

LAWS8421, Income Tax
Group Collaboration and Seminar Participation
ASSESSMENT TASKS 2 & 3

PRACTICAL SCENARIO, INTENSIVE

(Winter Session 2022)

The intensive (Assessment Task 2)

The purpose of the intensive is for you to apply the taxation law theory and principles, introduced in the topic videos, to a real-world scenario. The scenario which you will be considering involves an individual taxpayer whose income tax returns are being subjected to an audit by the Australian Taxation Office (ATO). The period under review by the ATO spans multiple income tax years¹.

Students will be placed in two groups of up to 16 students each. One group will perform the role of the ATO auditors and will be expected to assess whether the taxpayer has understated his tax liability in any of his income tax returns. The other group will act on behalf of the taxpayer and will be expected to respond to any concerns raised by the ATO auditors.

The intensive will be conducted face-to-face on Zoom, from 9.00 am to 12.30 pm, on each of the 25th — 28th July 2022. Each day we will consider a different set of income tax returns. The group acting as ATO auditors will present their views first and the group acting on behalf of the taxpayer will respond. After the formal presentations, there will be an opportunity, each day, for the whole class to discuss the merits of the different views.

Students have been allocated between the two groups on WATTLE. To prepare for the intensive, students will work together, in their online discussion forum, to identify relevant issues and formulate views as to how the taxation law applies to the taxpayer in each of the income tax years. Where there is any uncertainty in the law, those acting as ATO auditors would be expected to prefer views that advance the interests of the tax system as a whole and those acting for the taxpayer would be expected to prefer views which minimise the taxpayer's individual tax liability. The convenors will evaluate each student's contribution to their groups and to discussion during the intensive and that evaluation will form the basis upon which Assessment Task 2 is assessed.

Written judgment (Assessment Task 3)

We are anticipating that the intensive will highlight a number of contentious issues of law. To the extent to which such issues remain unresolved at the end of the intensive you can assume that the following will occur:

- the ATO will amend the affected assessments, pursuant to s 170 ITAA 1936;
- the taxpayer will object under Part IVC of the TAA 1953;

¹ Note, we have taken some liberties with this. Under s 170 of the ITAA 1936, unless there is a question of fraud or evasion, the amendment period for an individual assessment is limited to either two or four years, from the date of assessment, depending on the complexity of the taxpayer's affairs.

- the ATO will disallow the taxpayer's objection; and
- the taxpayer will appeal to the Federal Court.

The appeal will form the basis of Assessment Task 3. That is, students will be expected to decide the issues raised on the appeal by issuing a written judgment. The grounds of appeal will be shared with students on or before 5pm on Friday 29 July. The judgment (2,500 word limit) will be due on or before 5pm, Wednesday, 10 August 2022, via Turnitin.

Group collaboration

Students will communicate with each other using the on-line Wattle discussion forums to discuss the elements of the problem, to share research and other analytical tasks, and to divide up the presentational responsibilities.

It is important that group members establish clear expectations with each other about what they will contribute to the group. Students are to post their contributions to the discussion board. The on-line forums will be available for this purpose from Friday 15 July 2022 until Thursday 28 July.

The course convenors will monitor the on-line forums to ensure that the groups are focusing appropriately on the learning objectives associated with the scenario and to provide any assistance which might be required.

Zoom participation

In order to make this experience both intellectually stimulating and enjoyable we request that you observe the following:

- Do your best to attend all the sessions and let us know in advance if you have to miss any or are going to be late. The sessions will not be recorded.
- Prepare for the intensive, participate actively in the discussions and be assertive with your views but do so in a way which is respectful of others.
- Throughout the online sessions, try and keep your cameras switched on (except when you need privacy) and your microphones switched off (unless you are speaking). By doing so we hope to replicate, to some degree at least, the kind of in-person interaction we might have achieved in a physical classroom.

Technical Notes

When formulating your views as to how the taxation law applies to the taxpayer in a year of income, disregard the possible operation of Division 70 ITAA 1997 (trading stock).

Practical Scenario

Murgatroyd York

For discussion Monday, 25 July

Murgatroyd is a data specialist, employed by Google. He earns salary and wages of \$230,000 per annum plus superannuation.

On 1 August 2010, Murgatroyd York's great uncle Fester died and left Murgatroyd a property in the Northern New South Wales hinterland. Fester had acquired the property in 2005 for \$2 million dollars (including stamp duty and legal fees). The property comprised 3 hectares of gently sloping land with a fine homestead on the top of a hill, and separately, an old two-bedroom overseer's cottage which had been unoccupied as long as anyone could remember. Fester kept a few horses on the property, for his own enjoyment.

Fester lived in the homestead until a year before his death, when he moved into a nursing home in Murwillumbah. Whilst Fester was in the nursing home, a distant cousin, Hinchcliffe, occupied the homestead, and paid the overheads and looked after the horses, in lieu of paying rent.

At the time of Fester's death, the property was worth \$3 million. Fester still owed \$1.0 million on it – an interest only loan at a fixed rate of 5 per cent per annum – mortgaged against the property.

Murgatroyd and the bank agreed that he could take the property and assume the liability on the loan made to Fester. The property passed to him on 1 November 2010, after probate had been obtained on Fester's estate. At the date of transfer, the property was valued at \$3.2 million of which around \$1 million was attributable to the homestead and its curtilage.

Google agreed that Murgatroyd could work remotely, so he promptly moved into the homestead and lived there as his main residence, much in the same way as Fester had. Murgatroyd also liked horses, keeping several of his own. In July 2011, he started agisting horses for friends of friends at a rate of \$100 per horse, per week (which was below market agistment rates of approximately \$150 to \$300 per horse, per week). All of the horses, including Murgatroyd's, were kept in a fenced-off half hectare paddock (with stables). In each of the income tax years ending 30 June 2012 and 30 June 2013, Murgatroyd earned \$35,000 in agistment fees. His direct expenses of agistment, including extra feed provided to the horses as required, were \$10,000 in each of the 2012 and 2013 years. His interest expenses were \$50,000 in each of the 2012 and 2013 years. Rates were \$6,000 for each of those years. Murgatroyd did not pay land tax.

In early March 2013, Murgatroyd became aware that his neighbour was looking to sell 7 hectares of vacant land adjoining Murgatroyd's. This land sloped gently down towards a river. The land was priced at \$5 million as it clearly had subdivisional potential, and had water access.

Murgatroyd had an idea. Though clearly aware of its subdivisional potential, at least in the future, he thought the extra land would make an excellent glamping site, and people could fish, canoe, swim or paddle in the river as they wished. They could also ride his horses. 'Escape Sydney or Brisbane for a long week-end' was what he had in mind. He read some research published by the Glamping Association of Australia and they were predicting that the glamping market was going to grow by 2%, year on year, for the next decade.

Murgatroyd approached the bank he'd dealt with at the time he inherited the homestead. The bank said it would lend him an additional \$5 million on a fully-secured basis (over both properties) at the same interest rate (5% pa) as applied to the loan on the homestead. This would bring Murgatroyd's total borrowings to \$6

million dollars. These terms were satisfactory to Murgatroyd, who was optimistic about the glamping business. He entered into a contract to purchase the land on 30 March 2013. On 1 July 2013, he drew down the additional \$5 million and completed the purchase of the adjoining property.

The bank said that it would keep the loans separate: that is, the original loan with \$1 million owing (Loan 1) and the new \$5 million loan (Loan 2). The loans were structured so that M had to make principal repayments of \$200,000 at the end of each income year (30 June). The principal repayments were firstly to come off Loan 1, and only when Loan 1 was repaid, off Loan 2.

Murgatroyd had sufficient funds of his own to fit out the glamping facilities, which he did, and he started to market the property as a glamping destination. He hired Jack to maintain the glamping sites and to liaise with customers. He agreed to pay Jack \$30,000 pa and to let him live rent free in the overseer's cottage.

Jack's first glampers arrived in August 2013 and by the 30th June 2014, Murgatroyd had received \$375,000 in glamping fees and \$25,000 in agistment fees. However, his operating and marketing expenses for the year, excluding his payments to Jack, totalled \$80,000, his direct agistment expenses were down to \$7,000, and his interest expenses were \$300,000 comprising \$50,000 with respect to Loan 1 and \$250,000 with respect to Loan 2. Rates on the Homestead property were \$6,000 per year; rates on the adjoining land were \$50,000 per year.

In the second financial year (ending 30 June 2015) a pandemic hit and the bottom fell out of the glamping market. In the 2015 year, Murgatroyd had only earned \$300,000 in glamping fees and \$25,000 in agistment fees. Meanwhile, his operating and marketing expenses were only marginally lower at \$60,000 for the year, his direct agistment expenses were \$7,000 and he still employed Jack at \$30,000 pa. His interest expenses were \$290,000 comprising \$40,000 with respect to Loan 1 and \$250,000 with respect to Loan 2. Again, the rates were \$6,000 on the Homestead property and \$50,000 on the adjoining land.

Murgatroyd realised he was not going to be able to make a success of the glamping venture. He closed down his operations at the end of June 2015 and terminated his arrangement with Jack. He also stopped agisting horses.

Murgatroyd has lodged the following income tax returns for the 2012, 2013, 2014 and 2015 income tax years.

Year of Income	30/06/12	30/06/13	30/06/14	30/06/15
Assessable Income	\$265,000	\$265,000	\$630,000	\$555,000
- Salary	\$230,000	\$230,000	\$230,000	\$230,000
- Agistment fees	\$35,000	\$35,000	\$25,000	\$25,000
- Glamping fees	—	—	\$375,000	\$300,000
Allowable Deductions	\$66,000	\$66,000	\$473,000	\$443,000
- Agistment Expenses	\$10,000	\$10,000	\$7,000	\$7,000
- Rates	\$6,000	\$6,000	\$56,000	\$56,000
- Interest	\$50,000	\$50,000	\$300,000	\$290,000
- Salaries	—	—	\$30,000	\$30,000
- Operations & Marketing	—	—	\$80,000	\$60,000
Taxable Income	\$199,000	\$199,000	\$157,000	\$112,000

For discussion, Tuesday 26 July

After the demise of the glamping venture, Murgatroyd decided that he would try to recoup his losses by subdividing and developing the two parcels of land. His plan was to subdivide the original 3 hectare property into 6 lots, made up of four vacant half hectare blocks, a half hectare block including the overseer's cottage, and a half hectare block including the original homestead. The adjoining 7 hectare property would be divided into 14 vacant, half hectare, lots.

At the beginning of July 2015, the original property was thought to be worth \$4 million and the adjoining land was worth \$7 million; Murgatroyd had paid \$400,000 off Loan 1, leaving a balance owing of \$600,000; the balance owing on Loan 2 remained at \$5 million. The fixed interest remained the same at 5%.

Murgatroyd estimates that subdivision and development costs (other than finance) will be in the order of \$2 million, and that the project could take 2—3 years to bring to fruition. His aim is to sell the 18 vacant half hectare lots for around \$1 million each and the block with the overseer's cottage for \$1.5 million (so \$19.5 million gross sales). Murgatroyd intends to retain the homestead for himself.

Initially, Murgatroyd decides to undertake the venture in his own name. In July 2015, he extends the limit on his borrowing facility from the bank by an additional \$2 million dollars. Loans 1 and 2 are consolidated into a single borrowing secured against the title to both properties. The bank agrees to capitalise the interest expense, on an interest only basis, for three years, though now at a variable rather than fixed rate.

Murgatroyd undertakes the subdivision throughout the period August 2015 to 30 June 2017. The legal costs of the subdivision are \$80,000, paid in instalments during the year ending 30 June 2016. Construction of roads, and the provision of services to the new lots (including the overseer's lot), is undertaken during the year ending 30 June 2017. The total cost of this work is \$1.7 million of which \$1.4 million is paid on or before 30 June 2017, and the balance of \$300,000, is paid on 30 July 2018.

Murgatroyd starts his marketing campaign on 1 July 2017. This includes flying prospective buyers from Sydney, to inspect the site. By 30 June 2018 he has incurred \$120,000 in marketing costs (including the cost of chartering light aircraft).

Murgatroyd's additional expenses include accrued interest, debited by the bank to Murgatroyd's loan account, and rates:

- YE 30 June 2016: interest \$300,000; rates \$50,000
- YE 30 June 2017: interest \$340,000; rates \$50,000
- YE 30 June 2018: interest \$260,000; rates \$30,000

Murgatroyd enters into a contract to sell one of the vacant lots for \$1 million on 2 June 2017. That is the price he was hoping for. Subsequently, on 30 August 2017 he enters into contracts to sell 3 other vacant lots, also for \$1 million each. The first contract is completed on 30 July 2017. The other three contracts are completed on 31 October 2017. Of the lots sold, the first two were carved out of the title to the original homestead; the other two, out of the title to the adjoining property. Murgatroyd uses the proceeds of sale and some cash he has inherited to pay down his accrued interest, plus principal, taking the balance owing on his borrowing to \$6.5 million.

Murgatroyd returns a capital gain on each of the sales in the year ending 30 June 2018. For these purposes he treats the two homestead lots as each having a cost base of \$627,016 comprising: 1/6th of the value of the homestead property when it was transferred to him from Fester's estate (\$3.2m) and 1/19th of the

combined subdivision and construction costs (\$1.78m). He treats the other two lots as each having a cost base of \$450,825 comprising: 1/14th of the original cost of the adjoining land (\$5m) and 1/19th of the total subdivision and construction costs (\$1.78m). On that basis he calculates that he made a capital gain of \$372,984 on each of the homestead lots and a capital gain of \$549,175 on each of the other two lots. After applying the 50% CGT discount, he includes a net capital gain of \$922,159 in his assessable income for the year.

Year of Income	30/06/16	30/06/17	30/06/18
Assessable Income	\$230,000	\$230,000	\$1,152,159
- Salary	\$230,000	\$230,000	\$230,000
- Net Capital Gain	—	—	\$922,159
Allowable Deductions	\$350,000	\$390,000	\$690,000
- Rates	\$50,000	\$50,000	\$30,000
- Interest	\$300,000	\$340,000	\$260,000
- Marketing	—	—	\$120,000
- Carried fwd losses	—	—	\$280,000*
Taxable Income	(\$120,000)	(\$160,000)	\$462,159

- Losses carried forward are applied in year order

For discussion, Wednesday 27 July

In August 2018, the bank raises concerns with Murgatroyd that he has only sold four lots. The demand for vacant blocks is softening and the bank doesn't think Murgatroyd will be able to repay and/or service his loan.

Murgatroyd decides the only solution is to find an investor willing to partner up with him. He is introduced to Craig, a property developer. Craig is interested in joining the venture. Craig suggests a tweak to the business model. Rather than try and sell only vacant blocks, he suggests they build houses on the 14 vacant blocks — sell 7 as complete land and house packages — and hold 7 for long-term rental to be sold only when the market improves. They agree that Murgatroyd's contribution to the joint venture will be the 14 vacant lots (ie. not including the homestead and overseer's lots), valued at \$14 million. Craig's contribution will be to inject cash of \$12 million of which \$2 million will be immediately paid to Murgatroyd so he can pay down his loan from the bank and \$10 million will be used to fund the building works. The bank is happy to facilitate the proposed arrangement.

They decide to implement this arrangement by establishing a private company, which will act as the trustee of a unit trust. Murgatroyd and Craig will each own one \$1 share in the trustee company. They will also subscribe for units in the unit trust. The trust will have two classes of units: that is, ordinary and special units. The ordinary units will have a face value of \$1 million each and will entitle holders to a proportionate share of the income of the trust each year (defined to be the net accounting profits), and any surplus capital on winding up. The special units will pay 5% pa and will be redeemable by the holder, at face value, at any time.

On 29 August 2018, Murgatroyd subscribes for 12 ordinary units and two special units. He pays the total subscription amount, of \$14 million, by transferring his title to the 14 vacant lots, to the trustee (the bank having discharged its mortgages over those titles). On the same date, Craig subscribes for 12 ordinary units by paying the trustee \$12 million cash and Murgatroyd elects to redeem his two special units for \$2 million.

Murgatroyd uses the \$2 million, distributed to him by the trustee, to pay down his loan from the bank. After the repayment, Murgatroyd owes the bank \$4.5 million. The loan is secured by continuing mortgages over the homestead and overseer's cottage lots.

Murgatroyd and Craig get cracking and complete the construction of all 14 homes by 30 August 2019. The cost of constructing each house was \$500,000.

During the year ending 30 June 2020, the trustee enters into and completes sales of 7 of the properties for \$2 million each (the proceeds of sale total \$14 million); it rents out the remaining 7 for approximately \$1500 a week each (totalling \$550,000 for the year). Marketing costs total \$200,000. Miscellaneous expenses, including insurance and rates, total \$40,000 and are paid by the trustee.

The trustee determines that the net income of the trust for the year ending 30 June 2020 is \$3,660,000 calculated on the basis that the properties sold were held on revenue account and that capital allowances of \$150,000 were deductible with respect to the rental properties.

The trustee declares a net accounting profit of \$3,810,000 (it doesn't expense capital allowances for accounting purposes) and, on 1 July 2020, distributes the same in equal proportions, to Craig and Murgatroyd (ie. \$1,905,000 each). Murgatroyd uses the distribution (and other personal funds) to repay principal on his loan. He now owes the bank \$2.5 million. His interest expense for each of the 2019 and 2020 income tax years was \$210,000 and \$180,000 respectively.

In the year ending 30 June 2020, Murgatroyd includes in his assessable income, his 50% share of the net income of the trust.

Year of Income	30/06/19	30/06/20
Assessable Income	\$230,000	\$2,060,000
- Salary	\$230,000	\$230,000
- Net Capital Gain	—	—
- Share Net Income	—	\$1,830,000
Allowable Deductions	\$210,000	\$180,000
- Interest	\$210,000	\$180,000
Taxable Income	\$20,000	\$1,880,000

For discussion, Thursday 28 July

The property market rebounds with the result that the trustee can sell the remaining 7 lots for a further \$2 million each (the proceeds of sale total \$14 million). The sales are all completed by 30 June 2021. The marketing costs totalled \$150,000. Rent received during the year totalled \$300,000. Miscellaneous expenses,

including insurance and rates, total \$30,000. Capital allowances relating to the rental properties total \$110,000 for the year.

The trustee determines the net income of the trust to be \$1,965,000 comprising net rental of \$160,000 (ie. net of incidental costs and capital allowances) and a net capital gain of \$1,805,000 (after applying the 50% CGT discount). The trustee declares a capital gain on the rental properties because it decides it held them on capital account. It calculates the capital gain by allocating the properties a cost base of \$10,390,000 being \$7 million for the land, \$3,500,000 for the construction costs and \$150,000 for the marketing, reduced by the capital allowances of \$260,000 which were deducted in 2020 and 2021.

The trustee declares a net accounting profit of \$3,620,000 and, on 1 July 2021, distributes the same, in equal proportions, to Murgatroyd and Craig (ie. \$1,810,000 each).

Murgatroyd uses the distribution to repay principal on his loan. He now owes the bank \$1 million. His interest expense for the year ending 30 June 2021 was \$120,000.

On 1 January 2022, the trust is wound up by way of a distribution of the surplus funds (\$24,000,000), divided between Murgatroyd and Craig in equal proportions (ie. \$12,000,000 each).

Murgatroyd also enters into and completes contracts for the sale of the homestead lot (\$3 million) and overseer's cottage lot (\$1.8 million) during the income tax year ending 30 June 2022.

As a result, Murgatroyd is able to discharge his borrowings in full. His interest expense for the year ending 30 June 2022 was \$46,000.

In the year ending 30 June 2021, Murgatroyd includes in his assessable income 50% of the trustee's net capital gain from disposing of the remaining lots and 50% of the trustee's net rental income.

In the year ending 30 June 2022, Murgatroyd takes the view that the sale of the homestead lot is free from CGT under the main residence exemption and, further, that he has not made a capital gain on the disposal of his units in the trust. He does, however, declare a capital gain on the disposal of the overseer's cottage. He treats his cost base in the property as being \$627,016: that is, 1/6th of the value of the homestead property when it was transferred to him from Fester's estate (\$3.2m) and 1/19th of the combined subdivision and construction costs (\$1.78m). On that basis he determines that he made a capital gain of \$1,172,984 and, after applying the 50% CGT discount, includes a net capital gain of \$586,492 in his assessable income for the year.

Year of Income	30/06/21	30/06/22
Assessable Income	\$1,212,500	\$816,492
- Salary	\$230,000	\$230,000
- Net Capital Gain	\$902,500	\$586,492
- Share Net Income	\$80,000	—
Allowable Deductions	\$120,000	\$46,000
- Interest	\$120,000	\$46,000
Taxable Income	\$1,092,500	\$770,492