

Tax News, Views and Clues

Interest Deductibility on Trust Funds Distributed

The Tax Office released a Draft Determination (TD 2003/D4) outlining its view on the deductibility of interest incurred on borrowed funds used to pay distributions to beneficiaries.

The Draft Determination provides that a deduction is available to the extent that the borrowing is 'sufficiently connected' with the income earning activity or business carried on by the trustee.

The Tax Office considered a case where a beneficiary calls for the capital or income of a trust to be distributed to him or her and the trustee borrows to fund the distribution. Where the amount represents money invested in the trust by the beneficiary, either by settling an amount as trust capital, or by not drawing income to which the beneficiary is presently entitled, the Draft Determination provides that the borrowing is 'sufficiently connected' with the income earning activities of the trust and therefore the interest should be deductible.

Strangely, the Draft Determination provides that this is more likely to be the situation for fixed trusts rather than for non-fixed trusts, such as discretionary trusts.

The Draft Determination also makes it clear that interest paid on borrowed funds to pay trust distributions out of asset revaluation reserves are not deductible.

Adjusting Input Tax

The availability of input tax credits is generally assessed at the time a payment is made or when a tax invoice is received. Apart from the necessity that the supply to the acquirer is a taxable supply (i.e. GST is included in the price), a judgment is often required as to the extent of creditable purpose (i.e. business use). This judgment will determine whether a full, partial or no input tax credit is available.

The anticipated business use of an acquisition will need to be compared over time to its actual business use. Comparisons are done in adjustment periods. (Generally the tax period ending on or near 30 June in any given year).

The number of adjustment periods to be considered ranges between one and 10, depending on the GST exclusive value of the acquisition and whether or not it relates to business finance.

In the event that the actual business use over time differs from the anticipated business use, a change in creditable purpose has occurred and an input tax credit adjustment must be made by the business.

- **TIP:** The number of adjustment periods required will depend on whether the acquisition is used for making financial supplies (and the financial acquisitions threshold is not exceeded), or other supplies. Refer to the tables below and overleaf.

Acquisitions other than financial supplies

GST-exclusive value	Adjustment periods
Less than \$1,000	Nil
\$1,000 – \$5,000	2
\$5,001 – \$499,999	5
\$500,000 or more	10

Acquisitions for financial supplies

GST-exclusive value	Adjustment periods
Less than \$10,000	Nil
\$10,000 – \$50,000	1
\$50,001 – \$499,999	5
\$500,000 or more	10

Who Can Consolidate for Tax

Consolidation rules for tax commenced on 1 July 2002.

Broadly, any two or more wholly-owned companies in a parent/subsidiary structure can consolidate. Wholly-owned unit trusts can also be consolidated with one or more companies, provided there is a company at the top of the group.

Discretionary trusts can be consolidated with wholly-owned companies and unit trusts, but only where the discretionary trust can only distribute to members of the consolidated group. In reality, it's anticipated that discretionary trusts will rarely, if ever, be included in consolidated groups for that reason.

Consolidations will be a critical tax planning issue for the 2003 year and beyond. There are a range of concessions that can apply throughout this transitional period, including in relation to the tax value of assets and the treatment of tax losses.

After 1 July 2003, wholly-owned entities that do not consolidate will not be able to use capital gains tax rollovers, transfer tax losses, or pay tax-free unfranked dividends.

- **TIP:** Tax consolidations is a critical area for those with multiple entities in a wholly-owned group. There are a range of tax planning issues and opportunities. An important question will be, if you can consolidate, can you afford not to?

Partnerships: Commissioner Loses Part IVA Case

The AAT recently held that Part IVA did not apply to a husband and wife partnership, and therefore no tax shortfall penalties should be imposed.

The taxpayer carried on an engineering consultancy business in partnership with his wife. The Commissioner, however, formed the view that the partnership was a tax avoidance scheme and sought to impose penalties for the shortfall of tax.

Days before the hearing, however, it was discovered that state legislation prohibits engineers from entering into partnerships with persons who are not engineers.

As a result, the taxpayer withdrew his claim that he was in partnership with his wife and instead claimed a deduction for wages paid to her. The AAT allowed the deduction, noting that the taxpayer's wife did in fact make a significant contribution to the business.

In relation to the tax shortfall penalties, the AAT was satisfied that the taxpayer's entering into a partnership with his wife was more a statement about their relationship as 'life partners' rather than about obtaining a tax advantage. Therefore, the partnership between the taxpayer and his wife did not amount to a scheme under Part IVA and no tax shortfall penalties were applicable.

- **TIP:** For income tax purposes, a partnership exists where two or more persons are in receipt of income jointly. Where this is the case, a partnership exists even when no written agreement has been entered into.

Salary Sacrifice Arrangements

The AAT recently held that a taxpayer's direction for his employer to make payments to his superannuation fund for accrued performance bonuses and long service leave did not constitute an effective salary sacrifice arrangement, as the amounts had already been earned at the time of the request.

Accordingly, the AAT concluded the accrued amounts were assessable income derived by the taxpayer during the year of income.

- **TIP:** In order to have an effective salary sacrifice arrangement, any salary sacrifice request must be made by the employee, and agreed by the employer, before the relevant income is earned.

A Win for NSW Land Taxpayers

In a recent High Court case, a taxpayer successfully argued that his land valuation for land tax purposes had been inflated.

The *Valuation of Land Act 1916* (NSW) requires the Commissioner of State Revenue to use the 'unimproved' value of land as a basis for valuing land.

In this case, the taxpayer lived in a suburb where vacant land was scarce. Vacant sites recently sold in the area attracted very high prices. The Commissioner relied on these sales when setting a value for the taxpayer's land.

The taxpayer argued that this method of valuation was not appropriate as it inflated the true value of his land.

The Court held that the valuation should be redetermined to take into account sales of improved land.

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.