06 Budget Paper No.2</i> , p64.

The abolition of various duties may give rise to some technical questions on the timing of transactions. The removal of duties normally requires transitional measures and many transitional measures in this context are based on whether a transaction was performed (or agreement to perform the transaction was entered into) before a certain date. With the complexity and lack of uniformity in the program for abolition it can be expected that some disputes may arise about when certain transactions are entered into. Experience suggests that, even where a tax has been abolished and no general principle needs to be settled, state revenue authorities may conduct post-abolition

audits and even litigate vigorously to claim amounts alleged to be owed for duty that has been abolished.²¹

Notable for its absence from this program of abolition is duty on the transfer or conveyance of real property. The states and territories derive a significant proportion of their taxation revenue from duty on dealings with interests in real property.²² The program of changes to stamp duty that flow indirectly from the introduction of GST will only increase this proportion. As a result, it is to be expected that as the tax base of stamp duties narrows, duty on land transactions will become increasingly important to the states and territories.

AN INCREASING EMPHASIS ON DEALINGS IN LAND

If, as is expected, dealings in land will resume a greater relative significance in stamp duties, it is appropriate to contemplate the challenges that this might cause. Simple transfers of freehold interests are relatively easy to tax as systems of title by registration can act as powerful mechanisms to aid the collection of tax. However, a range of measures has grown in order to support the collection of tax on dealings in land. Perhaps most notable is "land rich duty" which applies to some dealings in land-holding entities. Other mechanisms include enactment of specific anti-avoidance provisions (some of which are discussed below) and, in some jurisdictions, general anti-avoidance rules. It is likely that these measures will be placed under pressure in order to prevent erosion of the States' and Territories' narrowing tax base.

The remainder of this article discusses some fundamental issues that may arise in the future in relation to land rich duty and anti-avoidance measures that support the collection of duty on dealings in land. It is not intended to be a comprehensive analysis of the detail of the provisions, but a more general discussion of the structure of stamp duties and some broad issues that may become important.

STATE AND TERRITORY LAW-MAKING POWERS: QUESTIONS ABOUT THE VALIDITY OF LAND RICH DUTY

Each State and Territory has broad law-making powers. These powers are expressed in various formulae such as the power to make laws for the "peace, welfare, and good government",²³ the "peace, order, and good Government"²⁴ or simply laws "in and for"²⁵ the relevant jurisdiction. These words all describe the plenary powers of the various legislatures and are not read as general words of limitation.²⁶ The power allows the States and Territories to make law that has extra-territorial operation²⁷

²¹ For an example of this, see the case of *ANZ Banking Group Ltd v Chief Commissioner of State Revenue*, [2005] NSWSC 960, which deals with liability to financial institutions duty in New South Wales.

²² In New South Wales for the financial year 2005-06 it is expected that transfer duty will account for 22 per cent of total tax revenue: New South Wales, *Budget Statement 2005-06*, 3-11. It would be expected that the vast majority of this transfer duty arises from dealings in land.

²³ See the *Constitution Act 1902* (NSW), s5.

²⁴ See the *Constitution Act 1889* (WA), s2.

²⁵ See the *Constitution Act 1975* (Vic), s16.

²⁶ *Mobil Oil Australia Pty Limited v Victoria* (2002) 211 CLR 1 at 33. In *Union Steamship Company of Australia Pty Limited v King* (1988) 166 CLR 1 at 9, the High Court notes that the first two formulations are "indistinguishable". In *Mobil Oil Australia Pty Limited v Victoria* (2002) 211 CLR 1 at 54, Kirby J stated that nothing turns on the difference between any of the formulations.

²⁷ See the *Australia Act 1986* (Cth), s2(1) and *Australia Act 1986* (U.K.), s2(1), although it is questionable whether in this respect these acts did any more than reflect the position at common law: see the

subject to the existence of a sufficient territorial nexus with the law-making jurisdiction.²⁸ The operation of this requirement is described in the context of taxation in *Broken Hill South Ltd v Commissioner of Taxation (NSW)* (1937) 56 CLR 337 where it is stated (at 375):

The power to make laws for the peace, order and good government of a State does not enable the State Parliament to impose by reference to some act, matter or thing occurring outside the State a liability upon a person unconnected with the State whether by domicile, residence or otherwise. But it is within the competence of the State legislature to make any fact, circumstance, occurrence or thing in or connected with the territory the occasion of the imposition upon any person concerned therein of a liability to taxation or of any other liability. It is also within the competence of the legislature to base the imposition of liability on no more than the relation of the person to the territory. The relation may consist in presence within the territory, residence, domicile, carrying on business there, or even remoter connections.

When applying the limitation in the context of taxation it is important to recognise that not only must there be some form of territorial nexus, but the matter that forms the basis of this nexus must be relevant to the imposition of the tax.²⁹ Questions of degree may be relevant in finding a sufficient nexus but, once a sufficient nexus is found, the legislature is not limited in its powers to an exercise of power that is proportionate to the degree of such nexus.³⁰

The refocus of stamp duties on dealings involving real property invites a few comments on these principles. Clearly, if a State or Territory imposes duty on the transfer or conveyance of land in that State or Territory, there will be sufficient territorial nexus.³¹ This will be the case regardless of the place of residence of the vendor or purchaser. However, in relation to less direct dealings involving land the matter is far from clear. The most serious constitutional difficulties arise in the context of “land-rich duty” such as that imposed under Chapter 4A of the *Duties Act 1997* (NSW).

In general terms, land rich duty is imposed on the transfer of shares in an unlisted company that holds land (whether directly or through intermediate entities). It may also be imposed on the transfer of units of a unit trust where land is held on trust. Thresholds may apply in respect of both the extent of the interest held or transferred³² and the extent of real property held by the company or trustee (in its capacity as trustee of the relevant unit trust).³³ Duty is payable not on the value of the share or unit transferred, but based on a proportion of the unencumbered value of the land holdings

comments of the High Court in *Union Steamship Company of Australia Pty Limited v King* (1988) 166 CLR 1 at 14.

²⁸ *Broken Hill South Ltd v Commissioner of Taxation (NSW)* (1937) 56 CLR 337 at 375; *Union Steamship Company of Australia Pty Limited v King* (1988) 166 CLR 1 at 14. It may be that this territorial limitation stems from the description of the States’ and Territories’ powers or it may flow from “the federal structure of which each State is a part”: *Mobil Oil Australia Pty Limited v Victoria* (2002) 211 CLR 1 at 34.

²⁹ *Broken Hill South Ltd v Commissioner of Taxation (NSW)* (1937) 56 CLR 337 at 375.

³⁰ *Ibid.*

³¹ See *Johnson v CSD* [1956] AC 331 at 352.

³² See, for example, the definition of “significant interests” in the *Duties Act 1997* (NSW) s163D.

³³ See, for example, the definition of “land rich” in the *Duties Act 1997* (NSW) s163B.

of the company or trustee.³⁴ The tax was introduced as an “anti-avoidance” measure³⁵ to prevent the minimisation of duty by the sale of land-holding entities rather than the land itself.³⁶

Land rich duty is not inherently problematic in relation to territorial nexus. However, there are potential difficulties where a State or Territory seeks to impose duty on the sale of shares in a land-holding company where the company was not incorporated in the taxing jurisdiction and neither transferor nor transferee has a connection with that jurisdiction. The holding of property in a jurisdiction clearly provides sufficient territorial nexus to tax the property holder on a dealing with an interest in that property. However, in the situation contemplated, the person being taxed (the purchaser of shares) does not have any legal or beneficial interest in any real property held by the company in the taxing state.³⁷ If the shares cannot be said to have a connection with the taxing state,³⁸ and neither party to the dealing is resident or domiciled in the taxing state,³⁹ then the connection with the taxing state is remote. While there may be real property held by the company in the taxing jurisdiction, it must be remembered that it is a dealing with the share rather than the real property that is the formal subject matter of taxation.

A starting point for analysis of territorial nexus in this context is the case of *Commissioner of Stamp Duties (NSW) v Millar* (1932) 48 CLR 618. That case dealt with the validity of New South Wales provisions that sought to impose death duty on shares where, at the time of the shareholder’s death, the company carried on certain businesses in New South Wales.⁴⁰ The court considered whether there was sufficient territorial nexus to support the legislation in circumstances where the testator was domiciled outside New South Wales, the company was incorporated outside New South Wales and the legal situs of the shares was outside New South Wales. The provision sought to tax the full value of the shares and not merely a proportion of the value based on the extent or value of the business carried on in New South Wales.

³⁴ See, for example, *Duties Act 1997* (NSW) s163S (1).

³⁵ Although note the comments in Hill, *Duties Legislation*, at [8.0020] that describe the duty as a “so-called ‘anti-avoidance’ measure” and the statement that “[t]he avoidance which the legislature saw fit to eliminate had been known and accepted for centuries”.

³⁶ Duty might be minimised both by the fact that a lower rate may apply to sale of securities than to land and the fact that duty in relation to the sale of land is based on unencumbered value, yet amounts owed by a company may operate to reduce the dutiable value of the company’s shares: see Hill, above n 33 at [8.0020].

³⁷ *Macaura v Northern Assurance Co* [1925] AC 619; *Commissioner of Stamp Duties (NSW) v Millar* (1932) 48 CLR 618 at 632. This reasoning may not apply in relation to unit trusts as a unit-holder typically will have a proprietary interest in the trust property: *Charles v Federal Commissioner of Taxation* (1954) 90 CLR 598 at 608.

³⁸ Such a connection might arise if the shares can be said to be property in the state, perhaps due to the location of the share register. A connection might also arise on the basis that the corporation was formed in the relevant state (see *Myer Emporium Ltd v CSD* (1967) 68 SR (NSW) 220), although since the referral to the Commonwealth of power over incorporation, this matter has been complicated a little.

³⁹ As is pointed out in *Broken Hill South Ltd v Commissioner of Taxation (NSW)* (1937) 56 CLR 337 at 375, mere residence or domicile may be sufficient to allow a state to tax any property held by a person, whether that property is within or without the state.

⁴⁰ (1932) 48 CLR 618 at 626.

It was held by Rich, Dixon and McTiernan JJ that the provision went beyond the powers of the New South Wales legislature.⁴¹ In a separate judgment Starke J agreed with this conclusion.⁴² The majority stated that the provision in question:

assumes to tax the share as property out of the jurisdiction, but does so because of the existence of the company's business within the jurisdiction. In doing so, it adopts a connection which is too remote to entitle its enactment to the description a law 'for the peace, welfare, and good government of New South Wales'.⁴³

By analogy it could be argued that land-rich duty provisions may go beyond the capacity of the States and Territories to tax. Indeed, this has been described by Hill as "quite a respectable argument".⁴⁴ Before any firmer conclusion could be drawn on the issue it is worth considering three further matters.

First, and probably of least significance overall, the decision in *Millar* was not unanimous. In a joint, dissenting judgment Gavan Duffy CJ and Evatt J found that there was a sufficient territorial nexus to support the legislation.⁴⁵ Second, there are some differences between land rich duty and the tax considered in *Millar*. In *Millar*, the legislature sought to impose tax on the full value of the share. However, the various land-rich regimes impose duty based on a value that represents a proportion of the value of land held. In *Millar*, Rich, Dixon and McTiernan JJ stated:

Let it be assumed that, in so far as the shareholder obtains an actual advantage from the possession by the company of property in New South Wales, that advantage may be taxed by the State. It may be the case that the Legislature can disregard the legal character of the relation between the assets of the company and the shareholders, and can fasten upon the actual benefit or economic advantage which the shareholder derives from property situated in or operations conducted in the State. But the subject of taxation selected by the present enactment is not this advantage or benefit. The subject is the entire value of the share.⁴⁶

When the subject matter of the tax is framed in this way it suggests a difference between land rich provisions and the death duty analysed in *Millar*.⁴⁷ This raises the difficult question of whether the subject matter in this context should be analysed on the basis of the event that attracts the imposition of tax or the method that is used to measure the amount of tax imposed. In form, land rich duty is a tax on the transfer of shares or units. However, arguably the calculation of taxable value makes it in substance a tax on indirect interests in land.

Finally, a number of comments in more recent cases suggest that any territorial nexus requirement will be construed very broadly.⁴⁸ While the matter is raised in contexts

⁴¹ Ibid at 631.

⁴² Ibid at 636.

⁴³ Ibid at 632.

⁴⁴ Hill, above n 33 at [8.0030].

⁴⁵ (1932) 48 CLR 618 at 629.

⁴⁶ (1932) 48 CLR 618 at 632.

⁴⁷ Hill, above n 33, characterises the issue as "whether the difference of subject matter suffices to distinguish *Millar*": at [8.0030].

⁴⁸ Hill, above n 33 at [8.0030].

well outside tax, and in many instances has been in obiter, it is stated by the High Court:

The requirement for a relevant connexion between the circumstances on which the legislation operates and the State should be liberally applied and... even a remote and general connexion between the subject-matter of the legislation and the State will suffice.⁴⁹

These comments have been reinforced in the recent High Court case of *Mobil Oil Australia Pty Limited v Victoria*.⁵⁰ Justice Kirby has stated that the High Court in the 20th century "adopted rules of growing ambit" in relation to the States' powers to legislate with extra-territorial effect⁵¹ and that it would be rare to succeed in a challenge of a State or Territory's law-making power on this basis.⁵² However, it is clear that the difficult question of whether there is a sufficient "real connection" remains.⁵³

The validity of land rich duty is not put beyond doubt by *Millar*. It may be that the High Court would hold that the measures are constitutional because the valuation for taxation purposes based on land in the taxing jurisdiction provides a sufficiently "real connection". However, the matter is far from settled and ripe for litigation. In particular, there must be questions about the validity of the provisions where the putative land rich entity has no real interest in land in a particular state but is merely the object of a discretionary trust. In such a situation the entity may be deemed to own the land entirely despite having no real interest in it.⁵⁴ This would seem to divorce further the subject matter of land rich duty and the connection with a particular State or Territory.

If it is found that the provisions are not valid in certain contexts, then this raises the possibility of structuring acquisitions in a manner that may avoid land rich duty. In turn, this raises the difficult issue of the scope of an individual jurisdiction's anti-avoidance measures (if any) to apply to activities deliberately undertaken outside the jurisdiction in order to avoid duty.

ANTI AVOIDANCE PROVISIONS IN STAMP DUTY LEGISLATION

As noted by the late Justice Graham Hill in a paper titled "Countering Avoidance of Stamp Duty" presented by His Honour at the Fifth Annual State's Taxation Conference conducted by the Taxation Institute of Australia:⁵⁵

Of the various state taxes enacted in Australia perhaps the most complicated and the most open to avoidance has been stamp duty. Although payroll tax produces a greater amount of revenue, indeed in the order of more than 40% of State Revenue outside of the GST state allocation, it is a less complicated

⁴⁹ *Union Steamship Company of Australia Pty Limited v King* (1988) 166 CLR 1 at 14. Here the High Court was expressing agreement with the decision of Gibbs J in *Pearce v Florenca* (1976) 135 CLR 507 at 518. Elsewhere in Gibbs J's judgment the test is stated in terms that legislation will be valid if it "operates on some circumstance which really appertains to the State": (1976) 135 CLR 507 at 517.

⁵⁰ (2002) 211 CLR 1 at 23 per Gleeson CJ, at 34 per Gaudron, Gummow and Hayne JJ, at 59 per Kirby J.

⁵¹ *Lipohar v The Queen* (1999) 200 CLR 485 at 547.

⁵² *Ibid* at 548. See also *Mobil Oil Australia Pty Limited v Victoria* (2002) 211 CLR 1 at 51.

⁵³ *Mobil Oil Australia Pty Limited v Victoria* (2002) 211 CLR 1 at 34.

⁵⁴ See, for example, *Duties Act 1997* (NSW) s163U.

⁵⁵ Hilton Hotel, Adelaide on 29 July 2005.

tax, and because it largely piggy-backs upon the group tax provisions of the income tax law, avoidance is somewhat easier to detect than avoidance in stamp duty...

There is an initial difficulty in defining what is meant by avoidance in the field of stamp duty. Perhaps that is why it has not been uniform throughout Australia for state legislatures to adopt general anti-avoidance provisions. Two examples suffice.

Traditionally, stamp duty has been a tax on instruments and not transactions although this principle has been much eroded over the past fifty years. It is a corollary of the principle that if a transaction could be carried out without an instrument, no duty would be payable. It is a nice point whether it would have been stamp duty avoidance not to document a transaction so that no liability to duty would arise.

His Honour goes on to note that the various state Parliaments thought such an arrangement did involve avoidance when brewery interests worth many millions of dollars were sold in this manner, resulting in amendments to the legislation to ensure that similar transactions were brought to duty notwithstanding that no dutiable instrument is brought into existence.

Notwithstanding the expansion of the ambit of stamp duty legislation to require tax to be paid on some transactions as well as instruments, the tax remained a stamp duty as transactions are generally taxed by the imposition of an obligation to make out and lodge for stamping a return which generally is deemed to be the instrument effecting the transaction.

The second example given by His Honour relates to the purchase of land rich entities discussed above (ie a company or unit trust holding land) rather than the direct purchase of the land. This results in a lower marketable security rate of duty being payable rather than the higher conveyance rate, again prompting the legislatures across Australia to enact "land rich" legislation to require duty to be paid where, at least in most jurisdictions, the land represents a significant proportion of the assets of the entity.

In addition to these responses by the state and territory legislatures aimed at requiring duty to be paid on transactions as well as instruments and, in circumstances which might otherwise be regarded as falling outside the stamp duty net, specific anti-avoidance provisions had been introduced from time to time to counter other avoidance techniques. Examples of such techniques are transactions designed to reduce the value of dutiable property the subject of a dutiable transaction. Subsection (1) of section 24 of the *Duties Act 1997* (NSW) provides in relation to such transactions that in determining the dutiable value of dutiable property for purposes of Chapter 2 of that Act:

any interest, agreement or arrangement (other than an encumbrance) granted or made in respect of the dutiable property that has the effect of reducing the dutiable value is to be disregarded, subject to subsection (2).

Subsection (2) provides that an interest, agreement or arrangement referred to in subsection (1) is not to be disregarded if the Chief Commissioner is satisfied (having regard to various matters set out in subsection (3)) that it was not granted or made as a part of an arrangement or scheme with a collateral purpose of reducing the duty otherwise payable on the dutiable transaction.

Transactions which could potentially reduce the value of land being transferred for example would include: the grant of an option where the option exercise price is low compared to the value of the land; the grant of a long term lease at a premium with less than market value rent payable over the term; and the grant of a life interest. However, it is arguable that in each case as the rights of the lessee, holder of the life interest or option holder (assuming the option is specifically enforceable) would constitute interests in land, the existence of the option, lease or life interest would not be said to be made "in respect of the dutiable property" being the reversion, remainder interest or property the subject of the option. However, as the section and similar predecessor sections were introduced to specifically cover these types of arrangements, it seems that the section would operate in these cases unless the Commissioner is satisfied in terms of subsections (2) and (3).⁵⁶

Another specific anti-avoidance provision inserted in Duties legislation is designed to counter splitting of transactions to prevent advantage being taken of lower rates of duty applying to transactions having lower values or to reduce the transaction value below the threshold for imposition of duty.⁵⁷ Similar provisions exist allowing aggregation of acquisitions of interests in land rich entities, not only by related entities but, for example in New South Wales, also by persons who acquire interests under transactions that:

together form, evidence, give effect to or arise from what is substantially one arrangement between the acquirers...⁵⁸

Despite the expansion of the scope of application of stamp duty legislation to require duty to be paid on transactions as well as instruments and, despite specific amendments being introduced to counter perceived avoidance of duty, taxpayers continue to find ways of structuring transactions so that they fall outside the legislative provisions.⁵⁹

This prompted Justice Hill to suggest that the Offices of State Revenue should urge the Courts in Australia to reconsider whether the doctrine of "fiscal nullity" can be applied to require duty to be paid in relation to "artificially structured" transactions which would otherwise fall outside the legislative provisions.

The doctrine of fiscal nullity was originally formulated by the courts in England in relation to determining the tax consequences of transactions perceived to have been structured in a particular way solely for the purpose of reducing or deferring a tax liability which would otherwise have arisen. The doctrine (more recently described by the courts as a broad "purposive" interpretation of tax legislation, giving effect to the intention of Parliament) requires a court to ignore steps interposed in a transaction where:

⁵⁶ Section 24 of the Duties Act 1997 (NSW) and similar previous sections were inserted to overcome the decision in *Commissioner of State Revenue v Bradney* (1996) 34 ATR 233; 96 ATC 5130 a case which involved the sale of a reversion.

⁵⁷ See for example section 25 of the *Duties Act 1997* (NSW). Originally predecessor sections allowed only aggregation of different interests in a single item of dutiable property. The section now allows aggregation of dutiable transactions relating to separate items of dutiable property.

⁵⁸ Section 163F of the *Duties Act 1997* (NSW).

⁵⁹ See for example *ISPT Nominees Pty Ltd v Chief Commissioner of State Revenue (NSW)* (2003) 53 ATR 527; 2003 ATC 4697.

- (a) the transaction (and steps making it up) is pre-ordained; and
- (b) the interposed steps have no commercial purpose but rather, can be regarded as having been interposed solely for the purpose of minimising tax (which would have been payable if such steps had not been interposed.)

The doctrine of fiscal nullity has been applied to stamp duty cases in both the United Kingdom,⁶⁰ and Hong Kong.⁶¹

In a number of Australian cases, the High Court⁶² and the Western Australian Supreme Court⁶³ have considered whether the doctrine should be applied to the facts before them. Each decided that it should not. In *Ashwick (Vic) (No 4) Pty Limited v Comptroller of Stamps (Vic)*⁶⁴ the High Court did not however rule out the possible application of fiscal nullity to Australian stamp duties in the future should an appropriate transaction arise.

However, even if a court applies the doctrine of fiscal nullity, the application of the doctrine is limited to the court disregarding a transaction, or part of a transaction, rather than being able to reconstruct a transaction. Accordingly, in the context of any particular arrangement, even if a step, or steps, in the transaction are disregarded, a liability to duty will only arise if the steps which are not disregarded give rise to a liability to duty.⁶⁵

Queensland has long followed a different path, having in its earlier legislation a general anti avoidance provision originally modelled on section 260 of the *Income Tax Assessment Act 1936* (Cth) (the “Tax Act”) and in the *Duties Act 2001* (Qld) measures modelled on the provisions of Part IVA of the Tax Act. Victoria and the Australian Capital Territory have now also adopted their own versions of anti avoidance provisions generally modelled on Part IVA of the Tax Act. The Victorian legislature has in fact adopted two similar sets of provisions applying separately to the land rich provisions of the *Duties Act 2000* (Vic) and the other provisions of that Act. Western Australia on the other hand has adopted similar provisions but they apply only to the land rich provisions of the *Stamp Act 1921* (WA).

Hill J analyses the differences in the anti avoidance provisions adopted by the different State/Territory legislatures concluding as follows:⁶⁶

It is obvious that in those jurisdictions without anti-avoidance provisions there will be vulnerability to stamp duty avoidance unless the courts of those jurisdictions adopt the fiscal nullity doctrine and further that that doctrine leaves exposed, when applied, a situation where duty would be payable.

In those jurisdictions with anti-avoidance provisions the question whether those provisions will apply will depend largely upon the circumstances of the particular case. Results may differ from jurisdiction to jurisdiction.

⁶⁰ *Ingram v Inland Revenue Commissioners* [1985] STC 835.

⁶¹ *The Collector of Stamp Revenue v Arrowtown Assets Limited* FACV No 4 of 2003.

⁶² *John v FCT* 89 ATC 4101.

⁶³ *Peko-Wallsend Operations Ltd v Commr of State Taxation (WA)* 89 ATC 4569.

⁶⁴ (1987) 87 ATC 5064.

⁶⁵ For a more detailed discussion of this aspect see the comments of Hill J in the paper referred to at note 55.

⁶⁶ *Ibid.*

It is likely that specific anti-avoidance measures such as aggregation provisions and mechanisms designed to prevent the manipulation of dutiable value will continue to have a role to play in reinforcing duty on dealings in land. It is also likely that despite such specific provisions there will be perceived need for general anti-avoidance mechanisms. In jurisdictions with a general anti-avoidance rule it is unlikely that fiscal nullity will have a role to play. However, in other jurisdictions the possibility of the acceptance of the doctrine should not be ignored.

HAS THE PURSUIT OF UNIFORMITY BEEN FORGOTTEN?

The dramatic changes to the stamp duty tax base should not be allowed to overshadow the pursuit of a greater degree of uniformity of law between the States and Territories. However, there is still a significant amount of work to be done before there would be a reasonable degree of uniformity. Also, the areas in which perhaps the greatest steps toward uniformity have been made are in relation to heads of duty being abolished (such as mortgage duty). There remains significant dissonance between the various jurisdictions on fundamental matters concerning the imposition of duty on dealings in land and the supporting anti-avoidance mechanisms outlined above.

At present the scope of application of duty legislation to transactions involving dealings in interests in land varies from jurisdiction to jurisdiction. The *Duties Act 1997* (NSW) for example taxes transfers and agreements for sale of interests in dutiable property.⁶⁷ The *Duties Act 2000* (Vic) on the other hand taxes as well transactions resulting in a change of beneficial ownership of dutiable property.⁶⁸ The *Duties Act 2001* (Qld) brings to duty as well as transfers and agreements for sale of interests in dutiable property, a range of other transactions including a separate list under the heading "creation of new rights".⁶⁹ The South Australian and Western Australian Stamp Acts have persisted with the more traditional concept of "conveyances of property" as the principal transaction attracting duty.

The legislative provisions covering the creation termination and dealing with interests in trusts are also different in each jurisdiction.⁷⁰ So too provisions dealing with land rich entities, exemptions and other provisions granting relief from full duty (including corporate reconstruction provisions) and provisions dealing with securitisation of landholding interests. Most States and Territories provide full or partial relief from duty for dealings with interests in (and in some cases the establishment and termination) of listed/public/widely held/wholesale, investment vehicles (companies and trusts.) But the provisions are far from uniform.⁷¹ As noted above, even the specific and general anti-avoidance provisions adopted by the various states and territories differ significantly. There is even the possibility that the doctrine of fiscal nullity could be found to apply in some jurisdictions but not others (as they have a general anti-avoidance rule). The consequence of these differences is that the same transaction will be taxed differently depending on the jurisdiction which asserts the

⁶⁷ *Duties Act 1997* (NSW) s8.

⁶⁸ See *Duties Act 2000* (Vic) s7(1)(vi).

⁶⁹ See *Duties Act 2001* (Qld) s9(1)(g).

⁷⁰ For a discussion of some of the different legislative provisions dealing with the creation termination and variation of trusts see the paper presented by W Cannon on this topic at the Fifth Annual State's Taxation conference conducted by the Taxation Institute on 29 July 2005.

⁷¹ For a discussion of some of the differences see the paper presented by Steven Stevens at the Fifth Annual State's Taxation conference conducted by the Taxation Institute on 29 July 2005.

right to so tax the transaction (or part of it.) It also suggests that changes to stamp duties have distracted from any significant effort in the pursuit of uniformity between the States and Territories. The narrowing of the tax base has not significantly aided the task as there are still key differences between the jurisdictions in relation to the imposition of duty on dealings involving land.

CONCLUSION

Having regard to the above considerations, it would not be unfair to say that 2005 was a watershed year for stamp duty as a widely based revenue raising mechanism for the States and Territories. The renewed importance of anti-avoidance provisions as a means of expanding and protecting the remaining stamp duty tax base perhaps also heralds in a new era for advisors- an era perhaps marked with the uncertainties that have plagued income tax advisors for the past 25 years.

Following implementation of the program for narrowing the duty base, perhaps there will be a return to the process of trying to achieve some consistency of application of duty legislation across the various jurisdictions at least in relation to those provisions which relate to the taxation of public or widely held entities. As noted above, the States have shown in the past that they have been able to work together to achieve this in relation for example to mortgage duty, hire of goods duty and sale of business duty. If this occurs then the Rewrite process, which gave at least a glimmer of hope of achieving some simplification in the application of duty legislation in Australia, will not have been in vain.

Promoter Penalties

Gordon S. Cooper, AM*

Abstract

This article critically evaluates the rules applicable to the new Promoter Penalties regime. The article explains the background to the rules and describes the elements of the rules and the manner in which they will operate. Throughout, the article raises queries in relation to how the rules will work and identifies concerns with their operation. An example is the article's review of the operation of the Promoter Penalty regime alongside rules which essentially allow taxpayers to adopt positions that provide them with a "reasonably arguable" position. The article also queries the meaning of "promoter" explaining that it may not be clear-cut that a professional adviser is not a promoter.

INTRODUCTION

He's not the messiah; he's a very naughty boy.

(From the *Life of Brian* (1979), Monty Python)

The Promoter Penalty Provisions are a response to the debacle of the mass marketed schemes in the 1990s.¹ The intention to introduce such provisions was announced by the then Minister for Revenue and Assistant Treasurer, Senator Helen Coonan, in Press Release No C117/03 of 5 December 2003.

In paragraph 3.3 of the EM the need for the Promoter Penalty Regime is justified as follows:

Currently, there are no civil or administrative penalties for the promotion of these schemes with the result that promoters can obtain substantial profits while investors may be subject to penalties under the TAA 1953. This represents a significant asymmetry in risk exposure.

Division 290 is the revised version of the initial proposed legislation which was criticised for having a potential application which was too broad. There were submissions from the professional bodies and others as well as extensive consultation with respect to the initial proposed legislation and the Bill.

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¹ See for example "Beware the Magic Pudding" (Commissioner's address to Conference held by the Australian Society of CPAs) 12/06/98, "Walking the tightrope" (Commissioner's address to Monash University, Law School Foundation Lecture) 30/06/98, "Tax is in the Air" (Commissioner's address to Chartered Institute of Company Secretaries) 11/08/98, "A New Tax System – Changing Cultures", (Commissioner's address to Chartered Accountants in Business Congress 1998) 19/11/98, "Investment Schemes" (Address by Assistant Commissioner, Peter Smith to the Australian Taxation and Management Accountants Workshop) 20/11/98, "A Question of Balance" (Commissioner's address to the American Club) 17/09/99, "The Heat is On" (Commissioner's address to Freehills and Australian Council of Business Women) 09/06/00, "The Tax Reform Wave – Challenges & Opportunities" (Commissioner's speech) 20/07/00.

The Promoter Penalty Provisions

The objects of the Promoter Penalty Provisions are set out in Section 290-5. It provides that:

The objects of this Division are:

- (a) to deter the promotion of tax avoidance *schemes and tax evasion schemes; and
- (b) to deter the implementation of schemes that have been promoted on the basis of conformity with a *product ruling in a way that is materially different from that described in the product ruling.

A number of the concerns that were expressed with respect to the original proposal have been addressed. Those that have not studied the Promoter Penalty Provisions could be forgiven for thinking that because they are not involved in promoting mass marketed schemes the Promoter Penalty Regime will not have any potential application to their activities.

Although the original announcement regarding the introduction of the Promoter Penalty Regime may have referred to mass marketed arrangements there appears to be no such limitation within the Promoter Penalty Regime.

This article will seek to demonstrate that such a complacent attitude is not justified.

Parts of the EM may be likened to William Congreve's words that "*Music has charms to sooth a savage breast*".² This article will suggest that there can be a significant disjunction between the soothing language in the EM and the words used in a particular proposed provision.

Scope of the article

This article will look at:

- the definition of a "*tax exploitation scheme*";
- the definition of a "*promoter*"; and
- the potential penalties.

In so doing it will consider whether the provisions ever can apply.

It will not look at:

- injunctions;
- voluntary undertakings; or
- the failure to comply with a product ruling.

TAX EXPLOITATION SCHEME

*Under capitalism, man exploits man.
Under communism, it's just the opposite.*

John Kenneth Galbraith (1908 - 2006)

² W. Congreve. "The Mourning Bride", I.i.

Long has it been necessary to differentiate between tax avoidance and tax evasion. Often drawing the line between the two has been difficult even if the difference is accepted as being the legality or otherwise of the arrangement. Frequently the boundary between avoidance and evasion has been in the eye of the beholder. The Promoter Penalty Provisions introduce the new concept of “*a tax exploitation scheme*”. It is to those who promote “*tax exploitation schemes*” that the Promoter Penalty Provisions are directed.

Definition

A “*tax exploitation scheme*” is defined in Section 290-65. It provides that:

290-65 Meaning of tax exploitation scheme

(1) A *scheme* is a **tax exploitation scheme** if, at the time of the conduct mentioned in subsection 290-50(1):

(a) one of the conditions is satisfied:

(i) if the scheme has been implemented – it is reasonable to conclude that an entity that (alone or with others) entered into or carried out the scheme did so with the sole or dominant purpose of that entity or another entity getting a *scheme* benefit from the scheme;

(ii) if the scheme has not been implemented – it is reasonable to conclude that, if any entity (alone or with others) had entered into or carried out the scheme, it would have done so with the sole or dominant purpose of that entity or another entity getting a *scheme* benefit from the scheme; and

(b) one of these conditions is satisfied:

(i) if the scheme has been implemented – it is not *reasonably* arguable that the *scheme* benefit is available at law;

(ii) if the scheme has not been implemented – it is not *reasonably* arguable that the *scheme* benefit would be available at law if the scheme were implemented

Note: The condition in paragraph (b) would not be satisfied if the implementation of the scheme for all participants were in accordance with binding advice given by or on behalf of the Commissioner of Taxation (for example, if that implementation were in accordance with a public ruling under this Act, or all participants had private rulings under this Act and that implementation were in accordance with those rulings).

(2) In deciding whether it is *reasonably* arguable that a *scheme* benefit would be available at law, take into account any thing that the Commissioner can do under a *taxation* law.

Example: The Commissioner may cancel a tax benefit obtained by a taxpayer in connection with a scheme under Section 177F of the Income Tax Assessment Act 1936.

There should be no problem in identifying a “*tax exploitation scheme*”. As paragraph 3.52 of the EM blithely states that:

Tax exploitation schemes are schemes that exploit the tax system through avoidance or evasion. The terms and concepts used to define a tax exploitation scheme in this Bill are taken from the anti-avoidance provisions of the ITAA 1936, the ITAA 1997 and the TAA 1953. These terms and concepts are well established in case law and administrative practice.

If the “*concepts are well established*” it does seem strange that with respect to the application of Part IVA the Full Federal Court and the Full High Court came to such

different conclusions in *Hart's Case*. Particularly is this so given the roles played by Gleeson CJ and the late Hill J in the development of Part IVA.³

Presumably the “*sole or dominant purpose*” requirement is the same as that in Part IVA. That is purpose will be a matter of objective determination rather than the subjective motives of the promoter. However the EM at paragraph 3.55 refers to the penalty provisions in the TAA 1953 rather than Part IVA. It states that:

The purpose tests in paragraph 290-65(1)(a) is modelled on the tests that apply to taxpayers in the scheme penalty provisions in subsection 284-145(1) of Schedule 1 to the TAA 1953.

For there to be a “**tax exploitation scheme*” there must be a purpose of “*getting a *scheme benefit from the *scheme*”. “**Scheme benefit*” is defined in Section 284-150(1). It provides that:

An entity gets a “**scheme benefit**” from a *scheme if:

- (a) a *tax-related liability of the entity for an accounting period is, or could reasonably be expected to be, less than it would be apart from the scheme or a part of the scheme;

It may be reasonable to conclude that by the time the Promoter Penalty Provisions have come into play it will be clear that there is a “**scheme*”. Also it may be clear that there is “*a *scheme benefit*”. However it is important to note that “*a tax-related liability*” must “*reasonably be expected to be less*” as a result of participation in “*the scheme*”. Presumably this means that the scheme must have a reasonable prospect of actually reducing the tax liability.

The definition of a “*scheme benefit*” would appear to exclude effectively any tax evasion scheme. This is because tax evasion does not change the tax liability. The object of tax evasion is to hide from the ATO the fact that there is such a tax liability. At its simplest, tax evasion may involve no more than deliberately not including cash income receipts in the assessable income declared in a tax return.

Moreover it would seem that if a scheme does not have a reasonable prospect for success there will be no “**scheme benefit*”. If that is so the more “*aggressive*” mass marketed schemes which perhaps had little chance of success will not be caught by the Promoter Penalty Regime. This would be so even though such schemes, together with tax evasion schemes, apparently are the primary target of the Promoter Penalty Regime.

For example in *Vincent v FCT* 2002 ATC 4742 the Full Federal Court stated at 4744 that:

The application to the Court was a test case in the sense that there were several hundred people who had in one way or another become involved

³ “When both were at the Bar, Gleeson CJ and Hill J were retained to advise the government on a replacement for s 260 of the *Income Tax Assessment Act* 1936 (Cth). Part IVA was the ultimate result.” I. Gzell, (2006) “The legacy of Justice Graham Hill”, (http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/pages/SCO_gzell010506 accessed 11/1/06).

with a cattle breeding project involving a number of companies associated with an accountant ...

In *Vincent's Case* the Full Federal Court went on to note at 4645 that:

... there was a critical finding of fact made by the learned primary Judge that Ms Vincent was not carrying on a business

and then held at 4758 that:

In our view once the conclusion is reached that Ms Vincent did not carry on a business it followed that the costs that were necessarily incurred to produce the six calves promised was an outgoing of capital and simply not deductible.

Was there a reasonable prospect of success in obtaining the tax deductions promised from the cattle breeding project in which Ms Vincent participated? If so, then such a project now would have the potential to come within the Promoter Penalty Regime. However if the inept way that the project was implemented meant that there was no reasonable prospect of there being a reduction to Ms Vincent's tax liability it would appear that the Promoter Penalty Regime would not apply to such a "*scheme*".

The apparent requirement of a reasonable prospect for success in reducing a tax liability is considered further at paragraphs 2.19 and 2.20 as far as tax avoidance schemes are concerned.

As with Part IVA, under the Promoter Penalty Provisions it may be less clear that the "*sole or dominant purpose*" was to obtain the "**scheme benefit*". However even if that can be demonstrated there is a further condition to be satisfied before the Promoter Penalty Regime will apply.

Not reasonably arguable

Under Section 290-65(2)(b) the Promoter Penalty Provisions will not apply unless "*it is not *reasonably arguable that the scheme benefit is available at law*". The significance of this when coupled with the requirement discussed in paragraphs 2.6 to 2.11 is considered at paragraphs 2.19 and 2.20.

"**Reasonably arguable*" is defined in Section 284-15. It provides that:

- (1) A matter is "**reasonably arguable**" if it would be concluded in the circumstances, having regard to relevant authorities, that what is argued for is about as likely to be correct as incorrect, or is more likely to be correct than incorrect.
- (2) To the extent that a matter involves an assumption about the way in which the Commissioner will exercise a discretion, the matter is only "**reasonably arguable**" if, had the Commissioner exercised the discretion in the way assumed, a court would be about as likely as not to decide that the exercise of the discretion was in accordance with the law.
- (3) Without limiting subsection (1), these authorities are relevant:
 - (a) a *taxation law;
 - (b) material for the purposes of subsection 15AB(1) of the Acts Interpretation Act 1901;
 - (c) A decision of the court (whether or not an Australian court), the *AAT or a Board of Review;

(d) A *public ruling.

A cynical view of the ATO interpretation of what constitutes “*reasonably arguable” might be summed up as “*you would not be facing promoter penalties if what you had done was reasonably arguable*”. However a more measured view of what constitutes “*reasonably arguable*” is set out in Taxation Ruling TR 94/5.

It should be noted that before 29 June 2005 the test of “*reasonably arguable was “*as likely to be correct as incorrect*”. Taxation Ruling TR 94/5 does refer to “*about as likely as not*”. Paragraph 9 Taxation Ruling TR 94/5 states that:

The explanatory memorandum to the Taxation Laws Amendment (Self Assessment) Act 1992 , at pages 83 to 87, should be used as a general guide for administering sections 226K and 160ARZD. The following points expand on the matters covered by the explanatory memorandum:

- (a) the reasonably arguable test does not require that the treatment given a particular matter by a taxpayer must be the better view, or be more likely than not the correct treatment. The test is "about as likely as not". This requires that the prospects that the taxpayer's treatment will be upheld by a court or Tribunal as being the correct treatment must be substantial, whether or not those prospects are less than or greater than 50 per cent;
- (b) the list of authorities in subsection 222C(4) is not exhaustive. In broad terms, the authorities that may be taken into account for the purpose of determining whether the treatment of a matter is reasonably arguable are those that would be accepted by a court as bearing upon the correct treatment of a matter. The relevance of any authority is a matter to be weighed against other authorities. An authority that has some facts in common with the tax treatment at issue is not particularly relevant if the authority is materially distinguishable on its facts or is otherwise inapplicable to the tax treatment at issue. An authority that merely states a conclusion is ordinarily less persuasive than one that reaches its conclusion by cogently relating the applicable law to the pertinent facts. It will be relevant, however, to consider the source of an authority. For example, a High Court decision on all fours with the tax treatment in question will be accorded more weight than a Federal Court decision, which in turn would be accorded more weight than a decision of the AAT. Authorities could also include, for example, statements in texts recognised by professionals as being authoritative about how the law operates, particularly in cases where there are few authorities on the correct treatment of a matter apart from the legislation itself. The relative weight to be given to each authority would depend on the circumstances. A taxpayer may have a reasonably arguable position for the tax treatment of an item despite the absence of authorities other than the legislation itself. What is required in such cases is that the taxpayer has a well-reasoned construction of the applicable statutory provision which it could be concluded was about as likely as not the correct interpretation;
- (c) while a Public Ruling issued by the Commissioner under Part IVAAA of the Taxation Administration Act is an authority (subsection 222C(4)), the mere fact that a Public Ruling has issued does not necessarily mean that alternative treatments to that suggested by the Public Ruling cannot be reasonably arguable. For example, a taxpayer's treatment could be reasonably arguable if there was a line of court decisions (which had not been overturned by any subsequent decisions) that supported the taxpayer's treatment as opposed to the treatment suggested by the Commissioner. Whether the taxpayer's treatment was reasonably

arguable would depend on its relative strength when compared with the Commissioner's and other possible treatments. In other words, taxpayers should take particular note of the Commissioner's views on the correct operation of the law as expressed in a Public Ruling, but may adopt alternative treatments provided there are sound reasons for doing so;

- (d) the reasonably arguable test only applies to tax shortfalls caused by a taxpayer treating an income tax law as applying in a particular way. A taxpayer treats an income tax law as applying in a particular way where the taxpayer concludes that, on the basis of the facts and the way the law applies to those facts, a particular consequence follows (for example, an amount of expenditure incurred is deductible). Subject to the other preconditions of section 226K, the reasonably arguable test is designed to encourage taxpayers to ensure that the conclusions they reach are sound ones. However, in some cases, a taxpayer's conclusions on a particular matter may have been based on incorrect primary facts which the taxpayer did not know and could not reasonably be expected to have known were not the proper facts, such as where a taxpayer relies on a bank to provide details of the amount of interest earned on a deposit. In other cases, the statements in a taxpayer's return may not represent conclusions of the taxpayer, but might reflect errors in calculation or transposition errors. As a broad rule, where a tax shortfall was caused by an error of fact or calculation section 226K will not apply since the taxpayer will not have treated an income tax law as applying in relation to a matter in a particular way. In this context, errors of fact are errors of primary fact and not wrong conclusions of fact which a taxpayer may make which bear on the correct application of a tax law, such as whether the taxpayer is carrying on a business. Whether the statements in a taxpayer's return represent conclusions of the taxpayer or were caused by errors of fact or calculation should be determined on the basis of all the available evidence;
- (e) identical matters are treated as a single matter for the purposes of section 226K (paragraph 226K(b)). This rule is designed to prevent single matters being split into smaller components to avoid the operation of the section. It should not be used to treat as a single matter numerous similar but distinct items of adjustment. For example, in the case of repairs to similar but distinct items of plant, the application of the law to each repair will turn on the particular facts, so that each repair would need to be considered separately to determine the correct tax payable. On the other hand, in the case of lease payments made in respect of a single item of plant, the same considerations would ordinarily be relevant to the treatment of each lease payment, so that the sum of the lease payments for the year would be treated as a single matter in relation to which the correct application of the law needed to be determined;
- (f) the words "another matter" and "the other matter" used in subsection 222C(1) refer to the operation of the reasonably arguable test as it applies in sections 224, 225 and 226 and do not affect its operation in respect of section 226K;
- (g) where the application of section 226K (and 160ARZD) results in an unduly harsh outcome in all the circumstances of the case then the penalty otherwise attracted may be remitted in whole or in part (see Taxation Ruling TR 94/7);
- (h) taxpayers have the right to object against a decision by the Commissioner that the reasonably arguable position standard has not

been met and to have the Commissioner's decision on the objection reviewed by the AAT or the Federal Court;

- (i) a taxpayer will only be liable for penalty for not having a reasonably arguable position where the shortfall caused by the position taken is greater than the higher of \$10,000 or 1% of the tax that would have been payable on the basis of the taxpayer's return;

Also it should be noted that in considering whether for the purpose of Section 290-65(2) it is "*reasonably arguable that a scheme benefit would be available at law*", it is necessary to consider whether such a benefit could be cancelled by the Commissioner by applying Part IVA. This is stated specifically in the Example in Section 290-65(2).

Nugatory legislation?

If paragraph 2.6 correctly states the Section 284(150)(1) requirement that the "*scheme*" must have a reasonable prospect for success, how does this fit with the Section 290-65(2)(b) exclusion if the position taken in a "*scheme*" is "*reasonably arguable*". Does it render the Promoter Penalty Regime nugatory? Alternatively will the Promoter Penalty Regime apply only when the reasonable prospect for success falls short of "*reasonably arguable*"? If so, it may leave a very narrow band of operation.

If and when the Promoter Penalty Regime falls for consideration by the Federal Court there is the intriguing prospect of Counsel arguing that it was "*reasonably to be expected*" that the scheme would reduce the tax liability but that the position taken by the scheme was not "*reasonably arguable*". This might require the use of doublethink. George Orwell defined doublethink as:

... the power of holding two contradictory beliefs in one's mind simultaneously, and accepting both of them.⁴

On reflection that is the daily currency of Counsel.

Potential application of Part IVA

Of some concern is an implication in the EM that there needs to be a judicial split decision on Part IVA with respect to the relevant scheme for it to have been reasonably arguable that Part IVA would not apply. In Example 3.4 in paragraph 3.66 of the EM it states that:

Some years later, the Commissioner disallows the tax benefits claimed under Part IVA of the ITAA 1936. The company challenges the Part IVA determination in the Federal Court and loses; however, it is clear from the split decision in the case and the reasons that it was a close call and that Rona's opinion was not seriously flawed.

As a pedant it is noted that it is doubtful whether the tax benefits would have been claimed under Part IVA. Clearly the EM means to convey that the tax benefits would have been disallowed under Part IVA.

The consideration, by reference to subsequent events, of whether it was "*reasonably arguable*" that Part IVA would apply is contrary to Section 290-65(1). The definition

⁴ G. Orwell, (1949), *1984*, Chapter 1, Part II, ix.

of a “*tax exploitation scheme” requires consideration of what was “*reasonably arguable” “at the time of the conduct” of the “*promoter”.

Indeed determining what is “*reasonably arguable” by reference to subsequent events, is contrary to what is stated in the opening sentence in paragraph 3.66 of the EM. It states that:

When examining what is reasonably arguable **at the time of the promoter’s conduct**, the Federal Court may take into account anything that the Commissioner can do under a taxation law, including issuing a determination under Part IVA of the ITAA 1936 or exercising a discretion. (emphasis added)

It is considered to be quite clear that the determination of what is “*reasonably arguable” has to be done at the time that the scheme is being promoted. Subsequent events are not relevant. Obviously in a situation similar to that set out in Example 3.4 in paragraph 3.66 of the EM a “*promoter” will be happy to accept a decision that what they did was “*reasonably arguable” regardless of how that decision was reached.

Even if subsequent events were relevant there is the problem that a matter may never be litigated so that there can not be “a split decision” to make it clear that “it was a close call”. Even if a matter is litigated there may be judicial unanimity that Part IVA applies as happened in the Full High Court in *Hart’s Case*. Such unanimity does not of itself mean that it was not “a close call”. The earlier quoted paragraph from Example 3.4 in paragraph 3.66 of the EM does say that in addition to there being a “split decision” consideration needs to be given to “the reasons”. Do both requirements have to be satisfied? Would it be enough if “the reasons” in a unanimous decision make it clear that indeed it was “a close call”. Of course the EM is not the law, merely a guide to understanding the Promoter Penalty Provisions.

PROMOTER

*By adverting to the dignity of this high calling,
our ancestors have turned a savage wilderness
into a glorious empire; and have made the
most extensive and the only honourable
conquests, not by destroying, but by promoting
the wealth, the number, the happiness
of the human race*

Edmund Burke (1729 – 1797)

Not all promoters wear white shoes and bedeck themselves with gold chains.

Definition

“*Promoter” is defined in Section 290-60. It provides that:

- (1) An entity is a **promoter** of a *tax exploitation scheme if:
 - (a) the entity markets the scheme or otherwise encourages the growth of the scheme or interest in it; and
 - (b) the entity or an *associate of the entity receives (directly or indirectly) consideration in respect of that marketing or encouragement; and

- (c) having regard to all relevant matters, it is reasonable to conclude that the entity has had a substantial role in respect of that marketing or encouragement.
- (2) However, an entity is not a **promoter** of a *tax exploitation scheme merely because the entity provides advice about the *scheme.
- (3) An employee is not to be taken to have had a substantial role in respect of that marketing or encouragement merely because the employee distributes information or material prepared by another entity.

It should be noted that to be a “*promoter” there has to be marketing or encouragement of the “*scheme” which potentially generates income. Moreover the role of the marketing and encouragement has to be “*substantial”.

Leaving aside for the moment the specific exclusion in Section 290-60(2) for providing tax advice, paragraph 3.44 of the EM seeks to differentiate between a “*promoter” and a professional adviser. It states that:

Scheme promoters generally undertake promotional activities to earn higher financial rewards than would be available for providing independent and objective tax advice. Those scheme profits constitute consideration received from the marketing or encouragement of a tax exploitation scheme and help to establish that any entity is a promoter.

At this point most tax practitioners may well feel that it is crystal clear that they fall outside the definition of a “*promoter” and hence that they need have no further concern about the potential application of the Promoter Penalty Provisions to their activities. Consideration below of the exclusion with respect to the provision of tax advice suggests that it may not be quite so clear cut.

Tax advice exclusion

Section 290-60(2) excludes from the definition of “*promoter” situations where an “entity provides tax advice about the scheme”. This would appear to be making explicit what paragraph 3.44 of the EM quoted above suggests is implicit in the basic definition of “*promoter”.

The tax advice exclusion is explained in the EM as follows:

- 3.49 An entity is not a promoter merely because they provide advice about the scheme. As a result, financial planners, tax agents, accountants, legal practitioners and others are not promoters merely because they provide advice about a tax exploitation scheme, even if that advice provides alternative ways to structure a transaction, or sets out the tax risks of the alternatives. [Schedule 3, item 1, subsection 290-60(2)]
- 3.50 The civil penalty regime is not intended to inhibit the provision of independent and objective tax advice, including advice regarding tax planning. Advisers who advise on tax planning arrangements, even those who advise favourably on a scheme later found to be a tax exploitation scheme, are not at risk of civil penalty to the extent that they have merely provided independent, objective advice to clients.

The comfort to be gleaned from the statements in paragraphs 3.49 and 3.50 of the EM may be illusory. This is because Section 290-60(2) requires advice to be given “about the *scheme”. It would appear that there has to be a pre existing scheme with respect to which the tax professional is requested to opine on its efficacy. Indeed paragraph 3.49 of the EM repeats the statutory requirement that the provision of advice be

“*about the scheme*”. The Section 290-60(2) exclusion does not appear to extend to advice given which includes the development of “*the scheme*”.

The conclusion which can be drawn is that proactive advice to a client may be regarded as promoting a “**tax exploitation scheme*”. Indeed Example 3.1 in paragraph 3.50 of the EM suggests that is the case. It is that:

Example 3.1: When are tax advisers at risk of being promoters?

A partner (Graeme) in a major accounting firm approaches a high wealth client (Matthew) to advise him on an arrangement to minimise his tax liability by moving taxable income to an offshore tax haven.

The tax haven arrangement was initially developed by another partner (Brett) for another of the firm’s clients and the firm decided it should offer similar arrangements to other clients in similar circumstances.

Brett receives a fixed percentage of the fee obtained by other accountants in the firm who offer the arrangement to other clients. The other partners - including Graeme — who offer the scheme to clients receive a fee that is significantly higher than the billing rate for routine tax advice and that partly reflects the magnitude of the tax savings for scheme participants.

Graeme is able to persuade Matthew to adopt the tax haven arrangement because Matthew will be paying much less tax. Graeme puts in place the offshore financial facilities to enable Matthew not to declare income in Australia

Barbara takes the initiative to contact the accounting firm mentioned by Matthew. Graeme is not taking on new clients and therefore Barbara goes to Deborah, in another firm.

Deborah explains to Barbara how the offshore tax haven works, including the tax risks involved. Deborah bills Barbara her usual fee for advice.

In this example, Graeme and Brett would be likely to satisfy the criteria for being a promoter. This is because they have played a substantial role in marketing the scheme and encouraging client interest, and have also received consideration related to their promotional role. Deborah is not a promoter because she has only advised her client and would qualify for the advice exception.

Although Example 3.1 states that they “*receive a fee that is significantly higher than the billing rate for routine tax advice*”, that requirement does not appear to be explicit in Section 290-60. All that Section 290-60 requires is the receipt of “*consideration*”. However perhaps if what Brett has developed is a Wickenby⁵ style arrangement and the firm is promoting it, few may quarrel with Brett and Graeme being treated as “**promoters*”.

Consider what may be a far more common scenario than that outlined in Example 3.1 in paragraph 3.50 of the EM. A client comes to a tax professional for advice on how to structure the acquisition of a business. Clearly there are a number of possible ways of holding a business. The business could be held directly, in a partnership, through a

⁵ [Editors’ note - Such schemes appear to involve blatant evasion and involve the holding of funds overseas in secret. The funds are accessed by credit card and electronic transactions and the drawings are not declared for tax purposes. See *Operation Wickenby* a chronology and explanation at http://66.102.7.104/search?q=cache:YZFGTKC8ZeAJ:www.crimecommission.gov.au/content/media_re/2005/mr050615-acc.pdf+Wickenby+site:au&hl=en&gl=au&ct=clnk&cd=1 (accessed 1/11/06)].

company or a trust, perhaps even involving a superannuation fund. Also there may be options about the level of gearing etc. Does the advice regarding the appropriate structure to be used, level of gearing etc fall within the exclusion? It might be thought that it does. As is set out in paragraph 3.49 of the EM, advisers:

*are not promoters merely because they provide advice about a tax exploitation scheme, even if that advice provides **alternative** ways to structure a transaction (emphasis added).*

Unfortunately, as noted above, Section 290-60(2) and the EM are dealing with a pre existing “*scheme” not the development of a “*scheme”.

Perhaps if a client states that they are proposing to buy the business personally the adviser will not be a “*promoter” if they suggest that instead the acquisition should be made by a trust. Maybe. Even so that may not mean that the Promoter Penalty Regime could not impinge upon what may be regarded within the tax profession as normal advice.

Where will the tax adviser stand if they achieve what is often discussed, and seldom delivered, the provision of proactive advice to a client? The advice may be no more than suggesting to a client that they consider forming a consolidated group. Indeed the tax adviser’s firm may decide that all corporate group clients should be approached with this suggestion in order to generate substantial additional fees. Consolidation may not be regarded as being as offensive as the tax haven proposal in Example 3.1 in paragraph 3.50 of the EM. Indeed it may well fall outside the definition of “a *tax exploitation scheme”. But with respect to consolidations the ATO has indicated in “Part IVA and Consolidations” that there are a number of circumstances where they would seek to apply Part IVA. Consequently it is not as clear as it might appear to be that the Promoter Penalty Regime could have no application to normal professional advice.

The Promoter Penalty Provisions used “in terrorem”

Over the years there has been anecdotal evidence that sometimes when the ATO have audited a taxpayer and imposed penalties words have been said to the effect that “*under Section 251M you can recover the penalty from your tax agent*”. Moreover in the Taxpayer’s Charter Explanatory Booklet 2 it states at page 3:

If you’ve used the services of a registered tax agent, Business activity statement preparer, barrister or solicitor, and because of that person’s alleged negligence you’re liable to pay a fine, penalty or interest, the tax laws give you the right to sue for and seek to recover the amount from that person.

Let it be assumed that a diligent proactive tax partner persuaded one of his corporate groups to consolidate. There are favourable outcomes for the client group regarding losses and cost base step ups etc. The ATO audit the client. The ATO form the view that while the tax benefits are available Part IVA is applicable. The diligent proactive tax partner considers the application of Part IVA in such circumstances to be nonsense and in a full and frank exchange of views with the ATO auditor makes his position clear. The ATO auditor informs the diligent proactive tax partner to the effect that:

If your client does not drop these claims we will apply the promoter penalty provisions to you.

Where does that leave the diligent proactive tax partner? Clearly he has a potential conflict of interest and may no longer be able to act for the client. The ATO auditor may regard that as a satisfactory outcome. The diligent proactive tax partner and his client may not. Indeed outside the ATO it may not be an anticipated outcome of introducing the Promoter Penalty Regime. Hopefully it is not an intended potential outcome.

In “*A New Relationship with the tax profession*” the new Commissioner, Michael D’Ascenzo, made some comments about the application of the Promoter Penalty Regime. He said:

The promoter penalty legislation is aimed at eliminating unscrupulous operators who peddle unsustainable arrangements to the detriment of both the taxpayers and ethical advisers.

However, in achieving this objective we need to ensure that it does not unduly impact in an unintended way.

Accordingly, the ATO is committed to work with the NTLG to ensure that in practice this does not occur.

Even in the formative stage of this measure, we have agreed to co-design some important aspects of the administration of the measure, including the types of cases that should come under ATO focus and the governance arrangements within the ATO necessary to ensure that the new legislation is applied in a fair and proper manner. These additional checks and balances should give tax agents (and in-house advisors) comfort that the new law will be applied in accordance with its intent.

Undoubtedly comfort can be taken from these remarks. However as discussed in paragraphs 2.7 to 2.11 “*unsustainable schemes*” may not be within the Promoter Penalty Regime. Moreover other comments in that speech do not appear to accord with the actual Promoter Penalty Provisions even if they do reflect the apparent intended effect of the Promoter Penalty Regime.

PENALTIES

*Go to jail
Go directly to jail
Do not pass go
Do not collect \$200.*

Monopoly (1933) Devised by Charles Bruce Darrow (1889 - 1967)

The good news is that the penalties do not include going to jail. Here endeth the good news.

The potential penalty

Section 290-50(4) sets out the potential penalty if the promoter penalty provisions apply. It provides that:

The maximum amount of the penalty is the greater of:

- (a) 5,000 penalty units (for an individual) or 25,000 penalty units (for a body corporate); and
- (b) Twice the consideration received or receivable (directly or indirectly) by the entity and *associates of the entity in respect of the *scheme.

Note: See section 4AA of the Crimes Act 1914 for the current value of a penalty unit.

This means for an individual the current potential penalty is at least \$550,000 and for a company it is \$2,750,000. It should be borne in mind that they could be more than one “*promoter” with respect to a particular “*scheme”.

Onus of proof

Generally in tax matters there is a reverse onus of proof. That is a taxpayer has to prove that an assessment issued by the ATO is incorrect.

Section 290-50(3) provides that:

If the Federal Court of Australia is satisfied, on application by the Commissioner, that an entity has contravened subsection (1) or (2), the Court may order the entity to pay a civil penalty to the Commonwealth.

Because the ATO must initiate action in the Federal Court, it will bear the onus of proof. That was accepted by the Commissioner in “*A new relationship with the tax profession*”. He said that:

Both penalties require the Commissioner to prove his case before the Court. That is, the Commissioner bears the onus to prove, to the civil standard, his case. The decision to litigate in these circumstances will require careful analysis of the available evidence to ensure that there are reasonable prospects of success.

As a result it would appear that the ATO will have to prove that:

- there is a “*tax exploitation scheme” including the fact that the position taken was not “*reasonably arguable”;
- the entity was a “*promoter”; and
- the “*advice” exclusion does not apply.

It will be the civil onus of proof of “*on the balance of probabilities*” that applies rather than the criminal onus of proof of “*beyond reasonable doubt*”. However given the severe penalties, albeit falling short of a custodial sentence, the Federal Court may want the balance to be fairly heavily weighted against the alleged “*promoter”.

Unfortunately the Promoter Penalty Regime deals with strict liability offences. That is, if the ATO can demonstrate the three factors summarised in paragraph 4.6 it is irrelevant whether or not there was the intent to promote a “*tax exploitation scheme”.

Costs and damages

In the initial proposed legislation there was an exclusion from costs and damages being awarded against the ATO. No such exclusion appears in the Promoter Penalty Provisions.

Application

The Promoter Penalty Provisions applies to conduct since the Bill received royal assent. However there is a time limit on the Commissioner to bring an action where there is tax avoidance. However there is no time limit where there is tax evasion, assuming tax evasion comes within the scope of the Promoter Penalty Regime: see paragraph 2.7. Section 290-55 provides relevantly that:

- (4) The Commissioner must not make an application under section 290-50 in relation to an entity's involvement in a *tax exploitation scheme more than 4 years after the entity last engaged in conduct that resulted in the entity or another entity being a *promoter of the tax exploitation scheme.
- (5) The Commissioner must not make an application under section 290-50 in relation to an entity's involvement in a *scheme that has been promoted on the basis of conformity with a *product ruling more than 4 years after the entity last engaged in conduct in relation to implementation of the scheme.
- (6) However, the limitation in subsection (4) or (5) does not apply to a *scheme involving tax evasion.

Taxing Financial Arrangements: Harmonising Tax and Accounting?

Rodney Fisher*

Abstract

This paper comments critically on the proposed provisions governing the Taxation of Financial Arrangements (TOFA). It describes the tortuous consultation process and the somewhat piecemeal introduction of aspects of the taxation of financial arrangements legislation that have come in. It critiques the approach taken in the Exposure Draft and identifies a number of anomalies. The article regrets that the revenue authorities have been reluctant to link tax outcomes more directly to accounting outcomes in relation to taxing financial arrangements. The article notes the breadth of impact on a range of taxpayers that the Exposure Draft will have. The article accepts that some of the provisions appear to be moving in the right direction, but notes that there is still a need for modification and fine tuning before the legislation can be fairly regarded as final.

INTRODUCTION

The path leading to the introduction of the Exposure Draft¹ on proposed provisions governing the taxation of financial arrangements has followed a rather long and, some may suggest a rather tortuous, route. The public consultations began with the release of the 1993 *Consultative Document*, followed by the 1996 *Issues Paper*, the Ralph Report² in 1999 and culminating in the public release in December 2005 of Exposure Draft legislation providing a statutory regime for the taxation of financial arrangements. In the absence of a comprehensive legislative regime,³ the taxation of financial arrangements has largely been subject to determination at common law.⁴ With the proliferation in the scope and use of financial arrangements, the taxation consequences applying to the more innovative arrangements has become at best an arguable proposition, creating compliance issues which spread well beyond traditional financial institutions.

The Ralph Report had made recommendations in relation to a number of issues involving taxation of financial arrangements, including:

- Recommendations 12.10 and 12.11 - defining membership interests (essentially equity) and exclusion from this for debt interests;⁵
- Recommendation 9.4 - a retranslation election for foreign currency transactions;⁶

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¹ *Taxation Laws Amendment (Taxation of Financial Arrangements) Bill 2006*.

² *Review of Business Taxation: A tax system redefined*, July 1999.

³ There are legislative provisions covering limited arrangements, including Div 16E, ss 26BC & 70B.

⁴ See for example the decisions in *Coles Myer Finance Ltd v FCT* (1993) 25 ATR 95; *FCT v Energy Resources Australia* (1996) 33 ATR 52.

⁵ Ralph Report at 442 & 445.

- Recommendations 9.1 and 9.2 - prescribing an accruals basis for financial assets and liabilities, with a mark-to-market election.⁷

The government has broadly followed this division of topic areas, with legislation being developed in three tranches. Legislation dealing with the demarcation between debt and equity was introduced in the first tranche,⁸ with these provisions being classification provisions not dealing with the consequences of the distinction between a debt and equity instrument. In the second tranche, provisions were enacted to deal with foreign currency transactions,⁹ providing conversion rules and taxation treatment for gains and losses on foreign currency.

The remaining areas awaiting legislation involved hedging and taxation of gains and losses on financial arrangements and, while these areas were to be initially dealt with separately, they have now been combined and constitute the third arm of the legislative regime, encapsulated in TOFA 3 & 4. The Exposure Draft of the proposed provisions was publicly released in December 2005 and it is this Exposure Draft which is the subject of examination in this analysis.

The analysis in the paper examines the scope of the regime and aspects of the tax calculations in the proposals, with the discussion highlighting some of the similarities and the disparities between the Exposure Draft provisions and the accounting standards in relation to financial instruments.

TAXING FINANCIAL ARRANGEMENTS

The contentious issues in relation to the taxation of financial arrangements have traditionally focused upon the characterisation of the return on the financial arrangement, being whether a particular return had a revenue or capital nature,¹⁰ and the timing of recognition of the return in circumstances where the financial arrangement extended across income years. While the former issue may not have been fully resolved, it is the issue of the timing of the recognition of income or a deduction in relation to the financial arrangement which has come to the fore as the focus of compliance uncertainty. This issue was highlighted by Beaumont J in *Federal Commissioner of Taxation (FCT) v Australian Guarantee Corp Ltd*¹¹ in identifying that “the contest between the parties centres on the point of time, in terms of income year, in which the interest should be allowed as a deduction ... rather than deductibility as such ...”¹²

In addressing this issue the Full Federal Court in *Coles Myer Finance v FCT*¹³ looked to the test for ‘incurred’ in *Emu Bay Railway Co Ltd v FCT*,¹⁴ the test suggesting that

⁶ Ibid at 346.

⁷ Ibid at 337 & 340.

⁸ Introduced by the *New Business Tax System (Debt & Equity) Bill 2001* (Cth).

⁹ Introduced by the *New Business Tax System (Taxation of Financial Arrangements) Bill (No 1) 2003* (Cth).

¹⁰ The argument for the distinction suggests that “... discount is different from interest; it is not earned nor does it accrue from day to day” – see *Willingale (Inspector of Taxes) v International Commercial Bank* [1978] All ER 754, 756. The bifurcation argument based on this difference suggests that the discount represents “... two economic elements, the one the value of the usufruct foregone, as measure by interest, and the other the risk that the money will never be repaid at all” – see *Lord Sumner in The National Provident Institution v Brown (Surveyor of Taxes)* 8 TC 57, 96.

¹¹ (1984) 84 ATC 4642.

¹² Ibid at 4658.

¹³ (1991) 21 ATR 1185.

to be incurred a liability must be "... presently incurred and due though not yet discharged."¹⁵ In the view of the court, the "... critical question is whether, within the ... taxation year, the applicant was under a present liability to pay out the bills and promissory notes, as distinct from being in a position that a liability would certainly arise in the future".¹⁶

Australian courts have settled on recognition of gains or losses on a straight-line accruals basis,¹⁷ although there had previously been some judicial support for the alternative approaches of recognition on issue of an instrument and recognition on realisation of an instrument.¹⁸ The most authoritative statement in favour of an accruals recognition of deductions for financial arrangements comes from the High Court joint majority judgment of Mason CJ, Brennan, Dawson, Toohey and Gaudron JJ in *Coles Myer Finance Ltd v FCT*.¹⁹ The court recognised that the "relevance of the present existence of a legal liability ... is that it establishes that the taxpayer has 'incurred' in the year of income an obligation to pay an amount ...", but that "... it is proper to set against the taxpayer's gross income or profit for that period the net losses or outgoings referable to that period".²⁰

In the High Court decision in *FCT v Energy Resources Australia*,²¹ the Court determined that the discount at issue was on revenue account, and then had to decide the issue of the timing of the deduction for the discount. The High Court noted that where a financial instrument extended beyond the current financial year, "the decision in *Coles Myer* arguably requires that the cost of the discount for that issue should be apportioned on a straight line basis between the two financial years".²²

In the evolution of the common law approach to determining the tax treatment for financial arrangements, a contentious issue has been whether the accounting recognition of a return or outgoing associated with a financial arrangement had a role to play in determining the taxation treatment and, if so, the weight to be accorded this accounting treatment. In accepting the accruals basis, Toohey J in the Federal Court decision in *Australian Guarantee Corporation* would seem to have gone close to endorsing accounting practice as almost a determining factor in deciding the tax position, suggesting that if the "approach was in accord with sound accountancy practice ... I see no reason why the taxpayer should not be allowed a deduction accordingly, unless there is something in the Act which precludes such a course ...".²³

However courts have generally displayed a consistent reluctance to be bound by the accounting treatment prescribed for gains or losses on a financial arrangement, or economic arguments as to the nature of the returns on financial arrangements. Rather, the approach taken by courts has been that although regard may be had to the accounting treatment, which may even provide a degree of guidance in ascertaining

¹⁴ (1944) 71 CLR 596.

¹⁵ *Ibid* at 606.

¹⁶ Above note 13 at 1189.

¹⁷ See the High Court decision in *Coles Myer Finance Ltd v FCT* (1993) 25 ATR 95.

¹⁸ In *Coles Myer Finance v FCT* (1991) 21 ATR 1185 in the Full Federal Court the majority preferred recognition on realisation; McHugh J in dissent preferred recognition on initial issue of the instrument.

¹⁹ (1993) 25 ATR 95.

²⁰ *Ibid* at 105.

²¹ (1996) 33 ATR 52.

²² *Ibid* 56.

²³ Above note 11 at 4648.

the character and tax treatment to be accorded the returns on an arrangement, the tax determination has been and remains a question of law to be determined from the application of the law to the facts in the issue. The judicial view may be best summarised in terms such that “commercial and accounting practice may assist in ascertaining the true nature and incidence of the item as a step towards determining whether it answers the test laid down in s 51(1) but it cannot be substituted for the test”.²⁴

APPROACH TAKEN IN EXPOSURE DRAFT

This relationship between accounting practice and the taxation rules, in particular the degree of alignment between statutory provisions and the accounting treatment as prescribed by accounting standards, has been a significant consideration in the development of the Exposure Draft and is considered throughout this discussion. The other aspect of particular interest in the Exposure Draft is the adoption of a principles based drafting model.

Alignment with accounting

The question of the reliance to be placed on accounting practice again became a significant issue in the development of the TOFA 3 & 4 legislation.

One of the general concerns of the courts in not accepting accounting practice as determinative of the issue for tax had appeared to be that accounting standards may not have been sufficiently prescriptive of the accounting treatment to apply, with the result that there may not have been uniformity of approach across a range of taxpayers. This perceived lack of a prescriptive approach was seen to allow opportunity for tax arbitrage and for taxpayers to gain a taxation timing advantage.

At around the same time as the TOFA 3 & 4 legislative development, Australia had adopted and was engaged in the implementation of the Australian equivalent of the International Financial Reporting Standards (AIFRS) which were seen to be more rigorous and prescriptive in respect of the accounting treatment for financial arrangements. The suggestion was that the adoption of AIFRS may have created the opportunity for the taxation regime to more closely align with the newly operative accounting standards. The benefits being greater simplicity and compliance savings for taxpayers who could use accounting figures and thus avoid a second calculation for taxation purposes.

An alternative view would suggest that total reliance on accounting figures for taxation purposes may amount to an abrogation by the legislature of control of this aspect of the taxation law, being an outcome which would not be seen as acceptable by any legislative authority. In particular, the introduction of international accounting standards meant that interpretation of the standards would occur at an international level, creating the concern that, if Australian taxation law was reliant on the standards, the interpretation of that law would become a matter outside of the control of the legislative authorities. This was seen to have the potential for changes which could result in an erosion of the Australian tax base occurring outside of Australian regulatory control. A further concern was that changes in the standards, or the introduction of new standards, with the potential for a consequential adverse impact

²⁴ *FCT v James Flood* (1953) 88 CLR 492, 506–7.

on the Australian tax base, would again be outside the realm of influence of Australian legislative authorities.

Ultimately these latter concerns would appear to have prevailed, as the TOFA 3 & 4 draft provisions create a separate legislative regime, albeit one which does have some interaction and harmonisation with the accounting standards.

Principles based drafting

A notable feature of the Exposure Draft legislation is the appearance of yet another drafting style in taxation legislation. Current legislation is replete with examples of changes in drafting style, from very prescriptive and narrow black-letter law drafting, to the broad all-encompassing approach evident in some of the anti-avoidance provisions.

The TOFA 3 & 4 Exposure Draft adopts a principles based drafting approach, the underlying idea being that the operative legislative provisions implementing the policy are drafted as coherent principles. The Explanatory Material accompanying the Exposure Draft explains that, by contrast with other drafting styles, the coherent principles approach will often prescribe the legislative outcome rather than detailing the mechanism to be used to produce an outcome.²⁵ The danger with this approach may be that while the intended outcomes across a number of different scenarios may be clear, the difficulty lies in discerning the underlying principle which would produce the outcomes. Without this underlying principle, there would be no clear approach for use in new and novel situations.

The advantage for the coherent principles approach was seen to be its ability to allow flexibility and, given the ongoing development with financial engineering of financial instruments, it was presumably considered that the legislation should apply widely without the need for ongoing amendment to the legislative provisions.²⁶ With the legislation providing the principles, further explanation and clarification of the legislation would be provided by 'unfolding' of the principles in explanatory material.

While there may be a theoretical rationale for adopting this principles based approach, it may appear somewhat surprising that the financial arrangements legislation should be chosen to trial this drafting style given that the taxation treatment in such an area is, by its nature, quite complex and, given that the provisions as proposed would impact on such a wide range of instruments and large number of taxpayers. Also it may have been thought that, given the gestation period for these provisions, there would be the desire for a relatively smooth and incident free implementation, making it more surprising that this regime would be chosen to trial an unproven drafting style. It remains to be seen whether the approach works in practice in the way that the theory suggests it should.

SCOPE OF THE PROVISIONS

The taxation treatment specified in the Exposure Draft applies to gains and losses from financial arrangements, making the definition of a financial arrangement critical to the operation of the regime.

²⁵ Explanatory Material at para 1.2.

²⁶ Explanatory Material at para 1.4 – 1.5.

The definition of a financial arrangement is cast in terms whereby:²⁷

You have a *financial arrangement* if you have any of the following:

- (a) a legal or equitable right to receive something of economic value in the future;
- (b) a legal or equitable obligation to provide something of economic value in the future;
- (c) a combination of one or more such rights and/or one or more such obligations.

This definition serves to encompass a wide range of arrangements, the approach presumably being to have a wide all-inclusive definition, and then provide specific carve-outs for those arrangements not intended to be within the regime. The approach is explained as seeking to capture arrangements which exhibit the fundamental and common elements of the provision of finance and the shifting or allocation of risk²⁸ and, is seen as being more durable than would be a more narrow definition, particularly in the face of future financial innovation.²⁹

It is suggested that the common feature of financial arrangements is the right to receive, or obligation to provide, something of economic value, so the definition has attempted to encapsulate these concepts.³⁰ This approach is intended to be based more on economic substance of a transaction than the legal form and it is on this basis that the definition extends beyond legal rights and obligations to include equitable rights and obligations to receive or provide something of economic value.

This wide and all-encompassing approach of including both legal and equitable rights may be contrasted with the approach taken in the accounting standards. Accounting Standard AASB 132, dealing with disclosure and presentation of financial instruments, limits financial instruments for the purposes of the accounting standards to those involving a contractual right, with a financial instrument defined in terms such that:

A financial instrument is any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity.³¹

Financial assets and liabilities are themselves defined in terms of contractual rights or obligations.³²

²⁷ Proposed s 230-30.

²⁸ Explanatory Material at para 3.12.

²⁹ Explanatory Material at para 3.14.

³⁰ Explanatory Material at para 3.12.

³¹ AASB 132 para 11.

³² Financial assets and financial liability are defined in AASB 132 para 11 in the following terms.

A *financial asset* is any asset that is:

- (a) cash;
- (b) an equity instrument of another entity;
- (c) a contractual right:
 - (i) to receive cash or another financial asset from another entity; or
 - (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity; or
- (d) a contract that will or may be settled in the entity's own equity instruments and is:

A comparison of these definitions highlights the divergence in approach taken between tax and accounting. For accounting purposes a financial instrument only encompasses a legal right or obligation which has been created under contract, the right or obligation being broadly for the exchange of something of economic value. Contractual rights and obligations need not be absolute but could also include contingent rights and obligations. While the accounting approach may broadly be seen as adopting a substance over form approach, the definition only recognises instruments which have created legal rights and obligations.

However the definition of a financial arrangement for tax purposes adopts a much broader approach, encompassing not only arrangements which involve the creation of legal rights and obligations under a contract, but extending to include arrangements which involve the creation of equitable rights or obligations, which would not be created under contract.

On this basis the wider tax definition of a financial arrangement would include all financial instruments which fall within the accounting definition and extend further to include those arrangements where the rights or obligations are equitable rights and obligations rather than legal rights and obligations based in contract. The Explanatory Material suggests that this wider definition for tax purposes is required as the 'substance over form' approach being adopted for tax could identify the provision of finance or the shifting of risk through arrangements where rights and obligations are not founded in contract but are founded in equity.³³ It is somewhat unfortunate that the example used to illustrate this issue, being an interest under a trust, is also one of the specific exclusions from the regime.

In developing the taxation approach, some particular difficulties had been identified if the accounting definition was to be adopted for taxation purposes, with some of these difficulties being outlined in the Explanatory Material. While the accounting definition would not extend to rights to receive non-monetary amounts, it was considered that the provision of finance could include the right to non-monetary amounts and therefore these needed to be included in the tax definition.³⁴ Additionally, while the scope of the accounting definition comprises rights and obligations under individual contracts, it was considered that the rights and obligations

(i) a non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

A *financial liability* is any liability that is:

(a) a contractual obligation:

(i) to deliver cash or another financial asset to another entity; or

(ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or

(b) a contract that will or may be settled in the entity's own equity instruments and is:

(i) a non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or

(ii) a derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

³³ Explanatory Material para 3.10.

³⁴ Explanatory Material at para 3.7.

encompassed in the provision of finance and shifting of risk did not necessarily emanate from contracts.³⁵ While recognising that a financial arrangement for tax purposes would typically be constituted by a contract, the wider tax definition reflected a concern that a contractual basis would not be sufficient to mirror the substance of arrangements in all circumstances.³⁶ A further argument raised against adopting the accounting definition arose from the non-comprehensive coverage of the accounting standards, with not all entities being required to prepare accounts based on the AIFRS standards.³⁷

In addition to the differences with accounting, a further contrast may be drawn between different treatment within the tax provisions themselves. In particular a contrast may be identified between the scope of the TOFA proposals and the scope of existing legislative provisions dealing with financing arrangements. In the first tranche of the TOFA provisions, dealing with the debt/equity classification, the test for a debt interest³⁸ looked to whether a scheme constituted a financing arrangement, with a financing arrangement being defined as being broadly the raising of finance.³⁹ Examples provided of schemes to raise finance would include bills of exchange, income securities and convertible notes, with derivatives and contracts for personal service being outside the definition.⁴⁰

It would be suggested that the scope of a financial arrangement in TOFA 3&4, being a legal or equitable right or obligation to receive or give something of economic value, may be significantly broader than a financial arrangement under Division 974, being the raising of finance. That this broader scope is intended is confirmed by the Explanatory Material which suggests that financial arrangements would include not only debt type arrangements, but also risk shifting arrangements such as derivatives, swaps and options, hybrid financial arrangements and synthetic debt arrangements.⁴¹

A further distinction arising between the legislative debt/equity provisions in Div 974 and the proposed Div 230 is in relation to disaggregation of financial arrangements. Division 974 provides limited circumstances for disaggregation of what would otherwise be a single scheme.⁴² By contrast the new proposals would appear to have the intent of allowing for disaggregation and bifurcation of a compound interest for the purposes of identifying a financial arrangement which constituted a part of this compound interest.⁴³ In this regard, the new proposals would appear to align more closely with accounting standards, with AASB 132 mandating the disaggregation of a compound financial instrument into its component parts,⁴⁴ with each component then being separately classified.

As highlighted in the discussion, the new TOFA 3&4 proposals adopt a wider approach in identifying a financial arrangement than the accounting standards and

³⁵ Explanatory Material at para 3.10.

³⁶ Explanatory Material at para 3.23.

³⁷ Explanatory Material at para 3.11.

³⁸ Section 974-20 ITAA 1997.

³⁹ Section 974-130(1) ITAA 1997.

⁴⁰ Sections 974-130(2)&(3) ITAA 1997.

⁴¹ Explanatory Material at paras 2.40 – 2.42.

⁴² Section 974-150(2)(a).

⁴³ Proposed s 230-30(2).

⁴⁴ AASB 132 at para 28 – 32.

other taxation provisions. The rationale appears to be to ensure that arrangements developed in the future would still be encompassed within this broad definition.

The inherent difficulty with the approach taken of defining financial arrangements widely, and then providing specific exclusions from the regime, is that unless there is a specific legislative exclusion provided, an arrangement is caught regardless of whether this had been the intention. The burden is thus created for ongoing legislative amendments to provide for additional carve-outs as these are identified.

A number of specific exclusions are identified in the Exposure Draft, although many of these remain ill-defined and it is expected that there will be further development in relation to the exclusions. Exceptions from financial arrangements are provided in the Exposure Draft for:

- non-derivates held for longer than 12 months where the consideration is not money or money equivalent;⁴⁵
- individuals, or entities with turnover less than \$20,000,000, where the financial arrangement is for not more than 12 months and the implicit interest rate does not differ by more than 1.5% from the actual rate;⁴⁶
- equity interests;⁴⁷
- interests in partnerships or trusts;⁴⁸
- life insurance policies;⁴⁹
- personal services;⁵⁰
- restrictive covenants;⁵¹
- personal injuries;⁵² and
- leasing or property arrangements.⁵³

The number, range and scope of these exceptions would be expected to expand as Treasury engages in further consultation prior to the introduction of any legislation.

Having identified that a particular arrangement comprises a financial arrangement for the purposes of the legislation, the issue to be addressed turns to the taxation recognition of gains and losses from the financial arrangement.

TAX TREATMENT OF GAINS AND LOSSES

In broad terms, the operative provision of the legislative proposal treats gains and losses from financial arrangements as being on revenue account,⁵⁴ the suggestion being that the removal of the capital/revenue distinction reduces complexity and

⁴⁵ Proposed s 230-125.

⁴⁶ Proposed s 230-130.

⁴⁷ Proposed s 230-135(2).

⁴⁸ Proposed s 230-135(3).

⁴⁹ Proposed s 230-135(4).

⁵⁰ Proposed s 230-135(5).

⁵¹ Proposed s 230-135(6).

⁵² Proposed s 230-135(7).

⁵³ Proposed s 230-135(8).

⁵⁴ In this regard the proposed provisions are in accord with other legislative regimes such as New Zealand and the UK.

increases certainty.⁵⁵ With gains and losses being on revenue account, the proposal provides that:

Your assessable income includes a gain you make for the income year from a financial arrangement you have at any time in the income year;⁵⁶

and

You can deduct a loss you make for the income year from a financial arrangement you have at any time in the income year, but only to the extent that:

- (a) you make it in gaining or producing your assessable income; or
- (b) you necessarily make it in carrying on a business for the purpose of gaining or producing your assessable income.⁵⁷

Deductions would also be allowed for losses made by an Australian entity in deriving foreign source non-assessable non-exempt income where the loss is in relation to a debt interest.⁵⁸

The approach taken in the legislation, then, is based on including the full gain on a financial arrangement in assessable income, or deducting the full loss on a financial arrangement, in determining taxable income, rather than determining a net gain or loss on financial arrangements for the income year.

This general principle for taxing gains and losses is modified by specific exclusions, with gains not being assessable if made in gaining or producing exempt income or non-assessable non-exempt income, or in carrying on a business for the purposes of producing income of this character.⁵⁹ Both gains and losses are disregarded to the extent to which they are of a private or domestic nature.⁶⁰

The proposed Division 230 provisions would take priority over other taxing provisions, leaving a residual operation for other provisions where the new proposals did not apply, such as where the arrangement was excluded from the definition of financial arrangement.⁶¹ On this basis it would still be possible for some financial arrangements to be taxable under the capital gains provisions or other legislative provisions, undermining the argument that greater certainty and reduced complexity would result from having all financial arrangement provisions in one division. The details of the interaction of the proposals in this new division with other provisions of tax legislation remain to be finally determined.

MEASURING THE TAXABLE GAINS OR LOSS

With gains and losses from financial arrangements included in calculating taxable income, the key issues then become:

- identifying the timing for when a gain or loss on a financial arrangement must be included as assessable income or included as a deduction; and

⁵⁵ Explanatory Material at paras 4.6 – 4.8.

⁵⁶ Proposed s 230-15(1).

⁵⁷ Proposed s 230-15(2).

⁵⁸ Proposed s 230-15(3).

⁵⁹ Proposed s 230-20(1).

⁶⁰ Proposed s 230-20(2).

⁶¹ Proposed s 230-15(4).

- determining the quantum of the gain or loss to be recognised, this determination being a function of the timing.

Under the proposals, these issues are related in that both the timing of recognition and the calculation of the gain or loss to be recognised will broadly be functions of the methodology adopted. The proposals offer a number of methodologies, depending on certain conditions being satisfied, with the methods potentially available being:

- a realisation basis;
- an accruals basis;
- an elective fair value method;
- an elective retranslation method; and
- an elective hedge accounting method.

It is not intended that these different recognition models would all be available in all circumstances, so taxpayers are not being offered an unfettered freedom to choose any particular method. Also, the methods would not be mutually exclusive as, in particular circumstances, there may be two or more of the methods applying to a single financial arrangement either at any particular time, or over the life of the financial arrangement.

In addition to these methodologies, there is a discretion for the Commissioner to allow for the use of financial accounting records for tax purposes where threshold conditions are met.

If none of the elective methods has been chosen then recognition of gains and losses will be on a realisation and/or accruals basis.

The conditions for, and operation of, each of the methodologies is outlined below.

REALISATION BASIS

Realisation of a financial arrangement occurs when the whole or part of the financial arrangement ceases to be held, or something of economic value is received or provided, or the time for this occurs.⁶² There may be a disposal, or ceasing to hold, a financial arrangement either through the expiry of rights or obligations, the transfer of rights or obligations, or the assignment of rights or obligations. If there is an expiry, transfer or assignment of part of a financial arrangement this would constitute a part disposal.

The realisation method is intended to have operation both as a fall-back when other methods are not applicable and as a residual method when another method had applied to the financial arrangement.

The realisation basis would be seen as the base method to apply in recognising gains and losses from a financial arrangement when none of the other methods would be appropriate. This would be the case, for example, with a cash basis taxpayer who had not made an election for an alternative method and was not required to account on an accruals basis. If no gain or loss had been previously recognised on the financial arrangement, the quantum of the gain or loss on realisation would be the total gain or

⁶² Proposed s 230-25 item 4.

loss on the financial arrangement. This would be the case if there had been no prior accruals recognition of a gain or loss on the financial arrangement.

There would also be application of the realisation basis as a 'balancing charge' when gains or losses from a financial arrangement had been dealt with on the accruals basis and the financial arrangement ended during the current income period. In this case the amount of the gain or loss included under the realisation basis would be the total gain or loss on the financial instrument over the period held, less any amount which had previously been recognised as a gain or loss on the accruals basis. As explained in the Explanatory Material,⁶³ having the realisation method also applying on this residual basis ensures that the overall gain or loss on the financial instrument will be recognised.

Under the new proposals, the importance of the realisation method for recognising gains or losses is expected to diminish, being applicable for financial arrangements where the gain or loss cannot be determined with sufficient certainty. The intention under the proposed regime is that the accruals basis should have an increased application for financial arrangements.⁶⁴

ACCRUALS BASIS

The proposed provisions require the use of the compounding accruals basis for recognising gains and losses in circumstances where it is reasonably likely that there would be an actual net gain or actual net loss from the financial arrangement.⁶⁵ In determining whether this would be the case regard would be had to the terms and conditions of the financial arrangement, with the assumption made that the financial arrangement would be held to maturity.

Where it is reasonably likely that an overall gain or overall loss would be made from the financial arrangement the compounding accruals methodology would apply to the actual net gain or loss that was reasonably likely to be made, using a compounding period that did not exceed 12 months.

As noted earlier, the courts had applied a straight-line accrual basis to determine the return on a financial arrangement for an income period. By contrast the Exposure Draft provides for a compounding accruals allocation method, whereby the discount rate that equates the net present value of all cash flows to zero is applied to the initial investment to determine an estimated yearly gain or loss which will be the gain or loss subject to taxation. The advantage seen for the accruals methodology is that it smooths out volatility in gains and losses by spreading the gain or loss more evenly across the period of the financial arrangement.⁶⁶ Additionally, the accruals methodology is seen as moving closer to commercial outcomes and, more importantly, reduces the opportunity for tax deferral and tax arbitrage opportunities.⁶⁷

The compounding accruals approach is also seen as providing a closer alignment with accounting treatment, being conceptually identical to the effective interest method applied in AASB 139. The effective interest rate in AASB 139 is the rate that

⁶³ Explanatory Material at para 10.20.

⁶⁴ Explanatory Material at para 7.4.

⁶⁵ Proposed s 230-25 item 2.

⁶⁶ Explanatory Material at para 6.3.

⁶⁷ Explanatory Material at para 6.7 – 6.9.

discounts estimated future cash payments or receipts to the net carrying amount of the financial asset or liability.⁶⁸ The Exposure Draft proposal also allows for the application of a reasonable approximation of the compounding accruals basis, being a method with an outcome close to the compounding accruals.

The Explanatory Material requires that the determination as to whether a financial arrangement will be subject to the accruals basis is to be determined initially at the time when the arrangement is acquired.⁶⁹ This then requires that an evaluation be made at inception of the financial arrangement as to whether the threshold test is satisfied that it is reasonably likely that there will be an actual net gain or an actual net loss from the financial arrangement. If it is judged as not reasonably likely that there would be a gain or loss from the financial arrangement then the accruals method would not apply, in which case the realisation method would be applicable. If the reasonably likely threshold test is met, application of the compounding accruals method then requires a determination of the reasonably likely actual net gain or actual net loss, so the accruals amount for the period may be calculated.

This aspect of the proposals highlights the difficulty with principles based drafting of determining the practical application of the principle. The practical difficulty with the accruals test lies in identifying the meaning of the test of 'reasonably likely', which is applied both in the threshold test in determining if the accruals method is to apply and again in the calculation of the accruals amount. The difficulty with the test is that there is no clear objective meaning attaching to the term 'reasonably likely'. In the absence of a 'bright line' test, it may be that in the same situation different taxpayers may quite legitimately reach different conclusions as to the level of certainty implied in the reasonably likely test.

Risk averse taxpayers may require a higher degree of certainty to consider a return to be reasonably likely than may be the case with a less risk averse taxpayer, the inevitable result being a lack of consistency in application of the principle. It may be that taxpayers involved on each side of the same transaction may make different assessments of the reasonable likelihood of a gain or loss, resulting in one part of the transaction being included on the compounding accruals basis, while the other side of the transaction was deferred and recognised on a realisation basis. This is the very asymmetry which the proposed TOFA 3&4 provisions were designed to overcome, but the lack of precision in the principle as proposed may exacerbate the problem.

In seeking to provide some guidance on the application of this principle, the Explanatory Material⁷⁰ draws on the distinction made in the Ralph recommendations between certain and uncertain returns.⁷¹ If a contractual commitment provides for a greater return than the outlay, a gain is seen as certain and the accruals methodology should apply. However, with the broad definition of a financial arrangement, there will be arrangements involving contingencies, where the potential return is uncertain.

The Explanatory Material suggests that these certain and uncertain events be judged by having regard to the terms and conditions and if the net effect of the certain and uncertain outcomes is such that there is a relatively certain gain (loss) overall, then the

⁶⁸ AASB 139 at para 9.

⁶⁹ Explanatory Material para 6.39.

⁷⁰ Explanatory Material at paras 6.23 – 6.27.

⁷¹ See generally the discussion in *Review of Business Taxation: A tax system redefined* at pp 431ff.

gain (loss) would be reasonably certain. If the probability of a gain (loss) was relatively low, the gain (loss) would not be reasonably likely and the realisation basis would apply.

The difficulty with this explanation is that the reasonably likely test is explained in terms of a 'relatively certain' return or a 'relatively low probability', with these terms themselves lacking the precision and certainty required if taxpayers are to have a clear understanding of when the accruals basis is to apply. While it may be difficult to provide this certainty by way of a prescribed percentage or range of percentages, it is suggested that more precise guidance is required for taxpayers to be able to self assess without the lingering concern that a later ATO review may apply a different standard.

In looking to the alignment with accounting, the threshold test for applying the effective interest rate in AASB 139 differs from the proposed taxation accruals test. While the accruals method would apply when it is reasonably likely that there would be an actual net gain or loss, the accounting test is on the basis of there being fixed or determinable payments for a held-to-maturity investment. While there would appear to be little in the way of guidance as to when it is reasonably likely that there would be an actual net gains or loss, equally there appears little in the accounting standard to clarify what is intended to constitute fixed or determinable payments.

ELECTIONS TO USE ACCOUNTING CALCULATIONS

In what must be seen as an attempt to create some harmony between tax treatment and accounting treatment while at the same time not relinquishing control of the tax rules or the tax base, the proposed provisions allow for taxpayers meeting specified conditions to align their tax treatment for financial arrangements with the accounting treatment.

FAIR VALUE ELECTION

The Explanatory Material explains the fair value tax-timing method as a methodology by which gains or losses for tax purposes are measured as the change in value of the financial arrangement between two points in time.⁷² This fair value would usually be measured over an income year, with adjustments for amounts paid or received.

The proposals allow that if an entity meets the conditions for making the fair value election and makes the fair value election, then the gain or loss recognised for tax purposes will be equal to the gain or loss which would be recognised as the accounting gain or loss for the financial instrument. Taxpayers making the election would thus benefit from the simplicity and compliance savings from being able to use the accounting figures, rather than having to recalculate the gain or loss for tax purposes.

In granting this proposed concession to use accounting figures a number of significant conditions must be met, with Treasury no doubt concerned to maintain the integrity and tax base of the tax system.

⁷² Explanatory Material at 5.4.

Conditions for the fair value election to be available are designed to ensure the integrity of the accounting information on which the tax gain or loss will be based. These conditions requiring:⁷³

- the accounts for the income year must be audited under the requirements of Chap 2M of the *Corporations Act*, or a foreign equivalent; and
- the financial asset or liability must be required to be classified in the accounts as at fair value through profit and loss, this requirement arising from application of AASB 139, or a foreign equivalent accounting standard.⁷⁴

If the financial instrument for accounting purposes comprises the whole of the financial arrangement for tax purposes, then the fair value election will apply to the whole of the financial arrangement and no other tax-timing mechanism will apply. However if the financial instrument for accounting purposes does not comprise the whole financial arrangement for tax purposes, then the fair value election applies to only part of the financial arrangement, with the financial arrangement having to be split into components. The component corresponding to the financial instrument for accounting purpose may be subject to the fair value election, with the remaining component of the financial arrangement being subject to the accruals or realisation basis for tax purposes. This requirement for bifurcation arises as a direct consequence of the broad nature of the definition of a financial arrangement as opposed to an accounting financial instrument, as discussed earlier.

The proposed election for fair value would be irrevocable so, once chosen, all subsequent financial arrangements would be subject to this treatment. What is not clear is the position if, having made the election for fair value, a taxpayer subsequently fails to continue to meet the strict threshold requirements for the election to be available. There is no guidance as to whether existing financial arrangements within the election would continue to fall within the election or whether all financial arrangements would then be excluded from the election.

Two issues arising in relation to the fair value election are the accounting requirement for recognising a financial instrument at fair value through profit and loss, as this is a prerequisite for the tax election and the method of valuation to determine market value.

Accounting Standard AASB 139 defines a financial asset or financial liability at fair value through profit and loss as one which meets the following conditions:⁷⁵

- it is classified as held for trading, which in turn requires that it be principally acquired or incurred for the purpose of selling or purchasing in the near term, or be part of a portfolio of financial instruments where there is evidence of short term profit taking, or be a derivative; or
- the financial instrument be recognised at fair value through profit or loss on initial recognition, which is available for any financial instrument except equity

⁷³ Proposed s 230-45.

⁷⁴ Financial arrangements which are fair valued for accounting but with the change in value going to equity rather than to profit and loss are excluded from this election.

⁷⁵ AASB 139 at para 9.

instruments without a quoted price in an active market or whose fair value cannot be reliably measured.

In determining fair value for tax purposes no definition is provided, with the suggestion⁷⁶ being that reliance may be placed on the definition and guidance in AASB 139, which defines fair value in terms of the amount for exchange or settlement between knowledgeable willing parties in an arm's length transaction.⁷⁷

RETRANSLATION ELECTION

A further elective method is available⁷⁸ in relation to foreign exchange retranslation, the intention again being to align the tax treatment of gains and losses from rate changes on foreign exchange with the accounting treatment for these amounts. The election is restricted in its scope to foreign currency gains and losses arising from exchange rate movements and is thus different to the fair value election which would recognise gains and losses attributable to all variables. Because this election applies only to exchange movements, the method can operate in conjunction with other methods such as compounding accruals and realisation which would be used to recognise gains or losses from the domestic currency component. The same amount could not be recognised under more than one of the methodologies.

As with the fair value election, a number of requirements must be satisfied for a taxpayer to avail themselves of the alignment of tax and accounting. The conditions, again, being directed to ensuring integrity of the accounting information on which the tax figures will be based. The conditions to be met for the retranslation election require that:⁷⁹

- the accounts for the income year must be audited under the requirements of Chap 2M of the *Corporations Act*, or a foreign equivalent; and
- accounting standard AASB 121, or a foreign equivalent accounting standard, must require in the financial accounts the recognition of a profit or loss in respect of foreign currency gains and losses on the financial instrument.

It is this profit or loss on the financial instrument that is required to be recognised in the financial accounts that will then also be recognised as the foreign currency gain or loss on the financial arrangement for tax purposes. As noted, however, this may not be the total gain or loss on the financial arrangement for tax purposes as this election only applies to the foreign currency component.

The proposals require that the election is irrevocable. Although, again, the treatment is not clear for a taxpayer who has made the election and later fails to continue to meet the threshold requirements to make the election.

With the election requiring that AASB 121 require an amount be recognised in profit and loss, the issue arises as to when this requirement in the accounting standard must be met. In general terms AASB 121 requires that exchange differences on settlement of money items or on translating money items at a rate different from initial recognition be recognised in profit and loss. Additionally for non-monetary items

⁷⁶ Explanatory Material at para 5.19 – 5.20.

⁷⁷ AASB 139 at para 9.

⁷⁸ Proposed s 230-25 item 3.

⁷⁹ Proposed s 230-60.

which are recognised in profit and loss, the exchange component of gains or losses will also be recognised in profit and loss. For non-monetary items recognised in equity and monetary items forming part of a net investment in a foreign operation, the currency gain or loss will be recognised in equity and for these cases the taxation retranslation election would not be available.

HEDGING ELECTION

As noted earlier in the discussion, the definition of financial arrangements for tax purposes is designed to capture not only arrangements for the provision of finance, but also arrangements dealing with the shifting and allocation of risk, as occurs under hedging arrangements. While bringing hedging within the regime, the proposals do allow for an elective method⁸⁰ of measuring gains and losses from hedging transactions.

Effectively, the proposals seek to tax the actual net gains or losses arising from hedge arrangements, with these actual gains or losses allocated over the period of the hedge on a basis determined and recorded by the taxpayer at the inception of the hedge.⁸¹ The basis for allocating gains and losses is required to be an objective basis and reasonably correspond with the basis on which gains or losses from the underlying hedged item are allocated. A time limit is specified within which gains and losses are recognised, being 20 years for one hedged item and 5 years if more than one hedged item.⁸² If a taxpayer ceases to have the hedging arrangement then the gain or loss is recognised in the income year in which this occurs.

As a consequence of the hedging election effectively allowing a taxpayer to self assess the gain or loss to recognise each year for a hedge which is held, there are a number of quite prescriptive requirements which must be satisfied for the election to be available.

The election is only available in respect of hedging financial arrangements⁸³ which are defined as derivative financial arrangements which themselves satisfy a number of conditions, including:

- having the purpose of hedging risk in relation to an asset, liability, or current or future transaction;
- being classified under Australian (or equivalent foreign) accounting standards as a hedge; and
- being recorded in the financial accounts as a hedging instrument, with these accounts being audited in accordance with Chap 2M of the *Corporations Act*, or a foreign equivalent.

If all of these conditions are not satisfied, the hedging election may still be available, with the Commissioner having a discretion to treat the arrangement as a hedging financial arrangement if this is considered appropriate.⁸⁴

⁸⁰ See ED proposed Subdiv 230-D.

⁸¹ Proposed ss 230-70 & 230-75(1).

⁸² Proposed s 230-75(2).

⁸³ Proposed s 230-80.

⁸⁴ Proposed s 230-80(3).

A derivative financial arrangement is itself a defined term, being a financial arrangement whose value changes in response to a specified variable and where there is generally no requirement for a net investment.⁸⁵

This definition of a derivative aligns with the accounting definition. To be classified as a hedging instrument under accounting standard AASB 139 the instrument must be a designated derivative or designated non-derivative financial asset or liability whose fair value or cash flows are expected to offset changes in fair value or cash flows of a designated hedged item. The standard defines a derivative as being a financial instrument.⁸⁶

- whose value changes in response to changes in some other variable, such as interest rates, commodity prices, foreign exchange rates, or other variable;
- which requires no initial net investment; and
- which is settled at a future time.

As becomes apparent from these tax and accounting definitions, the defined meaning for tax purposes appears to effectively reproduce the accounting definition, the requirements of which must also be met for the financial arrangement to be a derivative financial arrangement. While this may appear as an unnecessary duplication, it is understandable in terms of Treasury's concern not to compromise the integrity of the tax system or the tax base, while simultaneously creating some harmony between tax and accounting. Becoming reliant on accounting rules that are not part of the statutory regime and which may be subject to subsequent interpretation or amendment by outside organisations, may be seen as potentially jeopardising the integrity of the tax regime.

For the tax hedging election to be available there is an additional requirement that the taxpayer record details of the hedge, the required details describing the hedging financial arrangement, the purpose of the hedge and nature of the risk being hedged, the hedged item and details of how the effectiveness of the hedge will be assessed.⁸⁷ In relation to the effectiveness of the hedge, the proposals require that:⁸⁸

- the hedging of the risk must be expected to be highly effective;
- the forecast risk must be highly probable;
- the market values of both the hedged item and the hedging financial arrangement must be able to be reliably measured; and
- the hedging must be assessed on an ongoing basis as being highly effective throughout the period.

Note that, again, if the statutory requirements are not satisfied the Commissioner has discretion to consider the requirements met if this is appropriate.⁸⁹

⁸⁵ Proposed s 230-85(4).

⁸⁶ AASB 139 para 9.

⁸⁷ Proposed s 230-90(1).

⁸⁸ Proposed s 230-100.

⁸⁹ Proposed s 230-105.

A comparison may be drawn with the accounting rules in relation to hedge effectiveness, with AASB 139 providing that for a hedging relationship to qualify for hedge accounting, a number of conditions must be satisfied, including:⁹⁰

- a formal designation and documentation of the hedging relationship and risk management objective and strategy at the inception of the hedge;
- the hedge is expected to be highly effective;
- for cash flow hedges a forecast transaction must be highly probable;
- the effectiveness of the hedge can be reliably measured; and
- the hedge is assessed on an ongoing basis and determined to have been highly effective throughout the reporting periods.

This close correspondence between the accounting and tax requirements should not be seen as surprising. As explained in the Explanatory Material, the introduction of tax timing rules for hedging has potentially significant administrative implications, so the alignment with accounting requirements provides an important administrative safeguard.⁹¹ By including the requirements in the tax provisions the integrity of the tax system is protected from external interpretation or amendment of the accounting standards which, if the tax was simply based on the accounting standard, could adversely impact on the government control of the tax system and tax base.

While the hedging proposals may initially appear relatively comprehensive, there is little guidance as to the intended operation in relation to the effectiveness requirements of a hedge. No explanation is provided of when a hedge would be considered to be highly effective, or how the effectiveness of a hedge is to be assessed.

Some guidance is provided with the accounting standard,⁹² with the Application Guidance accompanying AASB 139 suggesting that a hedge would be demonstrated as being highly effective by comparing past changes in the hedged item attributable to the hedged risk with past changes in the hedging instrument. The guidance requires actual hedge performance in the range 80 – 125 per cent to be judged highly effective. It is not clear whether it is intended that this accounting guidance be relevant or applicable in relation to the operation of the tax provisions.

With business operating in an increasingly globalised market, hedging of transactions has become an increasingly important part of the financial operations of organisations, making the tax hedging rules in the TOFA regime an area of particular significance. It is to be hoped that further explanation on the intended operation of the hedging regime would be forthcoming in any further Exposure Draft or in any proposed legislation. As it currently stands the area of hedging must be seen as one of the less clear parts of the proposals and, while it may be suggested that the broad principles have been stated, the operation and application of these principles remains uncertain.

COMMISSIONER'S DISCRETION

In addition to the above elections to use reported accounting figures as the tax gains and losses on financial arrangements, the proposals grant the Commissioner a

⁹⁰ AASB 139 at para 88.

⁹¹ Explanatory Material at paras 9.27 – 9.28.

⁹² See the discussion in AASB 139 at AG102 – AG113 generally.

discretion to accept the use of financial accounts for some tax purposes. As explained in the Explanatory Material, the purpose behind the discretion is to provide enhanced flexibility and lower compliance and administration costs, by allowing the use of financial accounts rather than recalculating gains and losses under disparate tax rules.⁹³ Because the discretion is granting the taxpayer a concession, exercise of the discretion requires satisfying a number of conditions, which include:⁹⁴

- financial records audited under Chap 2M of the *Corporations Act*, of a foreign equivalent;
- the fair value election and retranslation election must apply in relation to the financial statements; and
- the hedging election must apply.

Additionally the Commissioner must be satisfied that there is not a substantial difference between the accounting calculation and the tax calculation that would otherwise apply in determining the gain or loss on the financial arrangement.

The provision for the Commissioner to be able to accept the accounting formulation as representative of the tax position must be welcomed, although there are concerns that arise in relation to the discretion.

The proposal suggests that in determining to exercise the discretion the Commissioner should have regard to factors such as the cost of complying with and of administering, the provisions and any other relevant matter. While it is appreciated that a definitive list of factors to consider may not be feasible, it may have been seen as more helpful if the provision could have identified the range of factors to which the Commissioner should have regard in considering the exercise of the discretion. Such a specification of the factors would allow taxpayers to judge whether or not it may have been likely that the Commissioner would exercise the discretion in a particular case. Granting such an unfettered discretion without guidance on the matters which would assist judgment may not be seen as contributing to greater certainty in the operation of the tax system.

If the consideration to which regard should be had by the Commissioner were detailed, the question is then raised as to why the determination needs to rest on the Commissioner's discretion rather than being an election available to taxpayers. It may be that, particularly in a self assessment regime, taxpayers should have an election as to whether to adopt the option of using accounting records for tax purposes in relation to financial arrangements. If relevant considerations were specified this would allow taxpayers to self assess in particular circumstances whether the use of accounting records for tax purposes would be appropriate. It would appear to be more in keeping with the approach under self assessment for taxpayers to be able to make an election in these circumstances rather than seeking the exercise of a discretion by the Commissioner. Such an outcome would provide cost benefits for taxpayers through greater simplicity and certainty and the elections would be open to review as part of the ATO compliance program, thus serving to protect the integrity of the system.

⁹³ Explanatory Material at para 2.77.

⁹⁴ Proposed s 230-115(2).

CONCLUDING REMARKS

It is understandable that the revenue authorities would be reluctant to link tax outcomes automatically to accounting outcomes in relation to taxing financial arrangements. As noted in the Explanatory Material, this reluctance reflects, in part, the different objectives and functions of tax legislation and accounting standards.⁹⁵ Certainly each of accounting and tax serves a different purpose and audience. Additionally the revenue authorities are charged with maintaining the integrity and tax base of the tax system and it may be seen as an abdication of this role for tax outcomes to be solely reliant on accounting standards. The accounting standards would be subject to interpretation and amendment by bodies outside of the influence or control of the revenue, thus potentially placing at risk the base on which tax determinations would be made.

However, despite not placing total reliance on accounting records, the proposals in the Exposure Draft do provide elective circumstances where the accounting records may form the basis for the tax outcome. As would be expected, such elections do not come without conditions applying and, again, this may be seen as directed at preserving the integrity of the tax system.

With the wide range of financial arrangements encompassed within the regime there will be a significant impact on a wide range of taxpayers, creating the need for provisions which can be readily understood, interpreted and implemented if the regime is to operate successfully. Without doubt the taxpaying community would have diverse views as to the appropriateness of the legislative proposals. It would be expected that, while many may see the provisions as moving in the right direction, there would be a need for more modification and fine-tuning before final legislation dealing with financial arrangements can operate successfully.

⁹⁵ Explanatory Material at para 2.76.

Testamentary Trusts: Not Just “Another” Trust?

Arlene Macdonald*

Abstract

This article examines the use of testamentary trusts and the implications of the taxation of trust rules for such trusts. It looks at the advantages and disadvantages of creating a testamentary trust in the Will as distinct from leaving property to existing inter vivos trusts and deals with the rule against the delegation of testamentary power still existing in some States. It identifies difficulties associated with planning and amending such trusts. It identifies difficulties that may result in a new trust being created and identifies Capital Gains Tax issues arising from cloning or splitting trusts. The article also considers what it terms “after death trusts” and Capital Gains Tax issues arising from those as well as Capital Gains Tax issues arising from the premature ending of life interests. The article concludes that a testamentary trust is not just another trust but is associated with many aspects peculiar to testamentary trusts that do not apply to trusts inter vivos.

INTRODUCTION

*There was a young lad named Bill
A donee of Dad’s ancient Will
Dad said: ‘make it good’
So you did all you could
And got tax benefits and more for Bill*

Issues surrounding testamentary trusts are just one of the many good areas for fruitful discussion by tax advisors. In this article I will try to avoid the temptation of wandering too far from the central topic into other fascinating and linked topics to do with death and trusts and tax or some combination of all three.

There is no need to leave property to a trustee to hold that property on trust for one or more beneficiaries, the true recipients of your largesse. Where the choice is made to leave property in trust, that trust can be created in the Will, with the gift being the settled property or it can be left to a trustee of an existing trust which will already have other property (at least the settled sum).

Testamentary trusts have many uses but that doesn’t mean they are always a good thing. Where the trust is properly created with trustworthy appointors and trustees - including successors - carefully chosen, a testamentary trust allows flexibility in directing financial resources to those most in need (such as vulnerable adult children)¹ or withholding those resources where they would be at risk to creditors, ex-spouses, and wastage by those children and grandchildren who think money is for spending! It

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¹ This includes intellectually handicapped adults and those with gambling or drink/drug addictions.

can also be used as part of the plan to divide property and control among different family members and their descendants. There is another major advantage that is of particular interest to us: the income tax savings on distributions of unearned trust income to minors.

The much sought after tax advantage is quite simply that minors are taxed as adults with the benefit of the tax free threshold.

To achieve this tax advantage while ensuring all the asset protection and income flexibility is maintained, care is needed by the drafter and the trustee. The aim of this article is to identify where that care is needed and the reasons why.

A caveat is necessary. Tax law and trust law are uncomfortable partners. Tax advisors, the Australian Taxation Office (ATO) and the Courts are still discovering how they interact. In part the development of the law depends on the context in which the problem arises. In our case, it is usually in trying to apply a tax law to a trust. In many cases, trust law, including testamentary trust law develops without any care or concern for the tax implications and is more concerned with conflicting rights of beneficiaries. We tax practitioners are then left to consider the implications for us. The recent High Court decision in *CPT Custodians*² is an example of general trust law developments with the tax advisors trying to survive the swell.³

This article cannot provide absolute answers in these areas of uncertainty.

PECULIARITIES OF TESTAMENTARY TRUSTS

What is a testamentary trust?

It is first of all, a trust. It has the attributes of other trusts including trust property, trustee and beneficiaries. It can be a fixed trust (eg where a life interest is left) or a discretionary trust or a hybrid.

A *testamentary trust* is a trust created by a Will (or a codicil to a Will) and not inter vivos.⁴ A *testament* is a Will.⁵ A *testamentary instrument* is a Will or codicil.

Therefore for the testamentary trust to be valid, the Will must be valid! Two areas of common dispute concerning property left in Wills are over the capacity of a testator⁶ to make the Will and whether the testator made the Will under undue influence. These are unlikely to be a problem with the creation of inter vivos trusts or the transfer of property into them. There is something about a death of someone with property which

² *CPT Custodian Pty Ltd v Cmr of State Revenue* (2005) 221 ALR 196.

³ See John de Wijn QC, 'CPT Custodians', paper presented at the Taxation Institute of Australia's 14th National Intensive Retreat, Noosa, 17-19th August, 2006.

⁴ Inter vivos means between living persons; during life. A deed or other instrument executed inter vivos is executed between living persons (Butterworths Encyclopaedic Australian Legal Dictionary (online), Lexis Nexis, Australia).

⁵ Its strict meaning is a Will dealing only with personal property but it is used to deal with Wills generally (Butterworths Encyclopaedic Australian Legal Dictionary (online), Lexis Nexis, Australia).

⁶ *Testator and testatrix* are the male and female forms of the term given to the person who made the Will. Where I use testator, I mean testatrix if I am in fact referring to a female or if you consider I should be doing so.

brings out all the hopes and expectations and greed and resentment of those who knew the deceased.

Delegation of testamentary powers

A person of testamentary capacity may dispose of all of his/her property by Will as they like.

There is nothing to stop a person making the most capricious will. A person could make a will which said that he gave all his property to X to be held on trust, the terms of which were that X was to arrange for a 0055 telephone number and was to pay the whole of the testator's estate to the hundredth person who rang that number, or for the first child born at a certain hospital in 1998. There is nothing to stop the testator directing that his executor convert the whole of the money into bank notes and proceeding to the corner of George and King Streets at 8 o'clock on a designated night and throwing the money away.⁷

There is a rule that he/she must dispose of that property personally and may not delegate that power of disposition to another. So where a Will directed the executor to distribute the residuary property "to others not otherwise provided for who, in my opinion, have rendered service meriting consideration by the testator", the High Court found this clause breached this rule in *Tatham v Huxtable*.⁸ Kitto J said (at 653)

It is a 'cardinal rule', to which a power of selection among charitable objects is the sole exception, that a 'man may not delegate his testamentary power. To him the law gives the right to dispose of his estate in favour of ascertained or ascertainable persons. He does not exercise that right if in effect he empowers his executors to say what persons or objects are to be his beneficiaries': *Chichester Diocesan Fund v Simpson* (2). It is therefore necessary in all cases (other than charity cases) that the persons or objects to benefit under the will shall be, by the will itself, ascertained or made ascertainable. They may be made ascertainable by reference to a specified future event, including an act to be done by another person provided that that act does not amount to the making by one man of another man's will: *Stubbs v Sargon* (3).

The rule has been abolished or modified in some states⁹ but in others (NSW, SA, Tas, WA), it continues to exist.

The issue of interest to us of course is whether a testamentary trust which includes the power to the trustee to add beneficiaries would breach this rule. Logically, the answer is yes as the trustee would be able to give the testamentary gift to someone not chosen by the testator or not within the class of potential beneficiaries. However the case of *Gregory v Hudson*¹⁰ indicates this is not the case. In that case, the testator left a gift to an *intervivos* trust which included the usual power of variation.

⁷ Per Young J in *Gregory v Hudson* (1997) 41 NSWLR 573.

⁸ (1950) 81 CLR 639.

⁹ Australian Capital Territory (ACT), Northern Territory (NT), Queensland, Victoria –see relevant Wills Acts.

¹⁰ *Supra*.

Young J considered the rule against the delegation of testamentary power at length in dealing with a gift to a typical discretionary trust. He summarised the position in New South Wales (NSW)¹¹ (at 586):

In summary, reducing the foregoing to their simplest form, the position as to the rule against delegation of will-making powers is as follows:

1. The rule is part of the law of New South Wales.
2. A person will not exercise the power personally where a power is given to an executor or some third person to choose the persons who are to benefit from the testator's bounty.
3. There are exceptions to that rule in the case of powers of appointment including powers of appointment where there is a trust to exercise the power in favour of: (a) charitable purposes; (b) powers where the appointor can appoint to himself or herself so that the interest conferred is equivalent to ownership; and (c) special powers where the class of persons who can be benefited is defined with sufficient precision.
4. It is not a breach of the rule to give property by will [to] a pre-existing trust or to constitute a trust which is sufficiently constituted according to the rules of certainty in trust law.
5. There is a further apparent exception where secret or half-secret trusts are used.

The case was argued on the basis that a gift to a typical discretionary trust meant it was possible for the trustee to add as beneficiaries almost the whole world with the exception of the limited specified ineligible beneficiaries. Without agreeing that was the case, Young J said (at 584):

How then does the rule against delegation apply where the will sets up a trust? Usually, the rule does not apply at all. Thus, if a testator leaves property to the executor to convey it to the trustees for the Barristers' Sailing Club, that will be the end of the matter.... A testator clearly has power to leave his or her property to a trust without infringing the rule against delegation, provided that the trust is for a person or a defined class of persons or is a valid charitable trust.

By giving to the trustee, the testator has fully exercised his testamentary power so a challenge is not expected there. Of possible interest to the reader, he also warns (at 586-7):

During argument, I remarked that the discretionary trust set up in the instant case was one which makes a judge in equity in 1997 wonder why equity courts are bothering with this sort of trust at all. Trusts, and at an earlier time, uses, were enforced by courts of equity because it was against the conscience of the holder of the legal estate not to carry out the promise that had been made to hold the property concerned on the trust expressed in the instrument. However, where the trustee can virtually designate who is to be the beneficiary, this ground has no validity at all. When one sees that discretionary trusts are used for the anti-social purpose of minimising taxation or defeating the rights of wives (see, eg, *Re Davidson and Davidson*

¹¹ The decision of Young J was affirmed on appeal: (1998) 45 NSWLR 300. The conclusions expressed by him represent the law in SA (per Besanko J in *Lines v Lines* [2003] SASC 173 at [36]).

(No 2) [1994] FLC ¶92-469), there does not seem to be any reason in conscience why a court of equity should take any notice of them at all. Counsel were surprised that any judge should take this view and accordingly I announced during the argument that I would not seek to develop it in this case, but I believe that the message should be put abroad that the time may well have come where equity will have to reconsider its attitude to enforcing this sort of trust.

We have been warned!

Common benefits of testamentary trusts

The main benefit of a testamentary trust compared to the ordinary inter vivos trust is the income tax concession for minors who are taxed as adults with the benefit of the tax free threshold which in the current year results in up to \$10,000 being tax free per minor.¹²

Another advantage of the testamentary trust is that as it does not come into effect until death and until then the testator owns the property, the testator can vary it to his or her heart’s content until death (by Will or codicil). The testator can change the beneficiaries, trustees, powers, property etc. Also the testator can manipulate what property remains to be dealt with in his or her Will. Property can be transferred absolutely before death or to an inter vivos trust or left for the Will to deal with it.

Confusion in use of term “testamentary trust”

At one level, all deceased estates are for a time at least, “testamentary trusts”. On death, the assets of the deceased vest in the executor (if there is one who is willing to act). It is a common myth that the assets don’t vest until probate is granted to the executor or administrator by the Court.¹³ In SA, at least this isn’t correct. Some assets (but not land) can be transferred without probate.

The executor¹⁴ has duties of a trustee to administer the estate (ie to pay all debts including tax bills, funeral expenses and to distribute the bequests). It is only when administration is complete (ie all debts paid or assets have been set aside by the executor to pay them) that the beneficiaries become absolutely entitled to any assets or their share of cash (if there are no further trusts created) and the assets and/or cash are distributed to the beneficiaries.

This is the “estate during administration” and is as much a trust (relationship) as any other. The beneficiaries at this stage have no right to anything except proper administration. It is during this period that unhappy or omitted beneficiaries should make any relevant application for variation of the Will under the Family Provision legislation of the particular State or territory. There is a very limited time allowed for an aggrieved beneficiary to make an application for obvious reasons although the Court may extend the time if it considers it appropriate.

¹² Sec 102AG(2)(a). See later discussion.

¹³ For example see IT 2622 at [2] and see the recent (27.6.06) ATO Guide called “Managing the tax affairs of someone who has died” on ATO website.

¹⁴ *Executor and executrix* are the male and female forms of the term given to the person who is named as executor/executrix of the Will. *Administrator* is the term where the Court appoints a person to administer the deceased estate in the absence of a valid executor. In the CGT provisions, all of these are referred to as the *Legal Personal Representative* (s995-1 ITAA 1997).

Where a testamentary gift is left to an existing inter vivos trust, that may be fairly, although confusingly, be called a testamentary trust at least when dealing with the property given to the trustee through a Will.

However, when most lawyers, tax advisers, will drafters and estate planners refer to testamentary trusts, they usually mean the further trust created by the testator in the Will that continues in existence when administration is complete. Commonly the trustee of these long life trusts is the executor but a new trustee may be provided for in the Will or otherwise appointed.

Is it a different trust to the deceased estate in administration?

It is clear that the ATO treats them as different. The distinction (and some of the income tax implications as the estate passes into administration and out of it) is drawn by the Commissioner in IT 2622.¹⁵

The ATO also generally treats the trustee of the testamentary trust as the legal personal representative for the purposes of the Division 128 concessions for CGT on the passing of assets from the trustee to the beneficiary and does not treat the end of one trust and the beginning of the other as causing any CGT event (PS LA 2003/12).¹⁶

Let's agree on the term “testamentary trust”

So for our purposes a testamentary trust is a trust left in a Will to take effect in the period after the executor has administered the estate, ie the testator leaves identified property or the residue of his/her estate (after specific gifts and debts are paid) to a trustee to hold and deal with for beneficiaries.

Discretionary or Fixed

Such a trust left in a Will may be a discretionary trust - which allows the trustee the discretion to distribute income and/or capital to an identifiable (although not necessarily named) class of beneficiaries.

It may be a fixed trust where the income distribution is fixed for a period - usually for the income beneficiary's life (life interest)¹⁷ - and the corpus is held for the remainder beneficiaries. It may also be fixed in the sense that a particular person has right to occupy a house for life or until marriage or entry into a nursing home or whatever.

When does a testamentary trust start?

The testamentary trust starts when property is given to the trustee to hold on trust or if already held by the executor, when the executor starts to hold the property under the new trusts. It would be rare for an executor to make a declaration that “I am now holding this property under the testamentary trust”. The evidence would be more likely to show commencement at the earliest of the time when income is first distributed under that trust or a new bank account opened or a TFN sought or some other act which indicates the trustee is now holding under these trusts.

¹⁵ IT 2622 [4] and [5].

¹⁶ See especially [3] and [8].

¹⁷ The life need not be the life of the beneficiary, it can be the life of another person but this would be odd in a testamentary trust because the usual purpose of the life interest is to provide income for the life of the beneficiary. One example might be to leave a life interest to a child until a grandparent (who is providing for that child in his/her Will) dies.

Assume a life interest is created in the Will. If it is over specified assets such as named shares or real estate, when does the life tenant “enter” into that tenancy? What if it is a life interest over the residuary estate? Does the life tenancy commence when the debts and expenses are paid or at an earlier time, when the executor has set aside sufficient assets or cash to pay them?

The ATO explains its view is that the trust will commence at the completion of the administration of the estate or at earliest when the trustee first pays income:

...where it is apparent to the executor that part of the net income of the estate will not be required to either pay or provide for debts, etc. The executor in this situation might in exercise of the executor’s discretion, in fact, pay some of the income to, or on behalf of, the beneficiaries. The beneficiaries in this situation will be presently entitled to the income to the extent of the amounts actually paid to them or actually paid on their behalf. The fact that the estate has not been fully administered does not prevent the beneficiaries in this situation from being presently entitled to the income actually paid to, or on behalf of, the beneficiaries.¹⁸

Varying the terms of the a testamentary trust –how far can you go

The subtitle of this article is ‘not just “another” trust’? The question for us then isn’t about varying trusts in general¹⁹ but whether there is anything peculiar or simply different about varying testamentary trusts.

The general tax issue is whether the variation of the trust which is allowed under the specific trust deed, has the result of ending this trust and creating a new one (or to be more accurate, does it cause the trustee to have new obligations such that it is a new trust relationship?). One way this happens (according to the ATO’s Statement of Principles on the Creation of New Trust) is by the addition of beneficiaries.

This brings us back to the issue of the delegation of testamentary powers. In States such as SA, beneficiaries cannot be added to or removed from the testamentary trust to the extent this means the testator has handed to another his/her power of testamentary disposition. This is the case even if the terms of the trust say the trustee can add beneficiaries. Due to the present uncertainty about whether the addition of beneficiaries to testamentary trust is the delegation of testamentary powers (in those States which still forbid this), it is common practice to ensure the problem doesn’t arise by expressly excluding this power.

Other than that, the terms of the trust (such as powers of investment) can be varied if the Will contains a suitably wide power of variation of the terms of the trust.

What if the Will does not contain any power of variation? In the absence of a specific power of variation, there may still be some scope using the variation powers in the various *Trustee Acts* to request a Court to vary the Will (eg sec 59C of SA Act).

59C—Power of Court to authorise variations of trust

¹⁸ IT 2662 at [14] and ATOID 2004/458.

¹⁹ For which we must consider the ATO’s Statement of Principles (even if we don’t agree with all of its conclusions).

(1) *The Supreme Court may, on the application of a trustee, or of any person who has a vested, future, or contingent interest in property held on trust—*

- (a) *vary or revoke all or any of the trusts; or*
- (b) *where trusts are revoked—*
- (i) *distribute the trust property in such manner as the Court considers just; or*
- (ii) *resettle the trust property upon such trusts as the Court thinks fit; or*
- (c) *enlarge or otherwise vary the powers of the trustees to manage or administer the trust property.*

(2) *In any proceedings under this section the interests of all actual and potential beneficiaries of the trust must be represented, and the Court may appoint counsel to represent the interests of any class of beneficiaries who are at the date of the proceedings unborn or unascertained.*

(3) *Before the Court exercises its powers under this section, the Court must be satisfied—*

- (a) *that the application to the court is not substantially motivated by a desire to avoid, or reduce the incidence of tax; and*
- (b) *that the proposed exercise of powers would be in the interests of beneficiaries of the trust and would not result in one class of beneficiaries being unfairly advantaged to the prejudice of some other class; and*
- (c) *that the proposed exercise of powers would not disturb the trusts beyond what is necessary to give effect to the reasons justifying the exercise of the powers; and*
- (d) *that the proposed exercise of powers accords as far as reasonably practicable with the spirit of the trust.*

(4) *An order made by the Supreme Court in the exercise of powers conferred by this section is binding upon all present and future trustees and beneficiaries of the trust.*

(5) *This section does not apply to—*

- (a) *a trust affecting property settled by an Act; or*
- (b) *a charitable trust.*

(6) *This section does not derogate from any other power of the Supreme Court to vary or revoke a trust, or to enlarge or otherwise vary the powers of trustees*

This power isn't particularly useful for tax advisors at least in SA where the Court will not vary the trust if the purpose is to get tax concessions (59C(3)).

It is also interesting to note the usual practice of the SA Supreme Court when it comes to consider whether or not to approve a compromise in such circumstances is to seek an opinion by Counsel as to the desirability of the proposed compromise and not to release that opinion to the beneficiaries! (per Perry J in *Salkeld v Salkeld* [2000] SASC 296 at [34] and [37].

From the ATO perspective expressed in its Statement of Principles, will adding a beneficiary under a specific power given to the trustee to do so result in a new trust? It would seem inevitable and the problem for the testamentary trust is that as well as the

CGT result, it would almost certainly sever the connection with the deceased's Will (the concession applies only to a trust estate that resulted from a will) which gives the tax concession for income distributed to minors and so destroy the benefit which underpins the very reason for having a testamentary trust. (See 2.5 below for further discussion on this tax concession).

When does a testamentary trust end?

The testamentary trust ends like other trusts. If a life interest, it ends when the person whose life is to be counted, dies or when the person with the interest assigns or surrenders it. If a discretionary trust, it ends when the trust deed says so (when the trust vests by one of the actions provided for in the Will, such as distribution of the property to the various beneficiaries or by declaration by the trustee that the trust has vested) or the Court makes an order vesting the trust. It can also end by accident if there is no trust property.

Adding corpus to a testamentary trust

This is a current hot topic. There are some who consider property can be added to a testamentary trust and they read certain comments in articles and papers in support.²⁰ I am not convinced these comments go as far as some say and there may be more than a hint of wishful thinking on the part of proponents of this view. My view is even where you can add property; you can't obtain the minor's concessional tax rates from the income produced by the added corpus.

Assume the testamentary trust is in existence, and assume the Will provides that the trustee may accept gifts.²¹ Exactly what are we asking and why? If it is simply whether we can add property, the answer is yes. Subject to claw back provisions in bankruptcy law and the reach of the Family Court in property proceedings, that property should be safe from attack by creditors in the trust.

The starting point is what is this testamentary trust there for? If the answer is asset protection of some type, then assuming the trustee can accept new property to hold under the same trusts, assets can be added to that trust and be as protected as the other assets. To the extent that the trust is to split income then again, that also can be done. Here the trust is similar to the typical inter vivos discretionary trust

However, where the trust has income tax advantages of income distribution to minors, I assume our concern is to ensure that those tax advantages are maintained. As this is the major use of testamentary trusts as distinct from inter vivos trusts, the question really is "can you add corpus to a testamentary trust while maintaining the tax advantages of income distribution to minors?"

Can you add property and get the minor's tax concession from its income?

Minors who are beneficiaries of the trust can receive income from assets transferred into the trust and from any substituted or grown assets eg by borrowing, investment, sale and purchase etc. The original assets given to the trust may be viewed as the

²⁰ For example, see *TIA Trusts Workbook 2006* at 11.1.2 and Daniel Smedley *Establishing New Trust as part of succession Planning*, paper presented at the Taxation Institute of Australia's 13th National Intensive Retreat, Noosa, 2005.

²¹ If there is no specific power in the Will that allows the trustee to accept a gift of property, it is difficult to see how such property can be accepted by the trustee to be held on the same trust. If there is a power of variation, presumably the power can be added.

“seed assets” and they can vary. The benefit of the testamentary trust is not confined to the assets owned by the deceased or by the deceased estate during administration but that does not mean that other added assets will give rise to income that can be treated concessionally.

Assume the testamentary trust is to predominantly allow Betsy to distribute income among her 2 youngest children and 2 grandchildren (who are all under 18). The trust derives income of \$30,000 pa. Betsy has just read in the *Wealth* pages of *The Australian* that minors can get up to \$10,000 each tax free this year (taking into account the tax free threshold and the low income offset). She asks if she can transfer property to the trust (or ask her brother to do so) to earn an additional \$10,000 and so distribute this as tax free income?

The minor income tax advantages come from secs 102AG(1), 102AG(2)(a)(i) and 102AG(d)(i).

102AG(1) Where a beneficiary of a trust estate is a prescribed person²² in relation to a year of income, this Division applies to so much of the share of the beneficiary of the net income of the trust estate of the year of income as, in the opinion of the Commissioner, is attributable to assessable income of the trust estate that is not, in relation to that beneficiary, excepted trust income.

102AG(2) Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:

(a) is assessable income of a trust estate that resulted from:

(i) a will, codicil or an order of a court that varied or modified the provisions of a will or codicil; or.

(d) is derived by the trustee of the trust estate from the investment of any property:

(i) that devolved for the benefit of the beneficiary from the estate of a deceased person;...

The tax concession of treating trust income distributed to minors as if distributed to resident adults applies where the trust income comes from the deceased estate and assets acquired by the estate.²³ This was established in the decision of the late Justice Hill in *Trustee for the Estate of the late A W Furse No 5 Will Trust v FCT*.²⁴

In summary in that case, the trust was established with property of \$1 left in Mr Furse’s Will. The trustee borrowed \$10 and used that to acquire units in a unit trust which was a solicitor’s service trust.

The issue was whether the income from the unit trust which was distributed by the No 5 Will Trust to minor beneficiaries was excepted trust income. It was because Hill J held that all that is required was that the assessable income be assessable income of the trust estate where that trust estate be one resulting from a will, codicil, order of the

²² A minor is a prescribed person (unless also an *excepted person* eg employed).

²³ Because the income is *excepted trust income* and all the other conditions are satisfied.

²⁴ *Trustee for the Estate of the late A W Furse No 5 Will Trust v FCT* (1990) [21 ATR 1123](#); 91 ATC 4007.

court or arising on intestacy. Hill J also held that s102AG(2)(a) applies where the trustee borrows funds and invests them and derives assessable income from those investments. He did not go on to say (as it was not relevant here) that the same conclusion applies to income from assets gifted to the trust.

Hill J rejected the Commissioner's argument that the concession only applied to income derived from property left in the Will.

The Tribunal held that upon its true construction sec. 102AG(2)(a)(i) merely required that the trust estate should arise under or by virtue of a will. It was submitted for the Commissioner, however, that for the subsection to operate, it was necessary that the assessable income of the trust estate itself be sourced in the will or property of the deceased. With respect, I do not accept the Commissioner's submission. It requires that the words in sec. 102AG(2)(a) "that resulted from" refer to the assessable income rather than to the words in subpara. (i) "a will" etc. or in subpara. (ii) "an intestacy" etc. In my opinion all that is necessary to fall within sec. 102AG(2)(a) is that the assessable income be assessable income of the trust estate, that trust estate being one of the forms of trust estate referred to in sec. 102AG(2)(a)(i) or (ii) (that is to say not an inter vivos trust).

It is not clear what is meant by the notion that the assessable income be "sourced" in the will or the property of the deceased. Presumably the contention is that it is only income from assets already held by the deceased at the time of his death which will be exempted from the provision of Div. 6AA. Such a view is too narrow. Clearly the legislature must have contemplated the case where the will assets were sold and the proceeds reinvested. What happened in the present case is that the trustee borrowed funds and used the borrowed funds to invest in such a way as to derive assessable income from the investment. In my view the consequence of such an investment was that assessable income was derived by the trust estate so that that income was "assessable income of the trust estate" and clearly enough the trust estate was one that resulted from the will of the late Mr Furse.²⁵

Hill J also needed to consider whether the income subject to the concessional tax was limited because of s 102AG(3) as it then stood.

The former sec 102AG(3) provided:

102AG(3) Subject to sub-section (4), where assessable income is derived by a trustee, directly or indirectly, under or as a result of an agreement (whether entered into before or after the commencement of this sub-section) any 2 or more of the parties to which were not dealing with each other at arm's length in relation to the agreement and the amount of the assessable income so derived is greater than the amount (in this sub-section referred to as the 'arm's length amount') of the assessable income that, in the opinion of the Commissioner, would have been derived by the trustee, directly or indirectly, under or as a result of that agreement if the parties to the agreement had dealt with each other at arm's length in relation to the agreement, sub-section (2) does not apply in relation to that assessable income to the extent to which the amount of the assessable income exceeds the arm's length amount.

²⁵ At 91 ATC 4018.

The issue for sec 102AG(3) was whether the income derived by the Will Trust from the units in the service trust was as a result of an agreement between any 2 or more parties not dealing with each other at arm's length. The Tribunal (from which this case was the Appeal to the Federal Court) failed to identify the relevant agreement. The matter was remitted to the Tribunal to make the necessary findings of fact.

Since that decision, s 102AG(3) has been amended

It now provides:

102AG(3) [Non-arm's length transactions]

Subject to subsection (4), if any 2 or more parties to:

(a) the derivation of the excepted trust income mentioned in subsection (2);
or

(b) any act or transaction directly or indirectly connected with the derivation of that excepted trust income;

were not dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction, the excepted trust income is only so much (if any) of that income as would have been derived if they had been dealing with each other at arm's length in relation to the derivation, or in relation to the act or transaction.

Applying this to Betsy's example, a gift to the trustee (assuming it derives an arm's length amount) is nevertheless the first step in deriving assessable income of the trust and so is, in my view, an "*act or transaction directly or indirectly connected with the derivation of that excepted trust income*" and as it is a gift, the donor is not dealing with the trustee at arm's length. Therefore any income derived from gifted property would be excluded from the concessions applying to excepted trust income.

This interpretation is supported by the view expressed by the Commissioner in *Private Ruling 50621* where minor children had each received gifts of money from 2 sources which have been invested on their behalf by a relative. The sources were:

1. money left to them in a will,
2. other gifts made to them by persons who were alive at the time.

The questions and answers are:

- 1 Are investment earnings from monies from a deceased estate held in trust for minor beneficiaries excepted income? Yes
- 2 Are investment earnings from monies gifted to children by their living relatives excepted income? No

The explanation for the ruling included this

In contrast to such income, which arises from property inherited through a will or intestacy, any income derived from amounts given to a child by a living person or given to a trustee to hold on the child's behalf will not be 'excepted assessable income' or 'excepted trust income'.

Sec 102AG(4) may also prevent the income from the gifted property being excepted income.

102AG(4) [Agreement to secure income excepted trust income]

Subsection (2) does not apply in relation to assessable income derived by a trustee directly or indirectly under or as a result of an agreement that was entered into or carried out by any person (whether before or after the commencement of this subsection) for the purpose, or for purposes that included the purpose, of securing that that assessable income would be excepted trust income.

102AG(5) [Incidental purpose disregarded]

In determining whether subsection (4) applies in relation to an agreement, no regard shall be had to a purpose that is a merely incidental purpose.

CAN YOU CREATE A “TESTAMENTARY TRUST” AFTER DEATH?

*I wanted a testamentary trust
Without one I knew I would bust
So I asked my good friend
If towards that good end
He'd create one without any fuss!*

You can't create a testamentary trust once the testator has died (except by forging the Will!).²⁶ However you may be able to obtain some income tax benefits by transferring property left in a Will to another trust.

This isn't a testamentary trust but a post death trust using property left in a Will. There is no standard title given to this type of trust. It has been called a *Post Death Trust*, *Post-Mortem Trust*, *Post-Will Trust*, *Estate Proceeds Trust*, *Post Testamentary Trust* or even a “*Second Chance Testamentary Trust*”. The latter term is confusing because it isn't a trust created in a Will even though the tax saving is restricted to income from property that was in a deceased estate.

Charles has a home made Will in which he leaves everything he has, including shares and real estate investments to his wife, Dianna. They have one child, Wilma. Charles dies tragically in a work accident when Wilma is only 8 years old. Dianna is in full time employment and is already on the top marginal tax rate and she has heard that despite Charles' failure to create a testamentary trust in his Will, she can set up such a trust for Wilma which will save income tax. Is this a tax law urban myth?

No, it isn't a myth but it is very limited in application and even where it could be used, it may not be worth the trouble in making it work.

Where minor children receive income distributions from trusts, the income is usually taxed without the benefit of the tax free threshold and at roughly the same rate as the top adult rate.

One of the exceptions is where the income is *excepted trust income* (sec 102AG(2) *Income Tax Assessment Act 1936*) . It is one of these exceptions which provide the income tax advantage to testamentary trusts. Other examples of *excepted trust income* are bona fide employment income, child maintenance trusts following family

²⁶ Not recommended.

breakdown, income from certain trust income from personal injury damages and post-death trusts.

Saving tax with a “second chance/post death/post-mortem trust”²⁷

Dianna can transfer shares or investment property or money²⁸ left to her by Charles to a trust in which Wilma is a beneficiary. Income derived by the trustee from that property can be distributed to Wilma in a tax effective manner by using the provisions in sec 102AG(2)(d)(ii).

102AG(2) [Excepted trust income]

Subject to this section, an amount included in the assessable income of a trust estate is excepted trust income in relation to a beneficiary of the trust estate to the extent to which the amount:

(d) is derived by the trustee of the trust estate from the investment of any property: ;

(ii) that was transferred to the trustee for the benefit of the beneficiary by another person out of property that devolved upon that other person from the estate of a deceased person and was so transferred within 3 years after the date of the death of the deceased person; or...

Limitations

There are strict limits on when and whether and to what extent income derived from the transferred property is taxed at normal adult rates to the trustee (for the minors) instead of at the non concessional rates. Due to these limits it is often not practical to use this provision.

1. This type of trust can only obtain the tax benefit where the deceased is the parent of the minor child. It is of no value where the deceased is a grandparent and the child’s parent is still living because the tax concessions only apply to income derived from property that would have gone to the beneficiary if the deceased person died intestate (sec 102AG(7)). Here Wilma would have been directly entitled to almost half of her father’s estate if he had died intestate in SA.
2. The property transferred must have been inherited through the estate and not directly eg life insurance left directly to spouse.
3. The property transferred to the trustee must earn the income. This is a practical problem requiring careful recordkeeping at least if the trust consists of other property (or property for more than one minor child).
4. The concessional tax rates only apply to the arm’s length amount of income derived. Eg if Dianna transfers to herself as trustee a house which is rented to a friend, any rent in excess of the arm’s length amount will not attract the concession.
5. The minor must acquire the property that was transferred and from which the income was derived when the trust ends (sec 102AG(2A)) (this need not be when Wilma turns 18 and the end depends on the terms of the trust). Her entitlement

²⁷ I wish we could agree on what to call this type of trust –what about the *Clayton’s testamentary trust*?

²⁸ Property means any property whether real or personal and includes money –see 102AA(1) ITAA 1936.

must be an absolute right according to the terms of the trust and not depend on the discretion of the trustee. Strictly read, the provision requires the preservation of the actual property transferred! The requirement surely means that she must have the absolute right and the actual act of acquiring it isn't required. If it were, what do you do when 16 years after the trust has commenced and all the income has been taxed concessionally, Wilma disclaims her interest in the property?

6. And don't forget that if the property transferred is a CGT asset and there is a capital gain, then CGT will be payable due to the transfer and the funds will need to be found from other sources. Transferring money, if money was inherited, avoids this problem.²⁹

Practical matters

1. The gift of property from a testamentary beneficiary to the trustee must be within 3 years of the death of testator.
2. It is done by transfer after inheritance and does not require and should not involve any variation to the Will or renunciation of interests.
3. The usual CGT and stamp duty implications result from this transfer of property to a trust.
4. The trust for Wilma need not be a stand alone trust but for practical reasons including the need for special terms such as Wilma's entitlement to the property in the end, it usually is.
5. Dianna may transfer as much property as she wishes or allow the property to derive as much income as she (or an associate) can direct through the property but the excess is not concessionally taxed. It is far simpler (and therefore less prone to expensive errors and administration) to work out the property to which Wilma would have been entitled on intestacy and transfer only that amount. Similarly it is practical to ensure the income derived does not exceed arm's length amounts.
6. To ensure there are no tax problems with the settlor being entitled to the property (causing the trustee to be taxed at the maximum rate) the trustee should not be the settlor. If Dianna wishes to be the trustee (as she normally would) she should transfer the property to a trust already settled by an independent person).
7. If transferring to an existing trust with property, any variation (eg to ensure Wilma acquires the property on vesting) is likely to cause a resettlement and CGT and stamp duty issues for the property already held on trust.
8. In order to avoid any later challenge by Wilma (who eventually comes to hate Dianna), consider whether to use the trust income for expenses such as her private school fees and orthodontic treatment.
9. Finally, this method may not be the best way for Dianna to achieve her aims.

INCOME TAX ISSUES FOR TESTAMENTARY TRUSTS

The "big one"- the children's tax break

The main reason for the testamentary trust (as distinct from using an inter vivos trust) is that where there are minor children and/or grandchildren and/or great grandchildren (or they are still possible) income can be distributed to them tax free or at least at

²⁹ Assuming it is a problem-the CGT liability may be moderate or would have been crystallised soon in any event.

usual adult rates. If distributing only to adults the testator doesn't need a testamentary trust and an inter vivos trust can be used.

Income splitting

As with inter vivos discretionary trusts, any testamentary trust with the discretionary power to appoint the income to different beneficiaries can split the income among beneficiaries with mixed tax rates to reduce the overall tax liability. This combined with the children's tax break gives testamentary trusts a unique benefit where there are children.

Franking credits problems

For the beneficiaries of a testamentary trust to be entitled to franking credits, the trustee will generally need to make a Family Trust Election (FTE). This won't have the effect of reducing the scope of beneficiaries where we are dealing with simple life interests because only one person (the life tenant) is entitled to distributions of income.

If it is life interest with discretion to pay income to others then a FTE may restrict the tax effective distribution of the income where the life tenant is not a parent, spouse or child of the deceased. It sometimes happens that the life interest is left to a friend.

Example

Mrs Danvers was Arthur's nurse and close friend in the final years of his life and she is the life tenant of Arthur's estate. Arthur left an adult child, Rebecca and 5 grandchildren. Rebecca takes in remainder. Under Arthur's Will, the trustee can distribute income to the children and grandchildren with the consent of Mrs Danvers (who likes Rebecca).

Arthur is dead and so cannot be named as the test individual. If Mrs Danvers is named as test individual, the distributions of income to Rebecca or the grandchildren will attract family trust distribution tax (FTDT) (at maximum rates). If Rebecca is named as test individual, the distributions of income to Mrs Danvers will attract FTDT (at maximum rates). Furthermore Rebecca or Mrs Danvers (as appropriate) will not be entitled to franking credits.

"The "family" of an individual (the "test individual") consists of all of the following (if applicable):

(a) any parent, grandparent, brother, sister, nephew, niece, child, or child of a child, of:

(i) the test individual; or

(ii) the test individual's spouse;

(b) the spouse of the test individual or of anyone who is a member of the test individual's family because of paragraph (a).³⁰

Without a FTE, there was no entitlement to franking credits for the life tenant (or anyone else) from shares acquired post 31 December 1997³¹ until the retrospective amendments were announced in March this year.³² So, although franking credits will be allowed to a life tenant who has a vested right to the income but not the capital (the

³⁰ 272-95 Schedule 2F ITAA 1936.

³¹ ATOID 2002/122.

³² Minister for Revenue Press Statement No 010 20.3.06.

usual case), where there is any element of discretion (where the right to income is not vested), a FTE (with the possible problems of naming a test individual) will still be necessary.

Note that the income tax concessions given to the executor as trustee of estate during the administration of the estate are not tax issues concerning testamentary trusts (because of our earlier agreed meaning of the term *testamentary trust*).

Commencement of the trust

Each testamentary trust is a separate trust and needs to be treated as such for tax purposes, including lodging of tax returns. For more detail on the ATO’s requirements, see IT 2622.

CGT ISSUES FOR TESTAMENTARY TRUSTS

Commencement of the trust

There is no CGT liability on the transfer of any asset from the executor to the trustee or when the executor starts holding the property as the trustee of the particular testamentary trust. This is due to sec 128-15.³³

Cloning or Splitting

Assume a single testamentary trust exists and the deceased’s children are all adults with at least one having a burning desire to control his/her “own share”. Assuming the trust contains the right of the trustee to vary the terms; can you clone or split the trust as you may do for an inter vivos trust in some cases?

Cloning

The first step in cloning is to establish a new trust with “identical terms” to the testamentary trust. Can this be done where the trust to be cloned was set up in a Will? TR 2006/4, deals with the ATO’s view of the circumstances in which the beneficiaries and terms of two trusts are considered to be the same for the purpose of applying an exception to CGT event E2.

The following do not have to be the same:³⁴

- the trustees;
- name;
- commencement or establishment date;
- settlor; or
- trust property (except that the transferred asset must be an asset of both trusts, though obviously not at the same time).

However, the appointor, if any, has to be the same. The ATO is also of the view that if a FTE was made in one, it must be made with the same test individual in the other. Therefore, it may be difficult to achieve the desired separation of control by cloning.

³³ Confirmed in PS LA 2003/12.

³⁴ [25].

Splitting

Assuming splitting is effective in actually separating the assets and the different trustee’s indemnities,³⁵ there is nothing in particular which makes it more or less difficult to split a testamentary trust.

A Warning: Something that *may* impact the effectiveness of these is that ignoring the interposition of the testamentary trust between the executor and the beneficiary of the Will may really rest on the ATO’s practical indulgence which can be withdrawn. When the trustee of the testamentary trust distributes assets owned by the deceased to a beneficiary, the ATO has had a long-standing administrative practice of treating the trustee of a testamentary trust in the same way that a legal personal representative is treated for the purposes of Division 128 of the ITAA 1997, in particular subsection 128-15(3).³⁶

Paying the CGT

The Government has announced it will amend the CGT provisions³⁷ to enable the CGT liability arising from a CGT event happening to a trust asset to be paid by the trustee of a testamentary trust where a presently entitled income beneficiary will not obtain the benefit of the capital gain.³⁸ The trustee can make the choice on a beneficiary-by-beneficiary basis and this is intended to ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary, for instance where the income beneficiary is an exempt entity or a foreign resident. The amendments are intended to apply to the 2005–06 and later income years.

PLANNING ISSUES

Do you need one or more separate testamentary trusts at all?

It depends on what you are trying to achieve for your client. One size does not fit all. Not all clients require one and where one is suitable, it needs to be drafted to deal with the client’s actual needs and expectations. A client should be encouraged to review the Will and the trust as circumstances change and at least every 4 years³⁹ instead of trying to draft the trust to deal with any contingency.

I also doubt many people really think through the risks in giving responsibility for the assets to a trustee. People in control of other people’s money may be dishonest, whether they are the much trusted brother, friend or advisor. The assets will only be protected (from creditors, ex spouses etc) if the beneficiary does not have control so someone else must (trustee or appointor). Much careful thought must be given to protecting the beneficiaries from dishonesty or even incompetence. In some cases, a testator may prefer to give the property absolutely and let the beneficiary deal with it, whatever that means.

³⁵ And I don’t assume this, at least for the assets at the time of the split...but that is another topic!

³⁶ PS LA 2003/12.

³⁷ Following consultation with industry on the design and the implementation of the amendments – see Minister for Revenue and the Assistant Treasurer’s Press Release NO. 074, 17 October 2006.

³⁸ Media release no 074 from Minister for Revenue dated 17 October 2006

³⁹ A good trigger is the Federal election (4 years) or the Census (5 years).

Asset protection for one person may mean the creditor or ex-spouse who may have a moral claim is left with nothing. I am not sure advisers should assume our clients all want such asset protection!

What are you trying to achieve? What does your client want?

- Tax benefits on distributing income to minor children, grandchildren
- Tax benefits on distributing income to lower taxed beneficiaries
- Protection of assets from ex-spouses,
- Protection of assets from creditors,
- Protection of assets from being wasted by spendthrift beneficiaries
- Protection of assets from being wasted by addicted beneficiaries
- All of the above (what an unfortunate family!)

Ted the testatrix has one 45 year old daughter, Deborah who has no children and is not intending to or expected to have a child. Ted wants the bulk of his property to go to Deborah.

Do you advise a testamentary trust in case Deborah has a child or adopts a child or do you advise Ted to change his Will if the unexpected happens?

The advantages of the testamentary trust as distinct from an inter vivos discretionary trust are the opportunity to have where thought useful:

- different beneficiaries;
- different property;
- different trustees;
- different appointors; and
- different powers.

It can also be simpler for a less sophisticated trustee to deal with the property in different trusts instead of trying to have one trust cover all.

An existing discretionary trust may be quite suitable and if the beneficiaries, appointor, trustee and powers are suitable and if there are and will not be any minor children or grandchildren or great grandchildren (of the testator.)

Asset protection

*From frivolous spending, gambling, addiction, divorce and bankruptcy; good Lord deliver us!*⁴⁰

A secondary reason for the testamentary trust is to provide asset protection.

The first question for a client with substantial assets and a moderate to high risk profile is why are there any substantial assets in the Will? Surely the assets are already in discretionary trusts? So the first question is really what is owned by the testator

⁴⁰ This is not part of the prayers of the Church but should be.

(and spouse) in their own names? If it is merely the family home and some small investments, is there any need for the expense and comparative complexity of a testamentary discretionary trust?

The answer may be the testamentary trust is primarily to deal with superannuation or life insurance benefits and/or are intended for different beneficiaries to those in the discretionary trust. That's a good answer. I assume you will plan the required division accordingly and the tricks and traps that can occur are beyond the scope of this article.⁴¹

The second question is to what extent does the trust actually give protection from creditors and ex spouses? Again this is beyond the scope of this article.⁴²

No guidance from settlor (deceased)

Unlike an inter vivos trust, the trustee (and appointor) can obtain no assistance or guidance from the deceased. If the testator has firm views about what he/she is trying to achieve as distinct from ensuring maximum flexibility for the trustee at the relevant time, then they need to be expressed in the Will or at least in a Statement of Wishes.⁴³

Preserving pension entitlements⁴⁴

Another purpose of the testamentary trust is to allow a vulnerable beneficiary (eg someone in receipt of a disability pension) to remain eligible for the pension and associated benefits while allowing an independent trustee (such as trusted sibling) to provide for additional needs of the vulnerable person.⁴⁵ This is done by ensuring the appointor and trustee is entirely independent from the beneficiary.

It should be remembered that severing control in this and other testamentary trusts brings with it the risk of fraud by the trustee.

The Will and inter vivos trusts

It is well known that the assets owned in a discretionary trust controlled by a testator are not owned by that individual and so cannot be left in their Will. It is sometimes assumed the Will is entirely irrelevant to the assets but is it? Where the testator is the appointor at death, what happens? In many cases, the testator had the power to name then new appointor in the Will. In some cases, the trust deed provides that the executor is the appointor. Whatever the terms of the trust deed, it is essential the Will drafter properly deals with the issue to avoid expensive disputes or the appointment of an inappropriate person. There is danger in simply appointing the executor as appointor or even simply allowing the terms of the trust deed to take effect in default

⁴¹ See for example Whitney *Will drafting tips and traps*, TIA 3 June 2002.

⁴² See Michael Lhuede, 'Asset protection/Bankruptcy', paper presented at the Taxation Institute of Australia's 14th National Intensive Retreat, Noosa, 17-19th August, 2006.

⁴³ A Statement of Wishes is rather wishy washy and in no way binding but can serve the purpose of giving some guidance if the trustee wants any. Firm views should be expressed in the terms of the trust unless they are against public policy and so would be struck down.

⁴⁴ Under current pension/benefit rules.

⁴⁵ I do not comment here on the ethics of an act that ensures the taxpayer continues to support someone who is well able to be supported by the family.

of appointment. Where the executor is appointed by the testator does the executor have any duty to bring all property he can into the deceased estate?⁴⁶

It is also common knowledge that the testator cannot control the assets in the inter vivos family trust except through control of appointor and/or trustee but is this true?

First of all, where the trust deed expressly provides that where the appointor dies, they may appoint a successor in their Will or in the absence of this, the executor of their Will is the appointor.

It is common knowledge that this is the only way the testator can have some control – by controlling the appointor and so indirectly having control over the distribution of the trust assets and income (if the appointor and trustee know what the testator wants eg by a non binding statement of wishes). However, this may not be correct.

I was recently introduced to the concept of “fail-over trusts”. The concept as I understand it is to allow a direction from the testator to the trustee of the inter vivos family discretionary trust (ie direct control) over the trust’s assets and income.

Assume the typical family discretionary trust (which typically includes as objects, trusts in which any of the individual objects are also objects) is varied to acknowledge the existence of a sub trust called the Fail-over Trust (which needs to be separately created at about the same time) and the introduction of a requirement that the Trustee obey any Direction left in the Will of the Appointor.⁴⁷

Assume the Will provides a Direction to distribute specified income and/or capital to named or identifiable beneficiaries (of the family trust). The concept of the ‘fail-over trust’ is introduced into the inter vivos deed (by variation of its terms but assuming such a trust is already an object to the trust) to take the income subject to the testator’s direction in the Will if obeying the demand from the Will is inappropriate for tax reasons eg due to a Family Trust Election, the distribution would attract the Family Trust Distribution Tax.

The idea of a fail-over trust could be considered in cases where the testator wants to direct distribution of income and/or capital, eg to ensure the assets over which he had control in life but didn’t own are shared among the beneficiaries as he likes.

Obviously, if this control can be exercised, this could make it more attractive to put most assets into the family trust and in effect divide all controlled assets at death. The aim is to direct the trustee of the family trust to distribute certain income and/or capital from the grave.

So although assets of the family trust don’t pass through the Will, real control of them may!

Checklist for planning where assets go on death

This is simply one blank checklist which gives a range of matters that should be considered. It only deals with the questions we have been considering. You may have your own or wish to use this as a basis for yours.

⁴⁶ This is raised in *Aileen Pty Ltd v One Hawker Holdings Pty Ltd* [2006] VSC 135 at [52].

⁴⁷ This should not be a resettlement as the beneficiaries are not varied and these powers do not change the nature of the trust obligations etc.

1. ASSETS THAT DON’T PASS THROUGH WILL

Asset	MV \$	Anticipated CGT or income tax	Beneficiary

2. ASSETS THAT PASS THROUGH WILL

Asset	MV \$	Anticipated CGT or income tax	Preferred beneficiary

3. BENEFICIARY

Name	Under 18/For how long	Assets at risk to creditors, ex spouse	Assets need protection from beneficiary

4. PLANNING

Questions	Answers
What does testator want to achieve?	
What are alternatives to achieve this? What is best?	
What changes should be made to assets passing through Will so more effective protection or tax advantages?	
What will testamentary trust achieve for Beneficiary 1? ⁴⁸	
What will testamentary trust achieve for Beneficiary 2?	
etc	

An example of how this could work

The aim is to direct the mind to planning issues and having decided the preferred approach, then to take the necessary steps to achieve the plans.

Julian has 4 children by his first marriage aged between 12 and 24. He is currently in a defacto relationship with Melanie and they have one child aged 2 (Michael). He wants to ensure Melanie has sufficient income to live off after his death but that all his assets end up with his children.

1. ASSETS THAT DON’T PASS THROUGH WILL

⁴⁸ Having ensured only the appropriate assets pass through the Will.

Asset	MV \$	Anticipated CGT or income tax	Beneficiary
Home	400	None	Joint tenant-Melanie
Assets in first family trust	200	n/r	Expect all children to share overall, 1 st wife will be trustee when Julian dies
Superannuation ⁴⁹	300		Minor child or other dependant for tax benefits

2. ASSETS THAT PASS THROUGH WILL

Asset	MV \$	Anticipated CGT or income tax	Preferred beneficiary
Superannuation ⁵⁰	300	It depends on who gets it	Minor child or other dependant for tax benefits
Shares	110	10 CGT	-
Investment property	500	100 CGT	-

3. BENEFICIARY

Name	Under 18/For how long	Assets at risk to creditors, ex spouse	Assets need protection from beneficiary
1. Michael	Yes/16 years	No	No
2. Joseph	Yes/6 years	No	No (or at least, don't know yet)
3. Liz	No but has 2 children by 2 dads	Yes, bad at choosing partners	No
4. Joan	No	Yes, accountant	No
5. Oscar	No has 1 child	No	Spendthrift/Gambler
6. Melanie	No	Don't want her to get more assets	Don't want her to get more assets. Should Michael or all the siblings be remainder beneficiary?

4. PLANNING

1. What does Justin want? Equal share of assets or tax minimisation or asset protection? Any particular needs for particular beneficiaries? What is the priority?
2. What changes should be made to assets passing through Will so there is more effective protection or tax advantages?

Why is investment property in Justin's name and not in a trust? What about putting it in a new family trust effectively for Michael and his line?

3. What about superannuation –through Will or not?

Does Justin have the choice?

4. Having arranged the appropriate assets through the Will, ask should there be 6 separate testamentary trusts? If not, why not?

⁴⁹ Doesn't have to pass through Will but he can choose to make a binding death nomination if you advise.

⁵⁰ Supra.

What will the testamentary trust achieve for Beneficiary 1?

Children’s tax break while under 18. This may also mean that Melanie needs less from the life interest (ie fewer assets may be needed to give her sufficient income)

What will the testamentary trust achieve for Beneficiary 2?

Children’s tax break while under 18

What will the testamentary trust achieve for Beneficiary 3?

Maximum protection from property distribution in case of divorce(s)

Children’s tax break for grandchildren/great grandchildren under 18

What will the testamentary trust achieve for Beneficiary 4?

Maximum protection from losing assets in professional negligence claim

What will the testamentary trust achieve for Beneficiary 5?

Maximum protection from losing assets in professional negligence claim

Children’s tax break for grandchildren/great grandchildren under 18

What will the testamentary trust achieve for Beneficiary 6?

In this case, life interest in either investment property or some or all shares not discretionary trust

5. Assuming separate trusts in each case, who should be trustee/appointor and why? These are not fixed or “right” answers but indicate what should be considered

Name	Appointor	Trustees	Comment
1. Michael	2 or 3 of Liz, Joan and Oscar	Melanie	Assuming Mum will be good. If not her and all siblings or just them alone or just Joan.
2. Joseph	Liz, Joan and Oscar ⁵¹	Liz, Joan and Oscar	What will happen when he is 18 or 25?
3. Liz	Joan and Oscar	Joseph, Joan and Oscar	Not in control herself to protect from loss on divorce or to manipulative lover.
4. Joan	Joan	Joan	Do you assume Joan will remove herself as appointor and trustee if any risk arises (eg she becomes aware of a big problem by employee or partner).
5. Oscar	Joan and Liz	Joan and Liz	Spendthrift/Gambler so Oscar shouldn’t be trustee of his own trust unless two other

⁵¹ Assuming Oscar will be responsible when dealing with assets for the benefit of his little brother and his risk lies with his own assets.

			sensible siblings are joint trustees with him.
6. Melanie	No	Don't want her to get more assets.	Don't want her to get more assets.

Consider if these choices -which might look good on paper- will nevertheless cause family problems especially if Oscar or Melanie think they are being patronized.

Ask whether all the trusts except the life interest will have the same beneficiaries in effect (ie siblings, their children). So for example the Liz trust would have Liz as primary beneficiary, her spouse, children, grandchildren (all appropriately defined), associated companies, trusts and charities as objects.

Finally, do all you can to get this reviewed at least in 5-6 years? Joseph is nearly 18 - should he be given some responsibility at 18 or 21 eg as a joint trustee of his own trust? Has Oscar stopped drinking and gambling? You don't want to think about the possibility that Joan has gone off the rails partly due to the major responsibility she has taken on to keep the family happy.

DRAFTING ISSUES

Drafting the trust

Assume a testamentary trust is thought to be a good thing in a particular case.

It goes without saying that the testamentary trust(s) and the rest of the Will should be clearly set out, preferably in reasonably plain language and be able to be understood by the testator, executor, appointors, trustees and potential beneficiaries (some of whom may be young or not particularly well educated or not sophisticated in dealing with trusts or finances).

Should the Will be drafted to give the executor the power to decide whether to provide any property for it (ie to start it) or should some conditions be included in the Will.

One option is to add a *pro forma* modified discretionary trust to the Will creating one or more testamentary trusts. A *pro forma trust* is eminently suitable for a *pro forma client* eg happily married once with children, any married children are happily married, no disputes between any family members and their spouses, everyone's financial needs are more or less equal, all are responsible spenders and savers, no one is addicted or weak willed and no one is particularly vulnerable and where none of this changes between the date of making the Will and the date of death.

Otherwise you need to carefully draft the trust/s to provide exactly what best suits the client.

I know that in practice it is hard enough to get a client to make a Will at all and so there is a great temptation to draft the Will (and any testamentary trust) to take into account any contingencies between now and the date of death. Tax laws change and family circumstances change and drafters continually find better ways to express themselves. It is a pity the Will can't be drafted looking at say the next 5-10 years and not with an expectation that it is the best expression of the testator's wishes in 20 or 30 years. Is one solution to this a "free review" service each 5 years as part of the original cost?

Once you have decided what priorities can be best satisfied by a testamentary trust, then it should be drafted to provide for that priority (or with a range of aims).

Again, I know it is tempting to use a pro forma testamentary trust deed maybe modified a little but this may be the very worst of all options. The trust, by trying to be “all things to all people” may actually allow the very thing the testator doesn’t want.⁵²

If the priority is to protect the assets from the gambling oldest child, then control of the trust (via appointor and trustee) needs to be elsewhere. If it is to maximise the income splitting benefits including those for minor children, then the appointor and trustee can be the relevant child.

If it is to ensure maximum flexibility for the financial needs and desires of the income beneficiaries, it can be drafted accordingly.

What is to happen with trustee –is aim to hand it over at some time to child or grandchildren? Is this consistent with asset protection?

CLAUSES:

Don’t include:

- Any agreement with trustee.
- Any settlor clause as the Will itself is the settlement of the gift.

Do include as appropriate for the particular needs of the testator:

- The 28 or 30 day survivor issue (for the sake of ensuring clarity where the same event cause death of testator and spouse or child),
- Property to be held in the trust.
- Initial trustee of each trust with careful consideration of current and successor trustees. This depends on relationship between spouse and children (especially where the spouse is a second or third).
- Change of trustee.
- Removal of trustee and appointor on events such as bankruptcy.
- Trustee’s right to distribute income or capital to self (if intended to be a possible beneficiary) or, if professional or non beneficiary, trustee’s right to charge fees.
- Appointor clause with careful consideration of current and successor appointors including final control back to children etc. Who is to control the trust ultimately? There is an inherent conflict between the desire to give the children control and to protect these assets from creditors and ex spouses. Control can be given to other siblings but this may not work if there is a falling out between them. The power to distribute to maximise tax benefits and needs can be used a easily to do the opposite!

⁵² If you are serious about good trust drafting, you will find James Kessler QC’s UK book, *Drafting Trusts and Will Trusts* somewhere between invaluable and merely useful. Published by Thomson –Sweet and Maxwell. Current cost is \$310. It also includes a CD containing precedents. I only came across it by accident so I am not sure how many tax advisers are aware of its existence.

- Is the trust to be set up whatever age the children (and so is a trust for the grandchildren as well) or is the gift absolute if child is over 18 or 21 or 30 or whatever?
- When trust is to end and rights of trustee to end earlier (including by distribution of all income and capital so there is no trust property left) - this may require consent of spouse or some beneficiaries.
- Definitions especially for meaning of spouse and child (to give maximum flexibility if desired for children not yet conceived, foster children, 'test tube' children,⁵³ pre-adopted children, same sex partners etc) and income (including power to treat income as capital as vice versa).
- Who is to get a child's share if child dies before testator?
- Discretionary appointment of and distribution of income and capital.
- Streaming income from particular types or specified assets. This is essential if new assets are added to the trust and income from those assets is distributed to minors.
- Usual powers of trustee to sell, invest, borrow, lend generally and lend specifically to beneficiary at interest or otherwise, permit use of property by beneficiary free of charge etc.
- Usual protections to trustee for liability and indemnities.
- Power to accept gifts?? In the absence of such a clause can the trustee do so?
- Right to accumulate income (and whether it remains as income or is treated as capital).
- Investment powers including the preferred balance (if any) between investing for income or capital growth or total flexibility.
- What happens with any after acquired property eg through issue of bonus shares.
- Variation of terms including beneficiaries? Do you direct the trustee to get tax advice before exercising this?
- Perpetuity clause (if needed in your state/territory).
- Any specific requirements such as specific powers where vulnerable beneficiaries (especially if a professional trustee instead of a family one is used. For example, to specify the capital can be used for things for comfort and enjoyment eg holidays, travel).
- Add clause specifically negating any act that would be the delegation of testamentary power (and severing any act).

A couple of more points about the Will:

Does the Will create separate testamentary trusts for each child (and their descendants if any), with the spouse as first appointor and the relevant child as successor in each case. This allows the surviving spouse to control all the income and property during his or her life and then each child gains control on mum or dad's death.

At least in the States which prohibit delegation of testamentary power, the Will should specify the property for each testamentary trust (it need not be named, by percentage

⁵³ Assuming medical science will shortly allow children to be conceived and fully develop ex utero.

of certain assets is fine). Leaving the full decision to the executor may otherwise result in the trusts being ineffective.

Superannuation and tax benefits

This article is not dealing with death benefits from superannuation policies except to make these simple points:

1. Whether or not to pay the superannuation benefits into a testamentary trust is one of the last decisions in planning what to do with them.
2. If a superannuation payment is made to a trustee its 'death benefit' tax concession is generally lost. However, the ATO considers that a payment made to the trustee of a trust set up to benefit a single dependant of a deceased person will maintain this concession. Provided the benefit is paid to or for the benefit of dependant of the deceased person, it will be exempt from tax.⁵⁴ It needs to be noted this interpretation is based on the dependant having an absolute entitlement to the income (ie is the sole beneficiary and any income on death would form part of the dependant's estate).
3. To be sure the benefit of the ATO view is obtained, there needs to be separate testamentary trust for each dependant and the superannuation payment paid to the separate trusts. These trusts cannot be discretionary as to appointment of the income although accumulation could be allowed as long as the dependant is entitled to any accumulation in due course.

CURRENT ISSUES WITH LIFE INTERESTS AND CGT

Update on ruling on life interests

In late November 2006, the ATO issued its final ruling on the topic TR 2006/14. The most significant result relevant to this article is that the ATO has changed its view from the draft ruling on the cost base of the life tenant. The result is that the life tenant has a market value cost base (instead of a nil cost base). This solution to the complexities of the law gives some relief to the life tenant and in many cases will give complete relief where the value of the life interest has decreased. Where the value of the life interest has increased (because the value of the property has increased), the best result continues to be that no CGT is payable if the surrender is made before administration of the deceased estate is completed or where the life tenant does what comes naturally to us all one day.

The relevant extracts follow (my emphasis):

25. The first element of the cost base and reduced cost base of an equitable life or remainder interest is the sum of any money and the market value of any property given to acquire it: subsection 110-25(2).

26. If, as is generally the case, no money or property is given to acquire an equitable life or remainder interest, section 112-20 provides that the first element of the cost base and reduced cost base of the interest **is its market value at the time it was acquired.**

27. However a market value cost base cannot be obtained for an equitable life interest that arose other than as a result of someone's death) if:

nothing is actually paid or given to acquire it; and

⁵⁴ ATOIDs 2001/751 and 2002/155.

it is not acquired by way of assignment from another entity.
(See item 1 in the table in subsection 112-20(3).)

28. Note that for the purpose of paragraph 112-20(1)(a), **equitable life and remainder interests are considered to have been acquired as the result of CGT event E1 happening. That is, a market value acquisition cost is not denied** on the basis that the interests resulted from CGT event D1 happening or no CGT event at all happening.

The problem:

The problem is the massive CGT on the surrender of a life interest in CGT assets such as investments when the life interest ends other than through the death of the life tenant. This is particularly unfair where the life tenant does not receive anything for the surrender or receives well under full market value of his/her interest. Let me show you what I mean:

Assume shares with market value of \$120 are left in Robert's Will. Cost base of deceased is \$20.

Shares sold by deceased

If Robert had sold them at market value the day before his death, he would have CGT of \$25.⁵⁵

Capital proceeds	120
Less cost base	20
Capital gain	100
CGT, say 25%	\$25

Direct gifting, no life interest

If in his Will, Robert gifted 80% to Rosie and 20% to their son, Ryan then no immediate CGT liability arises when the shares are transferred to them and Rosie inherits shares with a cost base of \$16 (80% of \$20). Five years later Rosie sells all the shares at market value (to a third party or to Ryan, it doesn't matter for the calculation below) and the value is much the same due to the big dip we had in 2008:

Rosie

Capital proceeds	96
Less cost base	16
Capital gain	80
CGT, say 25% ⁵⁶	\$20

Ryan

Is holding onto shares inherited with market value of \$24 and cost base about \$4.

If he sells them now, his CGT is about **\$5**.

⁵⁵ For these examples I will assume everyone is on top marginal rates and will be entitled to 50% discount and that this is roughly 25% of total. It will be less but 25% is easier to work with and makes the same point.

⁵⁶ Supra.

The effect of the deferral of CGT given by Division 128 is simply that, the CGT liability is deferred and taken into account when the shares are finally sold. In either case the total CGT of \$25 gets paid some time (assuming the shares do not decrease in value).

Life interest ended 5 years later for nil consideration

When the executor is able to do so once the estate's debts are paid etc, he commences holding the shares on the trust with the income for life to Rosie. Ryan is the remainder beneficiary.

When Rosie starts to hold the life interest, CGT event E1 occurs and she has a new CGT asset which was not owned by the deceased. The deceased has no CGT due to sec 128-10.

Rosie's interest is property and has a market value.⁵⁷

It has no cost base (because she paid nothing for it and there is no deemed cost base). This is explained in TR 2005/D14:

14. An equitable life or remainder interest is a created interest acquired when it starts to be owned. Its first element of cost base and reduced cost base is limited to the sum of any money and market value of property given to acquire it, except where it is not acquired under an arm's length dealing. If no expenditure is incurred to acquire it, paragraph 112-20(1)(a) of the ITAA 1997 has the effect that the interest is not treated as having been acquired for its market value.

Sec 112-20 provides:

SECTION 112-20 Market value substitution rule

112-20(1)

The first element of your *cost base and *reduced cost base of a *CGT asset you *acquire from another entity is its *market value (at the time of acquisition) if

(a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:

(i) *CGT event D1 happening; or

(ii) another entity doing something that did not constitute a CGT event happening; or

(b) some or all of the expenditure you incurred to acquire it cannot be valued; or

(c) you did not deal at arm's length with the other entity in connection with the acquisition.

The expenditure can include giving property: see section 103-5.

112-20(2)

Despite paragraph (1)(c), if:

⁵⁷ Based on actuarial calculations of expected life.

- (a) you did not deal at arm's length with the other entity; and
 (b) your *acquisition of the *CGT asset resulted from another entity doing something that did not constitute a CGT event happening;
 the *market value is substituted only if what you paid to acquire the CGT asset was more than its market value (at the time of acquisition).

The payment can include giving property: see section 103-5.

Rosie

Capital proceeds	96
Less cost base	0
Capital gain	96
CGT, say 25% ⁵⁸	24

Ryan

Acquires the shares free of the life interest with market value of \$120 and cost base about \$20.

If he sells them now, his CGT is about **\$25**

Life interest ends in death of life tenant

Rosie

Capital proceeds	0 (market value at her death is also nil)
Less cost base	0 (incidental costs only)
Capital gain	0
CGT	0

You can see the problem!

The capital loss is ignored for the reason given in TR 2005/D14

69. If the life interest was measured by the life of its owner, any capital loss from CGT event C2 happening is disregarded under section 128-10 of the ITAA 1997. That section disregards gains and losses from CGT events that happen to assets owned by an individual as a result of their death.

If Rosie gives her interest away she becomes liable to CGT based on deemed market value even though she receives nothing.

I can think of no principle why this should be the case. It occurs because of the CGT provisions and especially the deeming provisions of the capital proceeds and cost base.

Life interest ended 5 years after death for market value consideration which is paid by remainderman in cash

Rosie

⁵⁸ Supra.

Capital proceeds	96 (in this case this is real)
Less cost base	nil
Capital gain	96
CGT, say 25% ⁵⁹	\$24

In this case, Ryan is in the same position except he has paid Rosie to end the trust early. Ryan gets \$120 worth of shares for \$80. Does he have his father's entire cost base of \$20 as well as the \$80 he paid? Why not?

Life interest ended 5 years after death by in specie transfer of shares owned by deceased

This becomes very interesting. Where Rosie ends her right to income by receiving an in specie distribution CGT event E6 would have occurred with the result that, as the shares being transferred are shares that were owned by Robert at death (and so are covered by Div 128), E6 does not apply. Rosie receives the shares as if gifted in the Will and any CGT liability is rolled over. CGT event E6 provides:

SECTION 104-80 Disposal to beneficiary to end income right: CGT event E6

104-80(1)

CGT event E6 happens if the trustee of a trust (except a unit trust or a trust to which Division 128 applies) *disposes of a *CGT asset of the trust to a beneficiary in satisfaction of the beneficiary's right, or part of it, to receive *ordinary income or *statutory income from the trust.

104-80(2)

The time of the event is when the disposal occurs.

Trustee makes a capital gain or loss

104-80(3)

The trustee makes a capital gain if the *market value of the asset (at the time of the disposal) is more than its *cost base. It makes a capital loss if that market value is less than the asset's *reduced cost base.

Exception for trustee

104-80(4)

A *capital gain or *capital loss the trustee makes is disregarded if it *acquired the asset before 20 September 1985.

Beneficiary makes a capital gain or loss

104-80(5)

The beneficiary makes a capital gain if the *market value of the asset (at the time of the disposal) is more than the *cost base of the right, or the part of it. The beneficiary makes a capital loss if that market value is less than the *reduced cost base of the right or part.

Note:

If the beneficiary did not pay anything for the right, the market value substitution rule does not apply: see section 112-20.]

⁵⁹ Supra.

Exception for beneficiary

104-80(6)

A *capital gain or *capital loss the beneficiary makes is disregarded if it *acquired the *CGT asset that is the right before 20 September 1985.

If Div 128 applies so CGT event E6 doesn't:

Rosie

Capital proceeds	nil (for life interest)
Less cost base	nil
Capital gain	nil
CGT	nil (she inherits the shares with the cost base of deceased)

This was the view expressed in several ATOIDS⁶⁰ withdrawn on the release of TR 2005/D14 but the view still seems to be accepted:

18. In the context of CGT events E5, E6 and E7, the exception will therefore apply if, as part of the administration of the deceased's estate, an asset the deceased owned when they died passes to the beneficiary in accordance with section 128-20 of the ITAA 1997. (Note that in certain circumstances where an asset passes to a beneficiary the Commissioner treats the trustee of a testamentary trust in the same way as he treats a legal personal representative: Law Administration Practice Statement PS LA 2003/12).

114. In the context of CGT events E5, E6 and E7 this means that the exception applies if subsection 128-15(3) applies to relieve any capital gain or capital loss that arises (or would apply in that way if there were a capital gain or capital loss) when an asset passes from the deceased's legal personal representative to a beneficiary in their estate.

It is not clear whether the former views are being re-expressed or are resiled from. The relevant example is: (with my emphasis)

Example 4: equitable life interest created by will – later agreement between the parties

162. Hector's will provided that his 50 hectare farming property be held on trust for his wife for life, and for his three daughters in remainder in equal shares. Hector acquired the property in 1993 and died in 2000.

163. In 2005, Hector's wife and daughters get together and decide to wind-up the trust and have the property distributed to them as tenants in common in equal shares (that is, four interests).

164. Hector's wife and daughters acquired their interests in the testamentary trust for no consideration. Their first elements of cost base and reduced cost base are nil.

165. The ending of the trust results in CGT event E6 happening in relation to the part of the land transferred to Hector's wife and CGT event E7

⁶⁰ ATOIDS 2003/1115, 2003/1117, 2004/151.

happening in relation to the parts of the land transferred to Hector's daughters.

166. The exceptions for trusts to which Division 128 applies have no relevance in this case because the land is not passing to the beneficiaries in terms of section 128-20. That is, the interests in the land are not passing under the will nor are they passing under a deed of family or family arrangement entered into to settle a claim to participate in the estate.
167. The trustee of the testamentary trust and Hector's wife may make a capital gain or capital loss from CGT event E6 happening. Depending on the application of Division 6 of Part III of the ITAA 1936, and on section 118-20 and subsection 118-20(1A) of the ITAA 1997, any capital gain made by Hector's wife may be reduced to the extent of amounts referable to the trustee's capital gain included in her assessable income under Division 6 (see also PS LA 2005/1 (GA)).
168. The trustee of the testamentary trust may make a capital gain or capital loss from CGT event E7 happening in relation to the parts of the land used to satisfy the interests of the daughters in the trust. CGT event E7 also happens on the ending of the capital beneficiaries trust interests. Because the daughters did not pay anything for their interests, or acquire them by assignment, any capital gain or capital loss they may make on the ending of their interests in the trust is disregarded by subsection 104-85(6).
169. The beneficiaries acquire their interests in the land for their market values at the time it was disposed of to them.

The land being distributed (a tenancy in common of 25% of the whole land) is different to interest left in the Will (which would have been for the girls a tenancy in common of 33.33% of the whole land. However, shares can be identified as the identical interest owned by the deceased and left in the Will. Does Div 128 still apply in such a case? It seems to me it does.

Life interest ended 5 years later by combination of cash and in specie transfer of shares owned by deceased

Assume the deed ending Rosie's interest is set out as follows:

- (a) Consideration for the right to x years income from estate \$30⁶¹
 (b) Consideration for balance of life interest \$50

Leaving aside the CGT effect on (a), will the CGT on (b) follow the same analysis as 8.1.7 above?

Life tenant disclaims life interest

A few months after Robert's death, Rosie disclaims the gift in writing. The CGT effect is based on the view that she never acquired the life interest (all she had was a right to proper administration of the Estate and this is not a CGT asset). As she didn't acquire it, she couldn't end it or dispose of it. Therefore there are no CGT implications but

⁶¹ Assume based on actuarial calculation.

beware of stamp duty!⁶² Ryan simply receives the shares when the executor is able to transfer them to him as if gifted absolutely in the Will.

Deed of Family Arrangement

Ryan was on active duty in Iraq when his father died. He returns to Australia and goes bush for 12 months to get over the experience. By this stage Rosie has started to receive the dividends. He then considers his bequest. He is most unhappy with his father's Will and is given bona fide written advice that he has a valid claim under the relevant family provisions statute in his State or Territory and even though he is out of time to lodge a claim, he also has grounds to obtain an extension of time.⁶³ He informs the executor and his mother and they enter into a Deed of Family Arrangement to settle his claim.

The deed ends the life interest and divides the shares 80:20. The CGT consequences are as set out above in 8.1.2 and are as if the agreed split was left in the Will.

Results summarised

Action	She receives	Her CGT	She keeps	Out of pocket
Gift to Rosie	96	20	76	
Ends 5 yrs for no consideration	-	24	-	24
Ends on Rosie's death	-	-	-	-
Ends 5 yrs for mv consideration	96	24	72	
Ends for shares owned at death UNCLEAR	96	20 (deferred until she sells)	76	-
Ends for combination of cash and death shares UNCLEAR	96	??	??	-
Disclaims shortly after Robert's death	-	-	-	-
Deed of Family Arrangement to settle dispute	96	20 (deferred until she sells)	76	

Some possible solutions: What can the adviser do?

⁶² Eg 71AA Stamp duty act 1923 (SA); 42 Duties Act 2000(Vic).

⁶³ 128-20(1)(d) ITAA 1997 and see ATOID 2003/107.

Assuming it is too late to disclaim without CGT implications (eg some income has been paid to Rosie or the trustee has commenced to hold the shares on the terms of the life and remainder interests)⁶⁴ the cheapest solution is to try to convince your client not to end her life interest early.

You need to find out why your client wants to end her life interest and whether there is a better way to achieve the aim. Some clients do not want to wait and often have personal reasons such as wanting to help the remainder beneficiaries for wanting to end the life interest!

There is nothing to stop her gifting the income she receives (after paying tax) or lending her son money or even possibly using the value of the interest to secure his debt. If Ryan needs money, does the Will allow the trustee to lend it directly or advance any?

What about using the relevant Trustee Act (if the relevant one allows it) to allow advancement of capital to the remainder beneficiary without the life tenant having to do anything? Would the equivalent of sec 33A *Trustee Act (SA) 1936* to pay up to half of capital from shares or similar investments to remainder beneficiaries (with the consent of the life tenant) be of any assistance? If allowed, it is difficult to see how the mere consent of the life tenant has any CGT effect.

33A—Power to apply capital towards advancement and benefit

(1) Where under a trust a person is entitled to the capital of the trust property or any share thereof, the trustee may from time to time pay or apply any capital money subject to the trust, not exceeding altogether in amount one half of the value of the property or share for the advancement, maintenance, education, or benefit of such person in such manner as the trustee shall in his absolute discretion think fit.

(2) The power conferred by this section may be exercised whether the person is entitled absolutely or contingently on his attaining any specified age or on the happening of any event, or whether his interest is subject to a gift over on his death under any specified age or on the happening of any other event, and notwithstanding that the interest of the person so entitled is liable to be defeated by the exercise of a power of appointment or revocation, or to be diminished by the increase of the class to which he belongs or whether the person is entitled in possession or in remainder or reversion.

(3) If the person is or becomes absolutely and indefeasibly entitled to a share in the trust property, the money so paid or applied for his advancement, maintenance, education or benefit shall be brought into account as part of such share.

(4) No such payment or application shall be made so as to prejudice any person entitled to any prior life or other interest, whether vested or contingent, in the money paid or applied, unless such person is in existence and under no disability and consents in writing to the payment or application.

(5) This section applies only where the trust property consists of money or securities or property held upon trust for sale calling in and conversion,

⁶⁴ Are you absolutely sure? Where and what is the evidence?

and the money or securities or the proceeds of the sale calling in and conversion are not by statute or in equity considered as land.

(6) This section applies only and if and as far as a contrary intention is not expressed in the instrument, if any, creating the trust, and shall have effect subject to the terms of that instrument and to the provisions therein contained.

Also consider if any of the potential beneficiaries have a valid bona fide claim under the family provisions statute. Although it is not necessary to commence court proceedings,⁶⁵ the claim must surely be bona fide (and provable as such).⁶⁶

If that fails, would Rosie be satisfied with an in specie transfer of shares owned by Robert? Obviously the longer the life interest has been active, the more post death assets will usually exist. As a partial balance, the older the life tenant, the less the market value of their interest! At this stage, if the answer is yes, seek a private ruling (until TR 2005/D14 is finalised).

Another possible approach is set out below.

Other possible solutions: Over to the ATO!

The different results for the ending of the life interest over investment assets appear to have no logical reason. The overall policy of Div 128 is to allow gifting of assets with deferred CGT liability. Where there will be no CGT liability (eg on the ending of the life interest by death) then why not interpret the CGT trust provisions in such a way (even generously) to achieve the aim. The draft ruling is a noble effort to try to deal with the issue in a relatively abstract manner by trying to make sense of the trust law implications of starting and ending life interests (including those left in Wills). It tries to do too much by dealing with legal and equitable life interests and does not face the practical inconsistencies that I refer to above.

The life tenant has no CGT

Why not accept that a life tenant can surrender the life interest whether for full market value consideration or not, “tax free”. There is no loss to the Revenue as the remainder beneficiary doesn’t acquire the life interest and so the payment isn’t part of his cost base of any CGT asset and so is not taken into account in any CGT liability.

The ATO may fear this approach may be used as a planning tool to get a tax free amount to the “life tenant”. However, it is difficult to see what the mischief is. There will still be all the normal CGT on the disposal of any assets which finally pass to the remainder beneficiary. Where the life and remainder beneficiaries are related (as is often the case) the arrangements are domestic not commercial. Where they are not related, the remainder beneficiary is paying for an advancement of the trust but not acquiring an asset.

I accept with sadness that as a practical matter it is too much to expect Parliament to change the CGT law to allow this (even if it is fair or even intended in the current legislation) but the ATO can deal with the inconsistency by introducing an administrative practice based on the policy behind Div 128. This has been done before

⁶⁵ 128-20(1)(d) ITAA 1997 and see ATOID 2003/107.

⁶⁶ A written legal advice should suffice especially if from counsel or solicitor who practices in the area.

eg in PS LA 2003/12 (also concerning Div 128) and eg TR 95/35 which was necessarily to make CGT on compensation receipts work at all!

In PS LA 2003/12, the ATO states:

Although this is a difficult issue, particularly given the wording in section 128-15 of the ITAA 1997, it is open to the Commissioner to follow a long-standing practice that promotes the policy intent of the provisions and that might be adopted by a court.⁶⁷

The following explains why there is no loss to the revenue.

1) Shares sold by remainder on death of life tenant-

Assuming Rosie dies while still entitled to the life interest, she will have no CGT liability on the acquiring or ending of her life interest.

Ryan then inherits the capital assets with a cost base of \$20 (as Robert had). Assume he sells them all. Assuming the value hasn't decreased, then the capital proceeds that Robert would have obtained and paid tax on will now be “included” in Ryan's gain and the “above CGT” will then be paid.

That is the usual case. All that has happened is the CGT on the shares owned by Robert is deferred until his capital beneficiary disposes of them. This is the point of the CGT death concessions in Div 128.

2) Life tenancy surrendered for no consideration-

Assume instead, Rosie ends the life interest when it has a market value of \$50. She asks for and receives nothing.

The effect of the ending is that Ryan's interest is accelerated so he inherits the capital assets with a cost base of \$20 (as Robert had). Assume he sells them all. Again all that has happened is the CGT on the shares owned by Robert is deferred until his capital beneficiary disposes of them. Robert does not gain except by either being able to sell the shares sooner than Robert and God intended which is a benefit to the Revenue as it gets the deferred CGT earlier. There is no loss to the Revenue in ordinary income tax—whichever holds the rights to the income from the shares will be paying income tax on the income derived.

3) Life tenancy surrendered for mv consideration-

Ryan pays \$50,000. Rosie receives it and surrenders her interest. Ryan doesn't acquire the life interest by paying the amount nor does he acquire the remainder interest or the absolute interest in the assets by the payment (as these were acquired because of the Will). By paying his mother, she ends her life interest. That means the payment simply accelerates his interest left by the Will. As the sum does not form any element of the cost base of any CGT asset, it is not available to be offset against any later capital gain. The payment of the \$50,000 has no CGT effect on Ryan. Therefore there is no revenue need to impose a CGT liability on Rosie to offset or balance any benefit to Ryan.

⁶⁷ From [7] of PS 2003/12. The practice need not be long standing to attract this approach.

The relevant parts of sec 110-25(2) are set out below so you can check my claim. In summary, the cost base rules deal with amounts incurred etc. in acquiring the asset. If Ryan spent the money for a reason other than acquiring the asset (ie the shares), the cost base rules don't apply.

5 elements of the cost base -

110-25(2)

The first element is the total of:

(a) the money you paid, or are required to pay, in respect of *acquiring it; and

(b) the *market value of any other property you gave, or are required to give, in respect of acquiring it (worked out as at the time of the acquisition).

[Note 1: There are special rules for working out when you are required to pay money or give other property: see section 103-15.]

[Note 2: This element is replaced with another amount in many situations: see Division 112.]

110-25(3)

The second element is the *incidental costs you incurred. These costs can include giving property: see section 103-5.

[Note: There is one situation to do with options in which the incidental costs relating to the CGT event are modified: see section 112-85.]

110-25(4)

The third element is the costs of owning the *CGT asset you incurred (but only if you *acquired the asset after 20 August 1991). These costs include:

(a) interest on money you borrowed to acquire the asset; and

(b) costs of maintaining, repairing or insuring it; and

(c) rates or land tax, if the asset is land; and

(d) interest on money you borrowed to refinance the money you borrowed to acquire the asset; and

(e) interest on money you borrowed to finance the capital expenditure you incurred to increase the asset's value.

These costs can include giving property: see section 103-5.

[Note: This element does not apply to personal use assets or collectables: see sections 108-17 and 108-30.]

110-25(5)

The fourth element is capital expenditure you incurred:

(a) the purpose or the expected effect of which is to increase or preserve the asset's value; or

(b) that relates to installing or moving the asset.

The expenditure can include giving property: see section 103-5.

[Note: There are 3 situations involving leases in which this element is modified: see section 112-80.]

110-25(6)

The fifth element is capital expenditure that you incurred to establish, preserve or defend your title to the asset, or a right over the asset. (The expenditure can include giving property: see section 103-5.)

4) Life tenancy surrendered for less than mv consideration-

The only difference here is the deemed market value for the first element of the cost base due to sec 112-20. This doesn't matter in this case as there is still no nexus between the acquisition of any asset by Ryan and the payment. Therefore the argument for less than market value is the same as for market value payment.

The life tenant has a cost base

An alternative to no CGT is a reduced CGT by accepting there is a deemed market value cost base as Rosie didn't pay anything for her life interest. It is possible to interpret sec 112-20(1) in this case so that the cost base (where no consideration was received) is deemed market value. If it is deemed market value, then there is a reduction in the capital gain. For ease of reference I set sec 112-20 out again:

SECTION 112-20 Market value substitution rule

112-20(1)

The first element of your *cost base and *reduced cost base of a *CGT asset you *acquire from another entity is its *market value (at the time of acquisition) if:

- (a) you did not incur expenditure to acquire it, except where your acquisition of the asset resulted from:
 - (i) *CGT event D1 happening; or
 - (ii) another entity doing something that did not constitute a CGT event happening; or
- (b) some or all of the expenditure you incurred to acquire it cannot be valued; or
- (c) you did not deal at arm's length with the other entity in connection with the acquisition.

The expenditure can include giving property: see section 103-5.

112-20(2)

Despite paragraph (1)(c), if:

- (a) you did not deal at arm's length with the other entity; and
 - (b) *your acquisition of the *CGT asset resulted from another entity doing something that did not constitute a CGT event happening;
- the *market value is substituted only if what you paid to acquire the CGT asset was more than its market value (at the time of acquisition).

The payment can include giving property: see section 103-5.

In summary, for our purposes, the market value cost base substitution rule will not apply to determine the cost base of the taxpayer's life interest where the acquisition of the asset resulted from any one of these three:

- A. CGT event D1 happening on acquisition of life interest;
- B. another entity doing something that did not constitute a CGT event happening; or
- C. the life tenant did not deal at arm's length with the other entity from which the life tenant acquired the life interest.

Personalising this to Robert, Rosie and Ryan the market value cost base substitution rule will **not** apply to determine the cost base of the taxpayer's life interest where the acquisition of the asset resulted from any one of these three:

- A. CGT event D1 happening on acquisition of life interest;;
- B. Robert or someone else doing something that did not constitute a CGT event happening; or
- C. Rosie did not deal at arm’s length with Robert or whoever she acquired the life interest from.⁶⁸

The arguments are as follows:

A. The Will creates a life interest in Rosie and remainder interest in Ryan over assets. Is this a CGT event D1? Was the life interest created as a result of CGT event D1 happening (section 104-35 of the ITAA 1997).

CGT event D1 happens if the deceased or someone else creates a contractual right or other legal or equitable right in another entity. Has the deceased created an equitable right in Rosie or can you argue that the Will has no effect until the person dies and at that moment, when the Will comes into effect the deceased is no longer is (at a minimum) able to create a legal or equitable right in any entity?⁶⁹ Also she does not acquire her life interest until the estate has been administered and by then the deceased is well out of the picture. The deceased set up the process (the Will) that results in the life interest but doesn’t actually create it.⁷⁰

B. The market value substitution also does not occur where the acquisition of the life interest resulted from another entity doing something that did not constitute a CGT event.

Was the acquisition of the life interest the result of the deceased or executor or another person doing something that did not constitute a CGT event? The steps required for the life tenant to acquire the interest are:

1. The deceased leaves the life interest in the Will –no acquisition yet.
2. The deceased dies-no acquisition yet.
3. The executor administers the estate-no acquisition yet.
4. The executor or a new trustee commences to hold the assets under the terms of the life interest – acquisition now.

Which of these actions, if any, result in the acquisition of the life interest? Arguably only the last can be said to result in the acquisition. At any earlier stage the life interest may not happen eg. if there are insufficient assets in the estate to pay the deceased’s debts. Also arguably, the last step is not “something done” by the executor or trustee (in the sense of what the section means). It is simply the consequence of duly administering the estate.

C. The market value substitution also does not occur if Rosie did not deal at arm’s length with Robert (or whomever she acquired the life interest from). For the reasons given above, Rosie did not acquire the life interest from anyone so it is irrelevant

⁶⁸ Apologies for the preposition ending the sentence!

⁶⁹ I am leaving aside any ongoing spiritual existence because as you are deemed to have disposed of all your assets at the moment of death, you have no ability to do anything with them after that time. I am quite simply applying the tax law to the deceased.

⁷⁰ The ATO considers the life tenant acquires the interest from the deceased - see TR 2005/D14 at [45] to [48].

whether she was dealing with them at arm’s length or not. Furthermore, and as a further illustration of how impossible it is to use the general CGT provisions with assets held on death, it is also likely that **in fact** Rosie did not deal with Robert at all – she may have no knowledge of the life interest until after his death. Even if she was aware, this is surely not the type of “dealing” that the CGT provisions are meant to tax.

Another (almost) solved CGT problem for life tenants

A life tenant of an active testamentary trust is the sole income beneficiary and is presently entitled to the income pursuant to the Will. The result is that any CGT liability arising from the sale of trust assets (such as shares) also flows to the life tenant even though the life tenant has no right to the capital benefit of the event that gave rise to the liability. The Commissioner has a current concessional administrative practice allowing the trustee of a testamentary trust to assume liability for the CGT in certain circumstances.⁷¹

The Government has very recently announced it will amend the CGT provisions to fix this problem.⁷²

The aim of the amendments is to enable the CGT liability arising from CGT event happening to a trust asset to be paid by the trustee of a testamentary trust where a presently entitled income beneficiary will not obtain the benefit of the capital gain.⁷³ The trustee can make the choice on a beneficiary-by-beneficiary basis and this is intended to ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary, for instance where the income beneficiary is an exempt entity or a foreign resident. The amendments are intended to apply to the 2005–06 and later income years.

Is it in fact a life interest over each CGT asset? Does this matter?

The discussion always concerns the life interest left in the Will or terms similar to that. Is it more accurate to say that the deceased leaves a life interest over each CGT asset subject to the life interest? This would make it easier to end the life interest over the assets owned by the deceased and so use the exception to CGT E6 resulting in no CGT on those surrenders.

What if the life interest were an asset owned by the deceased

This approach has been promoted in arguments for the part disposal view.⁷⁴ The ATO holds the creation view which results in no cost base for the life interest.⁷⁵

53. Being trust interests, the life and remainder interests are created interests that are acquired when they commence to be owned: subsection 109-5(1) of the ITAA 1997. The interests are not acquired pursuant to Event number E1 in the table in subsection 109-5(2) because this is only relevant to the

⁷¹ Practice Statement PS LA 2005/1(GA). Note this PS applies beyond testamentary trusts.

⁷² Following consultation with industry on the design and the implementation of the amendments.

⁷³ Media release no 074 from Minister for Revenue dated 17 October 2006

⁷⁴ For example see Barkoczy, S and Cussen, P, (1993) ‘Capital gains tax and the grant of life and remainder interests under wills: the debate between the creation and part disposal views’, *Australian Tax Review*, Volume 22.

⁷⁵ TR 2005/D14.

trustee's acquisition of the original asset. Further item 3 in the table in section 109-10 does not apply because the trust is not a unit trust.

54. The first element of the cost base and reduced cost base of a life or remainder interest is limited to the sum of any money and the market value of any property given to acquire it, except where it is not acquired under an arm's length dealing. The market value substitution rule does not apply in calculating the first element of the cost base and reduced cost base of life and remainder interests acquired for no expenditure: paragraph 112-20(1)(a) of the ITAA 1997.

The problem for the life tenant arises in part because there is no cost base and no deemed cost base. This results in almost the entire capital proceeds or deemed capital proceeds (that is the other problem) being subject to CGT.

Could Robert was treated as owning not only the shares but also each interest that he can leave in the shares. So when the life interest commences, the life interest and remainder interest each have a percentage of the cost base of the shares etc over which the interests exist.

So if Rosie's life interest is worth 80%, she has 80% of the cost base. If she surrenders the interest for market value, she has 80% of cost base. In the above example, this was worth \$16.

If she surrenders the interest when its value is \$80 the result would be as if she was left shares with that value and sold them. In practical terms as far as she is concerned that is what should have happened.

If Robert leaves an interest in shares to Rosie then while she has that interest, the shares themselves will either:

- Be disposed of by trustee and he/she will use Robert's cost base and replace investment with new market value cost base. These shares formerly owned by Robert will never pass to Ryan and so the Div 128 cost base rules are irrelevant for those shares.
- Be held by trustee until interest ends (and so no one makes use of their cost base during this time) and when the interest ends, then if the shares pass to Ryan as would occur on Rosie's death, he acquires them with his father's cost base. This is the same whether he received the shares in the Will, on the death of Rosie or earlier if she surrenders or disclaims her interest.
- If transferred to Rosie in return for some or all of life interest, then she also acquires them with Robert's cost base. Ryan never gets them.

What about the CGT impact on the remainder beneficiary?

If Rosie dies when she still has the life interest, then as above, Ryan acquires the shares with his father's cost base.

If Rosie surrenders her life interest before her death, and has the use of the cost base of the life interest when she acquired it what is Ryan's position? The alternatives are:

She receives no consideration: she has deemed market value and offsets her percentage of the cost base. Ryan pays nothing to her and he acquires all Ryan acquires the shares with his father's cost base. There is a duplication of part of the cost

base but there is CGT on the balance of the deemed consideration which is a bonus to the Revenue (caused by the early ending of the life interest).

She "sells" her life interest. If she accepts shares, then Ryan only acquires the shares left over. If Ryan funds this out of his funds, then he acquires all the shares.

Comment on "solutions"

These ideas are offered as just that - ideas! I release these balloons of hot air in the hope one of them will be found to hold a better answer than the current position for the life tenant especially one who wishes to be generous and let the remainder beneficiaries receive their inheritance early.

CONCLUSION

*There once was a man named Flowers
Whose wealth was from building showers
He made his own Will
The silly old dill
So "gave" all of his assets to lawyers*

Well, after reading all of this, do you think testamentary trusts are just another trust? There are undoubtedly some interesting and difficult tax questions unique to trusts arising from Wills and as much as I hope more answers will come soon until they do, the interest will have to do!