

Tax News, Views and Clues

Taxpayer wins Anti-avoidance Appeal

The Administrative Appeals Tribunal (AAT) has ruled in favour of a taxpayer who was issued amended assessments by the Tax Office on the grounds that the taxpayer's company structure was a scheme to reduce income tax.

The taxpayer, an information analyst, provided professional services to clients through a company of which he and his wife were directors and shareholders. The company received income for the professional services rendered by the taxpayer and paid the taxpayer and his wife salaries and superannuation benefits.

The Tax Office issued amended assessments for the 1995, 1996 and 1997 income years that increased the taxpayer's assessable income to match the fees received by the company. The Tax Office acted on the assertion that the taxpayer's company structure was a scheme to reduce income tax and alleged that the company structure allowed the taxpayer to reduce his personal tax liability and pay his wife excessive superannuation benefits.

The AAT found that the company structure was required for the taxpayer to operate his business effectively and that the income paid was fair and reasonable for the work performed. The AAT also held that the Tax Office was wrong to assess

the taxpayer on the fees generated by the company based solely on the grounds that the taxpayer's professional activities generated the company's income.

The AAT declared that the Tax Office's treatment was incorrect and set aside the amended assessments and ordered the Tax Office to re-amend the assessments for the relevant years.

Family Trust Elections and Franking Credits

Where shares are acquired within a trust after 31 December 1997, there is a 45-day holding period rule which may prevent trust beneficiaries from accessing franking credits on dividend distributions.

Broadly, because discretionary trust beneficiaries do not have a fixed interest in shares, they are taken not to be the owners of shares at risk for the required 45-day period. Therefore, beneficiaries do not satisfy a *qualified person* requirement so franking credits may not be available.

Where the relevant discretionary trust makes a family trust election, the shares in the trust are taken to be beneficially owned by the trustee and therefore beneficiaries can access the franking credits, provided the shares are held for more than 45 days.

- **TIP:** Where shares acquired after 31 December 1997 are owned via a discretionary trust, a family trust election should be carefully contemplated. In addition, as discussed in recent editions, the opportunity for trustees to make retrospective elections was recently announced.

Trust Loss Deductions Denied

The Administrative Appeals Tribunal (AAT) recently disallowed trust loss deductions in a case involving distributions of trust net income between three related trusts. In the 1996 income year, the first trust conferred a present entitlement to over \$1.2 million of its net income to the second trust, which resolved to confer a present entitlement to \$859,806 of its trust net income to the third related trust that had carry-forward losses of exactly \$859,806. Neither amounts were physically paid or transferred as resolved, nor were the amounts invested on commercial terms.

The AAT found that this series of transactions constituted an income injection scheme, as both resolutions were constructed to enable the trustee of the third trust to derive the assessable income of \$859,806, which was totally offset by its losses.

Accordingly, the taxpayer failed the income injection test and the Tax Office's disallowance of the claimed tax losses was upheld.

Debt/Equity Arrangements

The Tax Office has recently released an Interpretative Decision regarding the implications of material changes to loan agreements and the application of the debt and equity tests.

These tests classify instruments under financial arrangements as either being debt (loan) or equity (shares). Accordingly, these tests determine whether the return paid by the company on the instrument is treated as a dividend (and potentially frankable) or treated as interest on a debt (deductible). These tests focus on the economic substance of the instrument's components over their legal form. Where an instrument satisfies both the debt and equity test, it will be treated as debt.

Under the law, the debt and equity tests are applied to arrangements such as loan agreements and preference shares at the time the arrangement comes into existence.

Where the components of the arrangement (e.g. terms of a loan) are subsequently changed, the tests are to be reapplied to determine whether or not the change is a material change that varies its classification from debt to equity or vice versa.

- **TIP:** Taxpayers should ensure that any debt or equity instruments related to their financing arrangements are re-examined after a change in the instrument's terms.

Capital Works

The Tax Office has issued an Interpretative Decision (ID) regarding the deductibility of capital works that aren't currently producing assessable income.

The ID considers a case where the taxpayer has constructed a building and leased it to a related company. The lessee did not pay commercial rent for the building due to insufficient cash flow and only paid the taxpayer's outgoings (e.g. rates, insurance etc.).

Under the law, an amount may be deducted for capital works in an income year if:

- there is a construction expenditure area;
- there is a pool of construction expenditure for that area; and
- the area is used, amongst other things, for the purpose for producing assessable income.

It is a well-established principle that assessable income is not required in the year in which the expenditure has been incurred. However, there must be either assessable income in future years or there must have been assessable income in the past.

In the case considered in the ID, no assessable income was produced and the taxpayer only satisfied the first two of the above three requirements. However, the receipt of commercial rent by the taxpayer in the future will increase as the cash flow of the lessee improves.

Due to the relative briefness of the lower rent period, the Tax Office was satisfied that the building's sole purpose was always to produce assessable income and hence capital works deductions were allowed in the current income year.

GST: Recording Consideration in the Absence of Payment

The Tax Office has released a Draft GST Determination regarding the GST liability and input tax credit entitlements in the absence of actual payments for transactions.

The Tax Office states that book entries can amount to the

provision or receipt of payment for GST purposes provided that an agreement to 'set-off' the mutual liabilities is in place between the parties. Such a set-off can occur where each party has made a supply to the other and each party is required to pay the other for the supply made to it. The agreement between the parties may be written, oral or implied.

Both parties will still retain their GST liability and entitlement for input tax credits, but no invoices are issued. Consideration in this case is taken to be provided on the date that the book entries are made.

Please contact us for further information.

General Interest Charge

The Tax Office has indicated that the general interest charge (GIC) rate for the quarter July to September 2004 is 12.51% — down from 12.57% for the previous quarter.

Rental Property Errors

The Tax Office has announced that many taxpayers are claiming incorrect deductions for travel expenses associated with rental properties.

The Tax Office stated that taxpayers are not automatically entitled to claim a deduction for two trips per year to inspect their rental property. The taxpayer must actually incur an expense before the deduction is allowed.

In addition, the 5,000 km limit per vehicle applies to the **total** number of business kilometres, which is made up of both rental-related travel and work-related travel. Many taxpayers have incorrectly applied separate limits to rental-related and work-related travel when claiming deductions.

Important: This is not advice. Clients should not act solely on the basis of the material contained in this Bulletin. Items herein are general comments only and do not constitute or convey advice per se. Also changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. The Bulletin is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and not be made available to any person without our prior approval.