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Contents

General Editor

Associate Professor Helen Hodgson, *Head of Department of Taxation, Curtin Law School*

Editorial Panel

Michael Blissenden, *Professor of Law, School of Law, Western Sydney University*
Andrew Clements, *Partner, King & Wood Mallesons, Melbourne*
Gordon Cooper AM, *Adjunct Professor in the School of Taxation and Business Law (incorporating Atax), University of New South Wales*
John W Fickling, *Barrister, Western Australian Bar*
Dr Paul Kenny, *Associate Dean Academic, Faculty of Social and Behavioural Sciences, Associate Professor in Taxation Law, Flinders Business School, Flinders University*
Craig Meldrum, *Head of Technical Services & Strategic Advice, Australian Unity Personal Financial Services Limited*
Karen Payne, *Chief Executive Officer, Board of Taxation*
Joseph Power, *Senior Associate, King & Wood Mallesons*
Andrew Sommer, *Partner, Clayton Utz*
Sylvia Villios, *Lecturer in Law, Law School, University of Adelaide*
Chris Wallis, *Barrister, Victorian Bar*

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Australian Tax Law
Bulletin

General Editor's introduction

Associate Professor Helen Hodgson *CURTIN LAW SCHOOL*

We have three very different articles for you this month, addressing different areas of tax practice.

The first article is a timely contribution from a new contributor, Brett Davies, regarding the superannuation transition measures. One of the key features of last year's reforms was the introduction of the $1.6 million transfer balance cap which requires that superannuation funds with more than $1.6 million in retirement phase restructure to reduce that balance. Capital gains tax (CGT) rollover relief is available to reduce the effect of CGT where the changes require restructuring of asset holdings within the superannuation fund. In his contribution, Brett works through the implications of the Australian Taxation Office (ATO) ruling[1] on the application of the transitional rollover measures.

The second article discusses the deductibility of stamp duty when it is applied to the acquisition of leasehold property. John McLaren and John Passant highlight the effect of s 25–20 to allow a tax deduction for stamp duty in certain property acquisitions where the property is acquired under a lease. The authors note that although stamp duty is a capital expense that is attributed to the cost base of freehold property, s 25–20 of the Income Tax Assessment Act 1997 (Cth) applies to allow a deduction for stamp duty on the lease of a property that is used to produce assessable income. With the exception of property in the ACT, leasehold transactions are relatively unusual, however such transactions are becoming more common particularly in industries where the government does not want to see ownership in foreign hands, such as pastoral leases, rendering a tax advantage to purchasers under a lease.

The third article for this Bulletin returns to small business and the operation of Div 7A of the Income Tax Assessment Act 1936 (Cth). Vasilios (Bill) Mavropolous reviews the ATO interpretation in the context of unpaid present entitlements. Since 2010, the ATO has considered unpaid present entitlements to be loans within the meaning of Div 7A. The article examines this position using the rules of statutory interpretation to consider whether the ATO position is sustainable.

By the time you receive this edition of the Bulletin, the federal government will have handed down the 2017–18 Budget, and we will have some indication of what is in store for the coming year. I hope that we can help you to navigate the changes as they become law.

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Footnotes

1. ATO Law Companion Guideline 2016/8 (8 March 2017).

Australian Tax Law
Bulletin

Transitional rules to reset the cost base of assets that support pensions and TRIS in SMSFs using the proportionate method

Adjunct Professor Dr Brett Davies *LEGAL CONSOLIDATED BARRISTERS & SOLICITORS*

Introduction

Under the reforms to superannuation that come into effect from 1 July 2107 anyone that has an amount exceeding $1.6 million of superannuation in pension phase will need to withdraw the excess from pension phase. The Australian Taxation Office (ATO) Law Companion Guideline 2016/8 (LCG 2016/8)[1] was released on 8 March 2017. It sets out transitional capital gains tax (CGT) relief available for funds that comply with the new transfer balance cap (TBC) and transition to retirement income streams (TRIS) reforms. Assets supporting income streams must be reallocated or reapportioned to accumulation phase before 1 July 2017, which may result in a capital gain on the dealing with the asset.

CGT relief is available up to midnight of 30 June 2017 to superannuation funds that need to:

- move assets to prepare for the TBC;[2] or
- deal with the changes to the tax treatment of TRIS and pensions.[3]

The LCG 2016/8 includes:

- how a superannuation fund makes the election to apply the relief;
- how the relief operates for both segregated and unsegregated funds;
- the effect of resetting an asset's cost base (CB); and
- statements regarding the operation of the general anti-avoidance provisions contained in Pt IV of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936).

This paper considers the issues facing self-managed super funds (SMSFs) making the election to reset (increase) the CB of assets supporting pensions or the TRIS. The election is transitional, irrevocable and complex.[4]

What is a pension?

A member contribution in the "accumulation" phase is preserved in their account until they satisfy a condition of release.[5] Once the condition of release is satisfied a pension can be established with the account balance. The pension is a tax-free income stream. The most common pensions are:

- an account-based pension; or
- TRIS.

Under the current legislation, TRIS does not attract tax. However, From 1 July 2017 a fund loses the income tax exemption for assets supporting the TRIS.[6]

Also, the account-based pension will be capped at $1.6 million (the Cap). That part of the pension that exceeds the Cap and is returned to the accumulation account will now be subject to income tax and CGT.

Proportionate vs segregated methods

There are two separate methods to obtain the CGT relief:

- proportionate method (unsegregated); and
- segregated method.

Exercising the CGT relief election is valuable for members either not wishing to remain in pension mode or who exceed their $1.6 million TBC limit.[7]

Most SMSFs only have access to the proportionate method.[8] In part, this is because most SMSFs have already applied the proportionate method to claim their pension exemption.[9] This paper only considers the proportionate method.[10]

Situations where the SMSF trustee would not elect a CB reset include:

- where the asset's market value (MV) is less than its CB (ie, there is capital loss if sold);[11] and
- where the asset is likely to be sold before 30 June 2017 and the one-third CGT discount[12] is more valuable than the CB reset.

How does the transitional CGT relief operate?

The relief provisions can only apply to assets that were in the fund by 9 November 2016[13] and are still in the fund come midnight of 30 June 2017 (Pre-Commencement Period).[14] However, SMSF trustees can only take advantage of this opportunity if they make the election before lodging their FY 2017 tax return. The provisions are contained in Subdiv 294B of the Income Tax (Transitional Provisions) Act 1997 (Cth) (IT(TP)A).[15]

Calculating the proportionate method

The proportionate method is set out in s 295–390 of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997). It can be applied to all of the SMSF's assets or on an asset-by-asset basis.[16] The SMSF first calculates the average balance and the days during the financial year that the average balances are held in the SMSF. It calculates the exempt portion of the SMSF's taxable income as follows:[17]

$$Exempt\ Amount = \frac{Average\ value\ of\ only\ the\ current\ pension}{Average\ total\ value\ of\ all\ superannuation}$$

If a fund has 100% of pension assets, then the exemption from capital gains is 100%. Therefore, it is worthwhile to consider establishing a second SMSF fund and rolling out all non-pension assets (accumulation assets).

Four conditions to take advantage of the proportionate CGT CB reset election

The four conditions are set out in ss 294–115 to 294–120 of the IT(TP)A. They are:

- the exempt amount is above zero;
- the SMSF asset is held during Pre-Commencement Period;
- the SMSF has no segregated pension assets during the Pre-Commencement Period (this is usually the case for SMSFs); and
- the SMSF trustee makes the valid election before lodging the SMSF's FY 2017 income tax return.

If the four conditions are satisfied then at the 12th stroke of midnight 30 June 2017, for CGT purposes, the SMSF is deemed to have:[18]

- sold the asset; and
- immediately purchased back the asset at the asset's MV (the CGT asset's CB is reset to the asset's MV as at midnight of 30 June 2017).[19]

"The deemed repurchase results in the fund becoming the owner of the asset 'again' at the repurchase time, for the purposes of the CGT regime."[20] The "repurchase time" or acquisition date is midnight of 30 June 2017.

The legislation provides two ways to implement the proportionate approach.

Method 1: paying the tax for the accumulation portion in the FY 2017

The non-exempt portion or (accumulated portion) is added to taxable income for FY 2017. Using this approach:

Example

An SMSF has $6 million in assets of which $4 million is in pension phase. The CB of the assets is $500,000. The assets have been held for over 12 months. The trustee has elected for CGT relief.

Step 1: calculate the amount of the SMSF that is tax exempt

$$Exempt\ Amount = \frac{Average\ value\ of\ only\ the\ current\ pension}{Average\ total\ value\ of\ all\ superannuation} = \frac{4}{6} = \frac{2}{3}$$

The two-third is the pension amount which receives the new CB with no CGT consequences. The remaining one-third is the accumulation amount and is subject to CGT.

Step 2: determine the notional capital gain (NCG) on 30 June 2017

= MV — CB
= 6,000,000 – 500,000 = $5.5 million

Step 3: calculate the capital gain that is exempt from CGT

= 1/3 x capital gain
= (1/3 x $6,000,000) – (1/3 x $500,000) = $1.83 million

Step 4: the CGT for FY 2017

CGT in FY 2017
= $1.84 million x [15% x (1 – 1/3)][21]
= $184,000 with a CB of $6 million

If the SMSF trustee does not elect to apply the CGT relief it means that they suffer CGT of $5.5 million x [15% x (1 – 1/3)] = $550,000.

Method 2: defer notional tax on accumulation assets until they are sold

An SMSF trustee can defer the accumulation NCG until that asset is eventually disposed of.[22] Deferring an otherwise upfront tax payment is usually highly beneficial to the member.[23] If the SMSF trustee elects to defer the NCG then the non-exempt portion is not included in the SMSF's assessable income until the asset is disposed of.[24]

Example

The Smith Super Fund purchased 1000 listed shares on 1 July 2006 for $40,000 (this means that the shares' CB is $40,000). These shares are now worth $170,000.

The shares are sold in 6 years' time. A deferment can be used if the SMSF trustee defers the gain on the non-exempt portion of the fund until the event occurs.

Unrealised capital gain
= 170,000 – 70,000
= $100,000

Capital gain
= 100,000 x (1 – 1/3)
= $66,667

The SMSF trustee has an opportunity to reset the CB of these shares to their market value. As 50% of the fund is in pension mode for FY 2017, the capital gain is:
= $66,667 x 50%
= $33,333.50 NCG arises in FY 2017.

Conclusions

It may be argued that there is an obligation to inform all trustees of SMSFs under the accountant's care of this opportunity. Beware, a client may have recently started a pension without the accountant's knowledge. It may be prudent to send information to all SMSF clients. To follow is some wording that an accountant may wish to base their letter upon.

Accountant's sample letter to client

> I am writing to all SMSF clients. If you have a pension or transition to retirement income stream (TRIS) (or had the right to set one up), then before midnight 30 June 2017 consider whether you need to elect to change the cost base of some of the assets. This generally has a favourable tax result as it may reduce the capital gain that you pay when you eventually sell that asset.
> The issues are complex. If you instruct us, then we would be happy to review your Super fund on an asset-by-asset basis. This is to determine whether an election should be made for some of the assets.
> Each election is irrevocable. Once the election is made, it cannot be reversed.

Part IVA of the ITAA 1936

As with any tax benefit strategy, Pt IVA of the ITAA 1936 is always a consideration. CB resetting is an ideal opportunity to reduce CGT on assets and save the 10% CGT.[25] Therefore, consider whether it is a "scheme" that helps the SMSF member minimise potential future CGT exposure.[26] Advisors must not artificially manipulate clients' circumstances to meet the CGT relief provisions.

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The author wishes to acknowledge the research undertaken by Legal Consolidated Barristers & Solicitors' Intern, Natalie Connor, LLB, BCom, law and commerce graduate from The University of Western Australia.

Footnotes

1. The LCG 2016/8 was released previously in draft form as Draft LCG 2016/8 and now includes more examples to illustrate the operation of the capital gains tax (CGT) relief where a fund uses the segregated method throughout the pre-commencement period (9 November 2016 to 30 June 2017).
2. The TBC starts at $1.6 million and is indexed periodically in $100,000 increments in line with consumer price index (CPI). If your pension balance exceeds $1.6 million the excess must be transferred out of the pension account. The transfer of the excess can be dealt with in two ways: transferring to accumulation or by withdrawing the excess from the superannuation fund. See ATO "Transfer balance cap" (28 March 2017) www.ato.gov.au/individuals/super/accessing-your-super/transfer-balance-cap/. See also, T Power "Burden for retirees: monitoring $1.6 million transfer balance cap" (29 March 2017) www.superguide.com.au/retirement-planning/liberals-1-6-million-cap-pension-start-balances.
3. See Australian Government The Treasury "Improving the integrity of transition to retirement income streams" (9 November 2016) www.budget.gov.au/2016-17/content/glossies/tax_super/downloads/FS-Super/11-SFS-Improve_integrity_of_transition_to_retirement_income_streams-161109.pdf.
4. A member is able to make a commutation election pursuant to s 136–20 of the ITAA 1936. The election applies on a per asset basis, not on a per asset class.
5. The conditions are outlined at ATO "Conditions of release" (2 May 2016) www.ato.gov.au/Super/Self-managed-super-funds/Paying-benefits/Conditions-of-release/.
6. LCG 2016/8, at [3A]. For more explanation on the legislative changes, see D Butler and G Chau "TRIS strategies after 1 July 2017" (2017) 51(8) *Taxation in Australia* 443.
7. This is because such assets are no longer protected by the pension exemption after 1 July 2017.
8. The segregated method is not available unless the fund was segregated before 9 November 2016. This is the date that the proposed legislation was announced.
9. For an explanation on the Segregation Model see: see D Butler and G Chau "Transitional CGT relief for pension and TRIS assets for FY2017" (21 December 2016) www.dbalawyers.com.au/federal-budget/transitional-cgt-relief-pension-tris-assets-fy2017. See also LCG 2016/8, at [19]–[27].
10. Under s 295–387 of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997), from 1 July 2017, the SMSF is no longer permitted to apply the segregated method to calculate the exempt income where a member is in pension phase and has over $1.6 million in superannuation.

11. In contrast, a capital loss is usually lost if the fund is in segregated pension mode.
12. ITAA 1997, Div 115.
13. The relevance of 9 November 2016 is that it was the day the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (Cth) was tabled in the House of Representatives. The Bill became Act No 81 of 2016 (Treasury Laws Amendment (Fair and Sustainable Superannuation) Act 2016 (Cth) (FSSA)) on assent on 29 November 2016.
14. Income Tax (Transitional Provisions) Act 1997 (Cth) (IT(TP)A), ss 294–110(1)(c) and 294–115(1)(c) require an asset to be held throughout the Pre-Commencement Period.
15. This was inserted by the FSSA.
16. The difference between the segregated method and proportionate is that the CB reset will trigger a capital gain on assets not fully in pension phase. Therefore, it triggers a potential tax on capital gain.
17. It is determined in accordance with the formula set out in s 295–390 of the ITAA 1997.
18. See LCG 2016/8, at [54]. If the fund ceases, for an instant in time, it is deemed to have disposed of the relevant CGT asset at the applicable sale time, and CGT event A1 will be triggered.
19. IT(TP)A, ss 294–110(3)(a) and 294–115(3)(a).
20. LCG 2016/8, at [58].
21. Applying s 115–25 of the ITAA 1997.
22. The SMSF may choose not to defer any capital gain. Proposition for this statement is based on Example 3.61 in the Explanatory Memorandum to the Treasury Laws Amendment (Fair and Sustainable Superannuation) Bill 2016 (Cth). For example, the Trustee of the SMSF sells the asset or it is transferred in specie to a member. This is under s 294–120 of the IT(TP)A.
23. See s 294–120(4) of the IT(TP)A.
24. IT(TP)A, s 294–120(4).
25. The CGT rate is 15% but this is automatically reduced by one-third, making the CGT rate 10% if the member holds the asset for greater than 12 months. See ITAA 1997, s 115–25.
26. ITAA 1936, s 177D.

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Australian Tax Law
Bulletin

Leasehold property and the deductibility of stamp duty

John McLaren *CHARLES DARWIN UNIVERSITY and* ***John Passant*** *THE AUSTRALIAN NATIONAL UNIVERSITY*

Introduction

The purpose of this paper is to explain the operation of s 25–20 of the Income Tax Assessment Act 1997 (Cth) (ITAA97) and the legal basis for the deductibility of stamp duty on leases if the property is used for the purposes of earning assessable income and to raise awareness of the existence of this important section of the ITAA97. The reason why there is an important need to produce this paper is that over the past few months senior tax agents and accountants working in Victoria and the NT have been asked this question: is stamp duty a deductible expense if the property is being used for income producing purposes in the ACT?[1] The answer has always been a resounding "no". The second question that has been asked is if the investment property is leasehold title and not freehold title, would that make any difference to your answer? The response has also been a resounding "no". The explanation has always been that stamp duty is a capital expense and therefore not deductible, but it becomes part of the cost base for capital gains tax purposes when the investment property is sold. The logical approach that is taken is that stamp duty is a one-off expense and is regarded as being of a capital nature and caught by the first negative limb of s 8–1 of the ITAA97. The accountant or tax agent knows that it will form part of the second element of the cost base for capital gains tax purposes pursuant to s 110–25 of the ITAA97. This view is reinforced by s 110–35(4) where stamp duty is listed specifically as an "incidental cost", namely the second element for cost base purposes. This will always be the correct approach when the interest in the real property that is being used for income producing purposes is freehold and not leasehold.

To be fair to those senior tax agents and accountants if they had been practicing their professions in the ACT, then they would probably know that the answer to the first question is a resounding "yes". All real property in the ACT is of leasehold title and there is no freehold title in the land. People who own their own house or business premises in the ACT have a 99-year lease over the land. This means that as a consequence of the operation of s 25–20, where the leasehold property in the ACT is purchased for rental purposes and stamp duty paid to the ACT Government will be deductible.[2] But, what is of great concern is that many pastoral properties in the NT and WA are of leasehold title and stamp duty is paid by the lessee. Many commercial properties are leased for many years and therefore their interest in the real property is a leasehold interest and stamp duty is paid. As will be seen later in this paper, agricultural schemes involving trees and fruit plantations also involve the land being used to grow the trees and the investor obtains a leasehold interest in the real property where the produce is being grown. The Stamp Duty Act 1978 (NT) specifically imposes stamp duty on both freehold and leasehold interests in real property.

For ease of understanding it is worthwhile to briefly explain the difference between a leasehold title to land and a freehold title to land. The starting point is to state that property is classified by law as being either real property or personal property.[3] Real property consists of land and anything attached to it such as minerals, trees and buildings.[4] Personal property is all property that is not real property such as tangible things, namely cars, books or intangible things, namely intellectual property rights or shares in a company.[5] All interests in land are "real" except for leases which are classed as "personalty".[6] The Crown, or as is the case in Australia, the Commonwealth Government or the governments of the states or territory own all real property absolutely. All you receive when you purchase real property from the government or a previous owner is an "interest" in the land.[7] An interest in land can be held either as a freehold interest or as a leasehold interest. A freehold estate is for an undefined period of time whereas a leasehold interest is for a certain period. In the case of all real property in the ACT, it is leasehold for a period of 99 years for residential purposes and a reduced period for commercial or pastoral leases.

Leasehold and stamp duty

For the purposes of this paper, the most important section that is often forgotten is s 25–20 of the ITAA97.

It is not always remembered by accountants and tax agents when preparing a client's tax return. The section allows for expenses incurred in the acquisition of an interest in leasehold real property to be claimed as a deduction against assessable income.

The specific deduction, "Lease document expenses", s 25–20 states:

> (1) You can deduct expenditure you incur for preparing, registering or stamping:
> (a) a lease of property; or
> (b) an assignment or surrender of a lease of property;
> if you have used or will use the property *solely* for the purpose of producing assessable income.
>
> Property used partly for that purpose
> (2) If you have used, or will use, the leased property only *partly* for that purpose, you can deduct the expenditure to the extent that you have used, or will use, the leased property for that purpose.

In particular, the expense associated with paying stamp duty to a state or territory government on the value of the leasehold interest in the land is deductible pursuant to s 25–20 of the ITAA97 if the leasehold property is being used in an income producing activity. The section essentially allows a capital expense to be immediately deductible where the leasehold property is used for income producing purposes. Professor Ross Parsons, in his authoritative work published in 1985,[8] recognised the operation of s 68 of the Income Tax Assessment Act 1936 (Cth) (ITAA 36), now s 25–20 as prevailing over s 51(1) now s 8–1. He makes the following statement as to how the two sections interact:

> The words of the section must have a wide operation, and will for the most part cover situations where s 51(1) (s 8–1) would not allow a deduction. A lease of property will most often be a structural asset of the lessee, though the possibility that a lease is in some circumstances a wasting revenue asset should not be excluded. If s 68 and s 51(1) do overlap, problems of correlation will not arise since each section will have the same operation. At least this is so if s 51(1) gives an immediate deduction, as clearly s 68 does, of costs of a wasting revenue asset. The view has been expressed above that the expense under s 51(1) should be spread over the life of the wasting revenue asset. If there is overlap and a problem of correlation arises, s 68 (s 25–20) will, presumably, prevail as the more specific provision.
> There will be a number of situations within s 68 (s 25–20) where a deduction would not be allowable under s 51(1) (s 8–1) because the expense is not a working expense or it is not contemporaneous.[9]

The deductibility of stamp duty in the ACT is well-known because of the fact that all real property consists of leasehold title. As the Australian Taxation Office (ATO) says in its guide for rental property owners *Rental Properties 2016*:

> **Lease document expenses**
> Your share of the costs of preparing and registering a lease and the cost of stamp duty on a lease are deductible to the extent that you have used, or will use, the property to produce income. This includes any such costs associated with an assignment or surrender of a lease.
> For example, freehold title cannot be obtained for properties in the Australian Capital Territory (ACT). They are commonly acquired under a 99-year crown lease. Therefore, stamp duty, preparation and registration costs you incur on the lease of an ACT property are deductible to the extent that you use the property as a rental property.[10]

However, clearly the deductibility of the stamp duty is not just limited to rental properties or the ACT. Stamp duty on any leasehold interest in real property, if it is used for the purpose of producing assessable income, is deductible under s 25–20 of the ITAA97. The ATO has confirmed the deductibility of stamp duty in a range of circumstances in product rulings relating to agricultural investment schemes. A few of these rulings are listed below just to reinforce the application of s 25–20 of the ITAA97 to a wide range of circumstances.

Product rulings and the deductibility of stamp duty

These seven ATO Rulings all say that the cost of stamping the lease for the various agricultural projects is deductible under s 25–20. Those leases appear mainly to be in WA. Many of the tax-effective agricultural investment projects that were heavily marketed in the late 1990s and early 2000s all involved the investor owning an interest in an agricultural product or timber on land leased from the original title holder.[11] All of these investment projects obtained product rulings from the ATO in order to give the investor an assurance as to the level of tax deductions that were available. Clearly the ATO confirmed that stamp duty on the leased land was deductible.

- TR 2005/6 — Income tax: lease surrender receipts and payments (as at 29 November 2006)
- PR 2009/11 — Income tax: 2007 Macgrove Project (2009 Growers) (as at 18 March 2009) — establishment of macadamia trees in Queensland:

  > (vi) The fee for registering and stamping the Sub Leases is a lease document expense and deductible in full under section 25–20 in the year that it is incurred. It is incurred for acquiring a sub lease over a property that is used or is to be used during the Term of the Project solely for income producing purposes.

- PR 2008/8 — Income tax: Mediterranean Olives Project 2008 — (Growers not in Joint Venture) (as at 6 February 2008)
- PR 2007/104 — Income tax: WA Blue Gum Project 2008 (Growers not in Joint Venture) (as at 19 December 2007)

- PR 2007/103 — Income tax: WA Blue Gum Project 2008 (Joint Venture Growers) (as at 19 December 2007)
- PR 2007/38 — Income tax: WA Blue Gum Project 2007 Joint Venture Growers (as at 18 April 2007)
- PR 2007/37 — Income tax: WA Blue Gum Project 2007 not Joint Venture Growers (as at 18 April 2007)

These Rulings confirm beyond doubt that s 25–20 allows for the deductibility of stamp duty costs in relation to leases of real property used for the purposes of earning assessable income.

Conclusion

It is very difficult for tax practitioners to know every section of the ITAA97 or the ITAA 36. Tax practitioners do have a very good knowledge of the general taxation law and how to apply it to a wide range of practical matters that occur within their practice and their clients. However, s 25–20 of the ITAA97 is sometimes overlooked because practitioners are usually dealing with clients that have investments in real property having a freehold title and not a leasehold title in the land. The exception being tax practitioners that operate in the ACT. It is important to be aware of the application of s 25–20 because investors in property are now finding that more land is being sold as leasehold interests when the various governments in Australia want to retain their absolute interest in the land but are content to see it being used for a certain period of time. Many of the large cattle stations that are being sold to foreign investors in the NT are of leasehold title and not freehold title and eventually the lease runs its term and the land reverts to the government or the lease is renewed. However, one very substantial advantage that these investors have is that the stamp duty paid to the NT Government is a deductible expense for income tax purposes.

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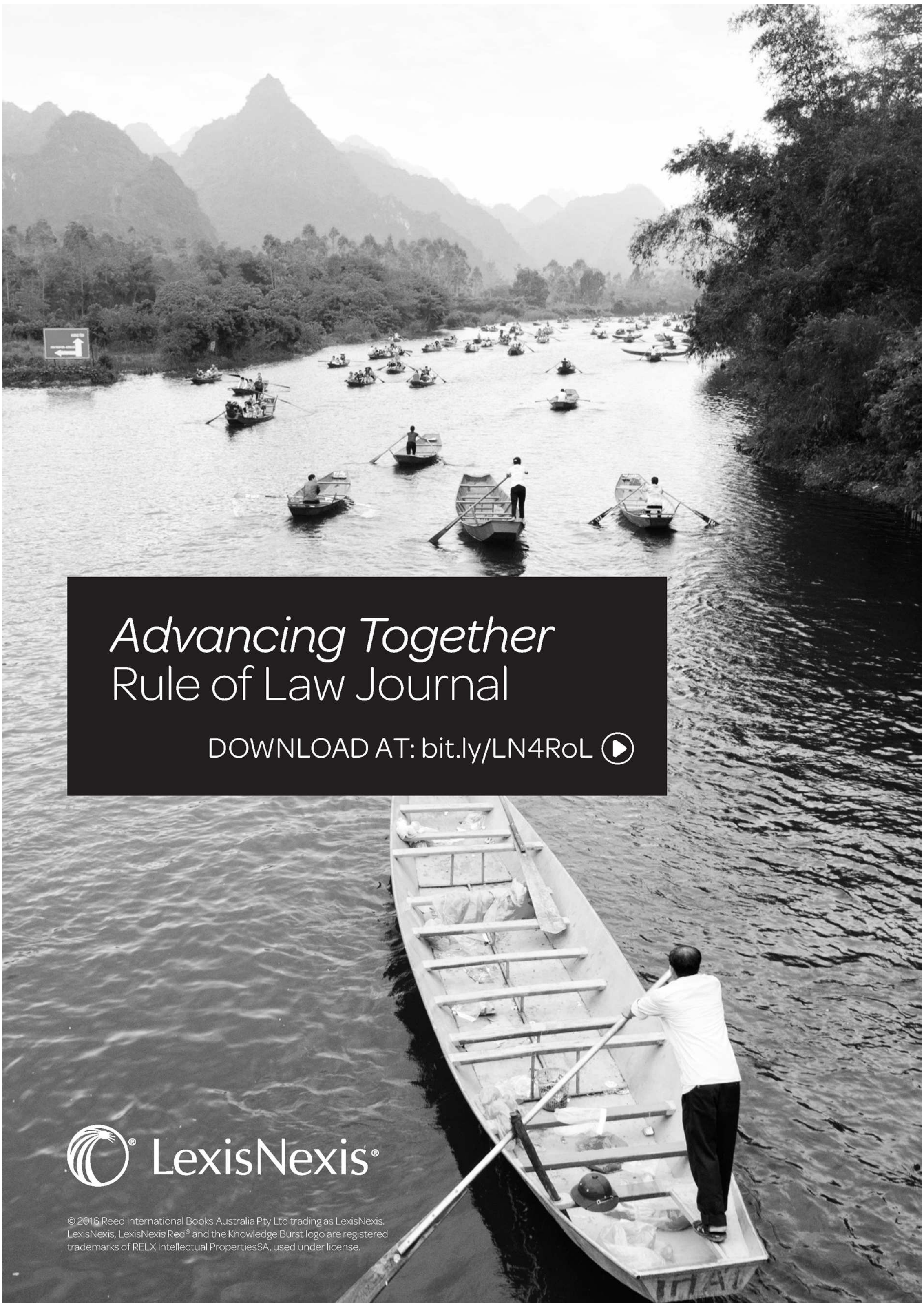
This article has been subject to independent review.

Footnotes

1. On 30 December 2016 when discussing the sale of the tax practice with a very senior tax agent of 35 years' experience in Melbourne and asking the same two questions of two senior tax agents at a function in Darwin on 9 December 2016.
2. The ACT Government has a long-term plan which has been in operation for more than 4 years to remove stamp duty and replace it with annual land taxes. At present there is a hybrid arrangement where each year, stamp duty reduces and land tax is increasing. See J McLaren "The Australian Capital Territory has adopted measures to abolish stamp duty and impose a land tax on all real property: will this approach be adopted by other states in Australia?" (2013) 8(1) *Journal of the Australasian Tax Teachers Association* 101.
3. C Turner and J Trone *Australian Commercial Law* Lawbook Co, 2017 p 514.
4. Above n 3.
5. Above n 3.
6. Above n 3, p 522.
7. Above n 3.
8. R W Parsons *Income Taxation in Australia: Principles of Income, Deductibility and Tax Accounting* The Law Book Co, 2011 (facsimile reproduction).
9. Above n 8, p 551.
10. ATO *Rental Properties 2016* (2016) 14 www.ato.gov.au/uploadedfiles/content/mei/downloads/rental-properties-2016.pdf.
11. Many of the problems faced by investors in the now-failed managed investment schemes developed by Timbercorp or Gunns in timber projects were a result of the investor not being able to harvest the timber growing on the land as the leasehold title had reverted to the owner of the freehold title.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Australian Tax Law
Bulletin

Revisiting Div 7A — a critique of the current ATO position

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Division 7A of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936) is a complex set of rules. The interpretation of the provisions contained within this Division has historically been contentious and difficult ever since the Australian Taxation Office (ATO) released binding guidance in Taxation Ruling (TR) 2010/3 "Division 7A loans: trust entitlements" (TR 2010/3). This article revisits and critiques this interpretation to provide practitioners with guidance in relation to their approach to what can be a fiendishly difficult exercise in practice.

Current state of play — ATO position over time

The ATO's official position in relation to an unpaid present entitlement (UPE) in relation to whether this type of equitable obligation falls within the extended definition of loan is based upon certain circumstances and the date on which they changed their view of these provisions in TR 2010/3. Prior to this tax ruling, the ATO did not hold this view.

This ATO approach can be artificial and has created a degree of ambiguity for tax practitioners. It is important to understand that the ATO position is one of many views on the issue and an independent analysis of the law may yield a different interpretation.

Legislative analysis

The genesis of the current Div 7A rules was enacted by Taxation Laws Amendment Bill (No 3) 1998 (Cth) introduced on 4 December 1997. The wording of the provision examined by this article is contained in s 109D(3) of the ITAA 1936 as follows:

> In this Division, ***loan*** includes:
> (a) an advance of money; and
> (b) a provision of credit or any other form of financial accommodation; and
> (c) a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and
> (d) a transaction (whatever its terms or form) which in substance effects a loan of money.

The first step in interpreting legislation is to try to determine the correct construction of the relevant legislative provision by reference to the provision itself without the aid of interpretative materials. This methodology is supported by High Court authority, for instance see *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* as follows:

> This court has stated on many occasions that the task of statutory construction must begin with a consideration of the text itself. Historical considerations and extrinsic materials cannot be relied on to displace the clear meaning of the text. The language which has actually been employed in the text of legislation is the surest guide to legislative intention.[1]

This rule of interpretation enunciated by the High Court was accompanied with guidance on how extrinsic materials should be used by practitioners to support characterisation of a legislative provision as follows: "Ultimately it is the text, construed according to such principles of interpretation as provide rational assistance in the circumstances of a particular case, that is controlling."[2]

The legal rule boils down to ascertaining the clear meaning of a provision. Where this is judged not to be possible the legislation should be interpreted using documents or texts that give rational assistance to determine the appropriate construction in the circumstances.

Contrast of different characterisations

There are obviously both liberal and narrow constructions that can apply to the words of any provision. Section 109D of the ITAA 1936 is no exception. A wide interpretation of the provision in question may characterise the words "provision of credit or any other form of financial accommodation" to mean any debit arising on behalf of a shareholder or their associate disclosed on a balance sheet of a company or not disclosed at all.

On the other hand, this same wording in the provision may only be enlivened where certain criteria are met or in certain circumstances. The critical issue in interpretation is always the meaning of the words in their current context. A practitioner should be alive to the need to interpret provisions in accordance with the High Court methodology and established principles of interpretation. In doing this, it would be remiss not to consider how the use of aids and external documents are used to assist in the characterisation process. This exercise should be done without displacing the clear meaning of the legislation in a particular set of circumstances.

These methodologies and principles should then be examined in light of the official ATO position in relation to the extended definition of the word "loan" for Div 7A purposes. It is important that a practitioner performs their own characterisation before examining the ATO position critically to ensure integrity in the position they hold.

Plain view of provision

The plain view of what s 109D(3) of the ITAA 1936 means can be broken down into its component parts. Then a practitioner should try to discern the provision's meaning without reference to anything else. The two key concepts when reviewing the provision are as follows:

- the word "loan" and an expansion of the definition of that word to include four other types of amounts; and
- the following key matters that form part of the expanded definition:
  - — an advance of money;
  - — provision of credit or any other form of financial accommodation;
  - — where there is an express or implied obligation to repay an amount, a payment of an amount for, on account of, on behalf of or at the request of, an entity; and
  - — a transaction (whatever its terms or form) which in substance effects a loan of money.

While this exercise seems obvious, it assists in the more difficult parts of the analysis to follow. Essentially, a practitioner should go through the component parts of the definition and characterise them.

Loan — ordinary meaning

It is settled by the Full Federal Court decision *Commissioner of Taxation v Radilo Enterprises Pty Ltd*[3] (*Radilo*) that the word "loan" for the purposes of a predecessor of the provision in question takes its ordinary meaning defined as such:

> A loan of money may be defined, in general terms, as a simple contract whereby one person (the lender) pays or agrees to pay a sum of money in consideration of a promise by another person (the borrower) to repay the money upon demand or at a fixed date. The promise of repayment may or may not be coupled with a promise to pay interest on the money so paid. The essence of the transaction is the promise of repayment.
>
> As Lowe J put it in a judgment delivered on behalf of himself and Gavan Duffy and Martin JJ: "'Lend' in its ordinary meaning in our view imports an obligation on the borrower to repay" … Repayment is the ingredient which links together the definitions of "loan" to be found in the Oxford English Dictionary, the various legal dictionaries and the text books. In essence then a loan is a payment of money to or for someone on the condition that it will be repaid.[4]

The meaning of the word loan is generally defined as one in which there is a contract between the borrower and lender. Furthermore, the lender agrees to pay out an amount of money to the borrower in exchange for the borrower agreeing to repay that amount when demanded or at some future time and date.

Advance of money

This term expands the meaning of the ordinary word "loan" interpreted above. While some overlap exists between this term and the ordinary meaning of the word loan, it should be borne in mind however that the focus of the process of characterisation should be on what constitutes an advance of money, but is not a loan within the ordinary meaning of that word.

Put simply, an advance of money from a company to a shareholder or their associate is captured here. For instance where that person performs services for the company without a contract specifically in place governing these services between the parties, although the arrangement would not meet the definition of the word loan, it would clearly fall into the definition of an advance of money.

Obligation to repay — both express and implied

This term can be further simplified into two component parts. These two components should be satisfied before a transaction can be captured under this part of the expanded definition. The components are:

- an express or implied obligation to repay an amount must be on foot; and
- payment of the sum for any of the following reasons by the company must exist:
  - — for an entity
  - — on account of an entity; or
  - — on behalf of or at the request of an entity.

This extension to the ordinary meaning of the word loan is actually a payment. Based on a literal reading of this limb, this term brings into the definition of the word loan actual payments where they are made because of an express or implied obligation to repay an amount by shareholders or their associates.

The payment needs to be to a third party for, on account of, on behalf of, or at the request of, the shareholder or associate. There may also be an overlap here between this limb and the ordinary meaning of the word loan.

Substance of the transaction is a loan of money

This limb acts as a "catch-all" type of provision. Where a transaction does not fit into any other limb and does not meet the ordinary definition but in essence is a loan of money is the requirement to repay an amount.

Here an established legal principle may be of some assistance. The doctrine of ejusdem generis may, in interpreting this limb, shed light on intended meaning of this part of the provision. This doctrine generally applies where a list of objects which share some key feature are followed by a general "catch-all" phrase. The general catch-all is limited to things of the same type as the preceding items with that same key feature. This principle can potentially apply to limit the very wide definition that could be applied to this term used in s 109D(3) of the ITAA 1936.

The definition that applies to the words "a transaction (whatever its terms or form) which in substance effects a loan of money" cannot therefore extend the definition of the word "loan" other than to types of amounts with the same key feature contemplated by the other items in the subsection. It will merely serve to catch amounts of the same type that may have different terms or be in a different form.

Provision of credit or any other form of financial accommodation

The provision the ATO utilises to bring in UPEs is the provision of credit or financial accommodation. This is the most contentious part of the construction exercise. This is where a practitioner should take care when reviewing the external interpretative aids so as not to fall foul of the established legal principles of statutory interpretation. The interpretation should always implement a rational approach given the circumstances so as not to displace the meaning of the actual provision.

The starting point is clearly in other parts of the legislation. The term "credit or any other form of financial accommodation" is actually used in s 109B of the ITAA 1936. This provision is the simplified outline to Div 7A, so it is reasonable to assume that this simplified outline will help in discerning the aim or purpose of Div 7A. The framework provides important context to aid understanding of a practitioner in determining the vital extended definition of the word "loan". Another aid may be the legislative history of the provision especially where a relevant provision is amended. Finally, the other provisions forming part of the Division can provide guidance.

Once a practitioner has gone through this review, they should then apply case law within this context. However, as ever care should be taken to ensure the case law interpretation does not displace the meaning of the words used in s 109D(3) of the ITAA 1936.

History and outline — Div 7A

The extended definition of the word "loan" was part of the original enactment of Div 7A under Taxation Laws Amendment Bill (No 7) 1997 (Cth). The Explanatory Memorandum to that Bill stated that the purpose of Div 7A was as follows:

> The purpose of the amendments is to ensure that private companies will no longer be able to make tax-free distributions of profits to shareholders (and their associates) in the form of payments or loans.

Subdivision E was also enacted at the time of the above Bill. Division 7A was then subsequently amended by the Tax Laws Amendment (2004 Measures No 1) Bill 2004 (Cth) to insert Subdiv EA and EB in support of Subdiv E. This amendment widened the scope of Div 7A in relation to interposed entities. When provisions are amended or inserted, the purpose of the amending legislation is often to rectify potential deficiencies in the original legislation. Relevantly, the Explanatory Memorandum to the amendments described the purpose of the amendment as follows:

> To ensure that a trustee cannot shelter trust income at the prevailing company tax rate by creating a present entitlement to a private company without paying it and then distributing the underlying cash to a shareholder of the company.[5]

The mischief that is trying to be prevented by this amendment is the distribution of underlying cash to shareholders (and associates) of a company where the trust income is being taxed at company rates.

Other provisions of legislation

Subdivision EA deals with the situation where a present entitlement between a company and trust exists. In order for Subdiv EA to apply, the trust must also have a loan, payment or forgiven amount to a shareholder or associate of the company. The complicating factor in applying these rules is considering the term "associate" defined by s 318 of the ITAA 1936 being so wide. The reason this is difficult is due to a trust often being an "associate" or shareholder of a private company. If the extended definition of loan included a UPE, wouldn't this mean that the trust would be subject to the primary provisions dealing with a payment, loan or forgiven debt?

A number of provisions attempt to clarify which Subdivisions will apply to transactions caught by Div 7A. Examples of two such provisions are as follows:

- section 109T(3) of the ITAA 1936 which excludes Subdiv E from applying where a payment or loan is made that is otherwise assessable under Div 7A; and
- section 109XI(3) of the ITAA 1936 which excludes Subdiv EB from applying where an amount is assessable under Subdiv EA because of the present entitlement of an interposed trust.

The striking thing is that Subdiv EA does not have an equivalent rule. Essentially, Subdiv EA deems an amount to be assessable income (referred to as the "Division 7A amount") where the amount was to attract the operation of the other Div 7A provisions under the following two conditions:

- the trust was deemed to be a company; and
- the shareholders and associates of the actual company were taken to be those of the deemed company.

This point is explored in more depth and discussed regarding the extended definition of the word loan later on in the article.

Division 7A — generally

Division 7A generally makes it clear three types of transactions are subject to its rules and should be treated as a dividend, subject of course to a company's distributable surplus. These are:

- amounts paid by the company to a shareholder or their associate (s 109C);
- amounts lent by the company to a shareholder or their associate (ss 109D and 109E); and
- amounts of debts owed by a shareholder or their associate to the company that the company forgives (s 109F).

The simplified outline contained in s 109B of the ITAA 1936 is important. This provision guides a practitioner to specific parts of the Division. This observation leads to the logical conclusion that the reference to sections links those sections with the specific amounts outlined by the dot points.

This conclusion can be applied to s 109D of the ITAA 1936 as it is contained within s 109B (the middle dot point) which should deal specifically with "amounts lent by the company to a shareholder or shareholder's associate". Section 109D(3) of the ITAA 1936 should be read within this context.

The word loan and its extended meaning should be considered in this context as covering all "amounts lent". Care should again be taken that the clear wording of the provision should not be displaced and a practitioner should not ascribe a meaning where one does not rightly exist.

The outline of the Division pursuant to s 109B of the ITAA 1936 describes Subdiv E with reference to amounts lent or paid through interposed entities. The outline then goes on to observe that an amount should be included in the assessable income of a shareholder or associate of a shareholder under the following two conditions:

- a company has a UPE to income of a trust; and
- the trustee makes a payment or loan to, or forgives a debt of, the shareholder or associate (see Subdivs EA and EB).

There are perhaps two important things to note about this part of the outline of the Division. First, they state that an amount is included in the shareholder or associate of the shareholder's assessable income where both of the above conditions are satisfied. Second, the provision refers to specific sections much like the first three dot points and that logically this infers that the situation described by the dot points is dealt with by the sections referred to.

The five situations described by the outline can therefore be summarised diagrammatically as shown below. The simplified outline of Div 7A in s 109B of the ITAA 1936 attempts to impose a structure on the Division. The structure can be described as one in which particular provisions or Subdivisions deal with different types of amount for the purposes of Div 7A. Note that s 109D is described in the simplified outline as dealing with "amounts lent by the company to a shareholder or shareholder's associate".

Contextual interpretation

The extended definition of the word loan, when read within this framework, suggests that the expanded definition of the word loan should not be taken to re-characterise amounts that are dealt with under other provisions of Div 7A. Rather, the definition of loan should be expanded to capture amounts where this expansion does not impinge on the application of other provisions dealing with these different types of amounts.

Guidance should be sought in terms of when a provision applies by reference to the "tie breaker" provisions contained in the legislation. Another key consideration when reviewing the word "loan" for Div 7A purposes is the Division's ultimate effect. Division 7A includes a dividend under s 44 of the ITAA 1936 in the assessable income of a shareholder or associate who receives the loan, payment or forgiven amount.

The first major interpretative exercise in this context should be to define the words "credit or any other form of financial accommodation". The *Radilo* case provides a definition of the words within the statutory context of a different provision. The case states:

> Similarly, in its statutory context, the expression "or any other form of financial accommodation" refers to a consensual arrangement between the person providing the accommodation and the recipient. Under a consensual arrangement for the provision of credit or financial accommodation [of] principal sum, or its substantial equivalent (by way of indemnity against a liability on maturing bills, for example, in the case of accommodation provided in the form of a bill acceptance facility), will ultimately be payable.

The term "provision of credit or any other form of financial accommodation" should be read within the context of s 109D(3) of the ITAA 1936 however. An extension of the word loan, keeping in mind the operation of Div 7A as a whole, may therefore be different compared to the definition in *Radilo*. The other important thing to note is that the phrase in Div 7A refers to "credit" and this reference does not. The word credit has a debtor and creditor connotation. This may colour the interpretation of the phrase. In summary the requirements in *Radilo* of "other form of financial accommodation" are:

- a consensual arrangement; and
- the provision of a principle sum or its equivalent which will ultimately be payable.

This brings us to the interpretation of the phrase "present entitlement" specifically a UPE. The term "present entitlement" in the context of the ITAA 1936 deems for the purposes of that Act under s 95A of the ITAA 1936 as follows:

- For the purposes of the ITAA 1936, where a beneficiary of a trust estate is presently entitled to any income of the trust estate, the beneficiary shall be taken to continue to be presently entitled to that income notwithstanding that the income is paid to, or applied for the benefit of, the beneficiary.
- For the purposes of the ITAA 1936, where a beneficiary has a vested and indefeasible interest in any of the income of a trust estate but is not presently entitled to that income, the beneficiary shall be deemed to be presently entitled to that income of the trust estate.

In this context it has been considered by a number of High Court cases. For example in *Federal Commissioner of Taxation v Whiting*[6] which stated that present entitlement is "entitled for an interest in possession as contrasted with an interest in expectancy".

Based on the legislative context, "any other form of financial accommodation" seems to suggest that the trust via a consensual arrangement with the company would provide a principle sum or its equivalent that would ultimately be payable to the company. The UPE is essentially the trust setting aside a share of its net income for the beneficiary company. Doubt exists as to both whether a consensual arrangement arises where present entitlement is conferred and also whether the extension of the word loan is so far reaching that it can capture an equitable entitlement when a loan is typically a common law entitlement.

To shed further light on the scope of the extended definition of loan, it is perhaps reasonable to consider whether a UPE would be included within this definition by examining how a UPE is dealt with under Div 7A. In Subdivs EA and EB, specific reference has been made to the term "unpaid present entitlements". Subdivisions EA and EB are two of the provisions that deal with interposed entities under Div 7A. Clearly both provisions deal with interposed entities where these entities are not shareholders or associates of a company. However, where the interposed trust is a shareholder or associate of the private company, the extended definition of the word loan where it is to include a UPE could potentially mean that both s 109D and one of these Subdivisions may apply.

Based on an in-depth reading of particular subsections that guide practitioners as to when certain provisions will apply and when they will be supplanted by other provisions, arguably two potentially more correct inferences are that:

- Subdivision EA deals with *both* interposed entities that are associates of shareholders of a company as well as those that are not; and
- a UPE does not form part of the extended definition of the word loan.

In order to explain these inferences, reference should be made to the primary provisions dealing with payments, loans and debt forgiveness where no interposed entity exists. These provisions essentially usurp Subdiv E where this Subdivision and the primary provisions both potentially apply (see s 109T of the ITAA 1936). This double up only really occurs in the case of a trust that is also an associate or shareholder of the company. Note that Subdiv EA works in a fundamentally different way however. This provision does two things:

- deems that essentially a "notional company" is put in place of the trust; and
- deems the shareholder or associate of the actual company to be the shareholder or associate of the notional company (the trust).

The amount included in the deemed shareholder or associate's assessable income can only be included where it would have been included in their assessable income under another provision of Div 7A given those modifications (see s 109XB(1) of the ITAA 1936). However, the provision that actually applies to include the relevant amount in a shareholder or associate's assessable income is still Subdiv EA. Section 109XB therefore has the effect of removing the UPE for the purposes of determining whether Div 7A should apply.

By doing this, Subdiv EA infers that the other provisions of Div 7A (except Subdiv EB) can only apply when a UPE is not a consideration. The extension of this inference is that the word loan for Div 7A cannot therefore include a UPE.

The ATO's interpretation

The ATO in TR 2010/3 seems to have interpreted the extended definition of the word "loan" to include a UPE. The term "financial accommodation" in the ruling was interpreted using the *Oxford English Dictionary*. The dictionary did not contain the phrase "financial accommodation" so the Commissioner instead took the interpretation of the word "financial" and added it to the interpretation of the word "accommodation". The problem is that this method, while giving the ordinary meaning of both words, is arguably flawed in two ways. First, when the meaning of two words is combined a reader must consider whether the phrase has a different or special meaning by virtue of the words appearing together. Second, the proper legislative context should be considered when applying the words. This means that the subsection in which the words appear, and to a lesser extent the Division, will colour the meaning of the words.

The Commissioner does concede that the scope of the words "financial accommodation" is limited somewhat by the legislative context in which they appear. However, the Commissioner refers to comments made by counsel for the applicant in a Full Federal Court decision *Corporate Initiatives Pty Ltd v Commissioner of Taxation*[7] (*Corporate Initiatives*) concerning a UPE in order to support the characterisation of a UPE as still forming part of the extended definition of the word "loan" as follows: "It is difficult to see the practical difference between a formally recorded loan and what happened here. In effect Eldersmede was the recipient of a loan …"[8]

Counsel went on to state that they thought a benefit was provided to the trustee in that case by the beneficiary not calling for payment of the UPE. The three conditions that the Commissioner believes will make a UPE "financial accommodation" are as follows:

- the supply or grant of some form of pecuniary aid or favour;
- under a consensual arrangement (similarly to *Radilo*); and
- where a principal sum or equivalent is ultimately payable (similarly to *Radilo*).

The Commissioner bases his arguments on the assertion that Div 7A is broadly speaking targeting benefits provided by a private company to shareholders and associates. This is a fairly liberal interpretation of the purpose of Div 7A given the original Explanatory Memorandum states the purpose of the Division is to stop "tax-free distributions of profits to shareholders (and their associates) in the form of payments or loans".

The Commissioner has since released guidance in respect of UPEs and bad debt deductions that may cause further consternation. The relevant guidance is contained in TD 2016/19 "Is a beneficiary of a trust entitled to a deduction under s 25–35 of the Income Tax Assessment Act 1997 for the amount of an unpaid present entitlement to trust income that the beneficiary has purported to write off as a bad debt?"[9] (TD). The Commissioner reasons in this TD that writing off a UPE will not give rise to a bad debt deduction under s 25–35 of the Income Tax Assessment Act 1997 (Cth) (ITAA 1997). This is because he states that a UPE is an equitable right and without more, no debtor-creditor relationship can exist.

The TD admittedly deals with a different provision of the tax law (and should therefore be read in a different context). However, the related concepts and methodologies employed by the Commissioner in this recent guidance, even when accounting for the different context of the provisions, is still difficult to reconcile back to his position in TR 2010/3.

Guidance — Div 7A

The issue of Div 7A can be extremely complex. The Commissioner takes a particular interpretation in terms of what constitutes a loan for the purposes of the provisions. However, the practitioner must keep in mind that the Commissioner's interpretation in the form of comments made in TR 2010/3 should be analysed with reference to other interpretations based on generally accepted rules of statutory interpretation. The ultimate goal of this interpretation should always be to come to the most rational conclusion as to what the words of a provision mean.

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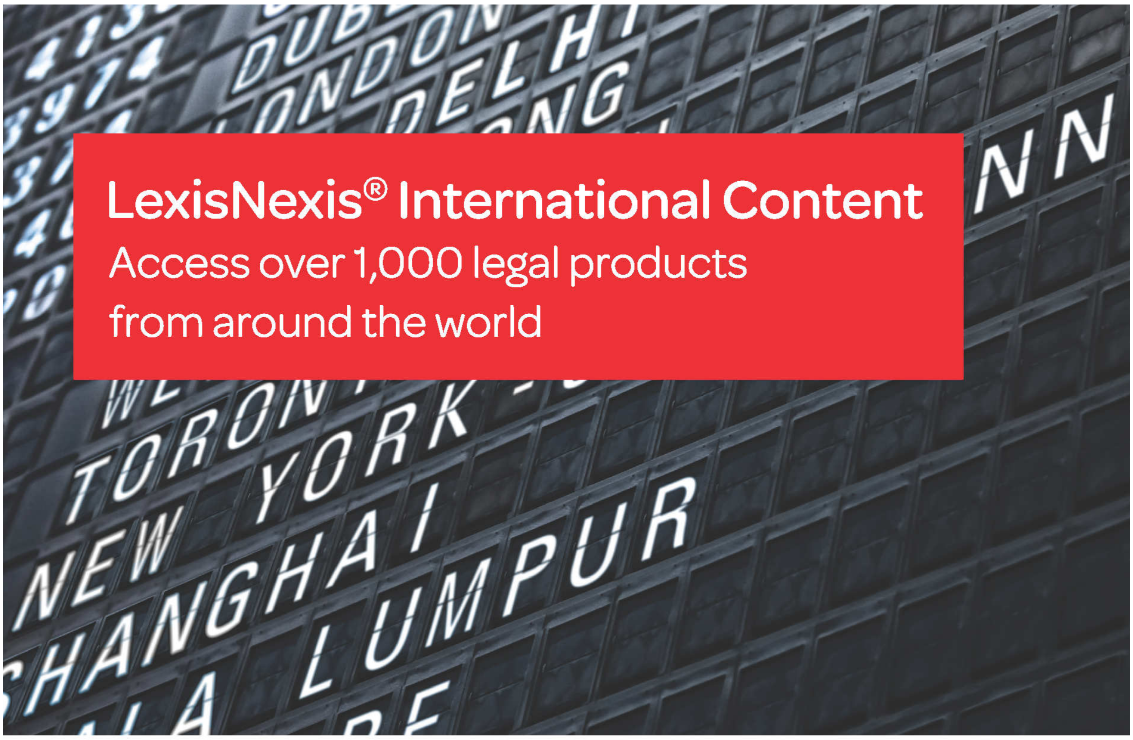
Footnotes

1. *Alcan (NT) Alumina Pty Ltd v Commissioner of Territory Revenue* (2009) 239 CLR 27; (2009) 260 ALR 1; [2009] HCA 41; BC200908882 at [47].

2. Above n 1, at [51].
3. *Commissioner of Taxation v Radilo Enterprises Pty Ltd* (1997) 72 FCR 300.
4. Above n 3 at 313.
5. Explanatory Memorandum, Tax Laws Amendment (2004 Measures No 1) Bill 2004 (Cth) 7.
6. *Federal Commissioner of Taxation v Whiting* [1943] HCA 45.
7. *Corporate Initiatives Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 279; (2005) 219 ALR 339; [2005] FCAFC 62; BC200502493.
8. Above n 7, at [25].
9. Which replaced ATO Interpretative Decision (ID) 2013/15 "Deductions and expenses: unpaid present entitlement and bad debt deduction".



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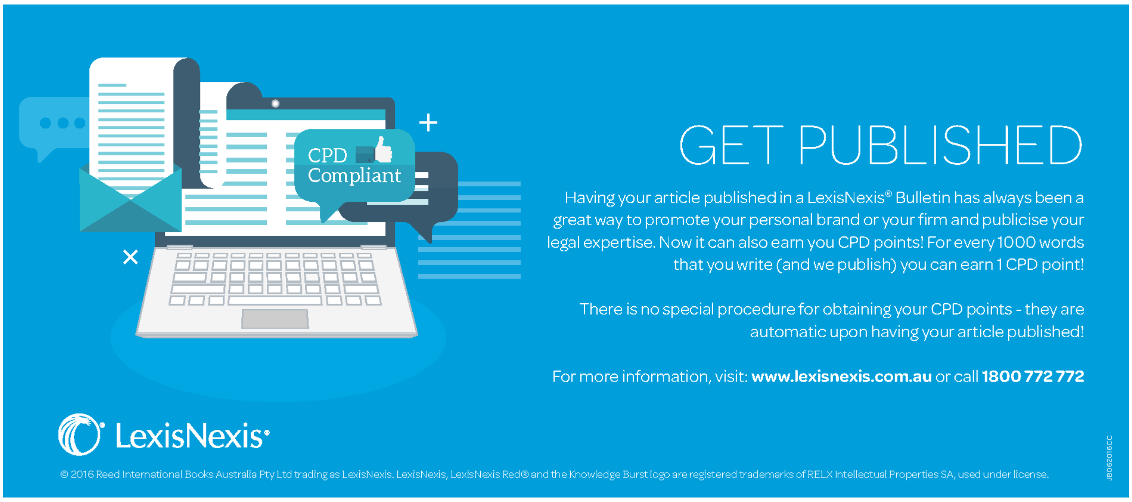

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