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**Tax News, Views and Clues**

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**Taxpayer Wins  
on Interest**

A taxpayer has had a significant win in an important case concerning deductibility of interest on limited recourse loans.

The taxpayer obtained 37 loans which funded the purchase of shares in three banks. The lender's recourse against the borrower (the taxpayer) was limited to the amount that could be obtained by selling the shares. The interest rates charged were between 17.3% and 19.3% depending on the date of draw down and the stock to be acquired.

The Commissioner unsuccessfully argued that part of the interest related to a capital protection charge which was capital in nature and non-deductible.

The Court held that the key issue was the use of the borrowed funds and that the interest should not be apportioned and was fully deductible in this case.

The Commissioner has now sought special leave to appeal to the High Court.

**A Chance to Split  
Entities and Groups**

After 1 July 2002, entities and groups may be able to be split up using demerger rules announced on 6 May 2002. Readers will recall that this development was discussed in our 2002 Budget Alert.

Basically, an entity may be split into two separate entities or a group of entities may be split into two smaller groups. Capital gains tax relief will be available provided consistent underlying ownership is maintained.

There is no legislation at this stage, only a summary press release.

Splitting an entity or group may have advantages from an asset protection perspective. The assets of one business or investment could be protected from claims arising in relation to another.

Alternatively, it may be necessary to introduce a new investor into only part of an entity or group.

The demerger rules may provide new restructuring flexibility for big business and small business alike.

**Commission or Gift?**

The Full Federal Court has concluded that a benefit received by a taxpayer, Mr. Brown (a former Minister for Tourism in the Hawke Government), was ordinary income for tax purposes rather than a mere gift. The taxpayer had assisted an Australian company in obtaining the requisite approvals to sell forest land for tourist development.

The taxpayer ultimately received title to a holiday unit in another location valued at \$1 million. Although there was no formal consultancy agreement, the parties regarded the property as commission, even though it was transferred voluntarily.

Brown argued unsuccessfully that the property was a gift inspired by good will which, although related to the success of the transaction, was not remuneration for services rendered.

**Tip:** Take care to ensure that business contracts, particularly those involving related parties, are documented and are quite clear in their terms. This should avoid uncertainty, the potential for disputes and possible adverse tax implications.

## Loans Could Be Equity

Under new legislation, loans to a company can be treated as equity in certain circumstances after 1 January 2003. Interest may be treated as (non-deductible) dividends declared by the company.

Loans by a company to its shareholders can also be deemed to be dividends, resulting in an adverse and unexpected tax liability.

**Tip:** Now more than ever great care should be taken in appropriately structuring and documenting related party loans to and from companies.

## Withholding Tax Where No ABN is Quoted

An entity paying for the supply of a good or service is required to withhold tax (PAYG) if the supply is made as part of an enterprise carried on by the supplier and no Australian Business Number (ABN) is quoted.

An enterprise includes business, trade, regular lease or license or charitable, religious or government body activities.

The Tax Office has recently released a lengthy ruling explaining

the PAYG withholding obligations in some detail.

**Tip:** Make sure that an ABN is quoted on an invoice or some other document related to each supply received from another business. That way, there should be no requirement to withhold tax and PAYG rules will not be breached.

## Audit Targets

The Commissioner has flagged some of the Tax Office's audit targets and review activities for this year.

The Tax Office will continue to target 'cash economy industries' such as building and construction, cleaning, hair-dressing and beauty salons, restaurants, cafes and takeaway shops, road freight, smash repairers and taxis.

Review activities will include:

- 60,000 GST help and education visits;
- reviews of ABN registrations to identify outstanding obligations; and
- the use of field officers to review situations of undisclosed income or turnover for tax and GST purposes.

## Shareholder Loan Review

The Tax Office will be undertaking a project to assess the level of understanding of, and compliance with, Division 7A of the *Income Tax Assessment Act 1936*.

Division 7A concerns loans, payments and the forgiveness of debts between private companies and shareholders, which can all be deemed to be unfranked dividends. Loans from trusts can also be caught in some cases.

In the first stage, a letter will be sent to a number of private companies to obtain details of

relevant transactions. The ATO will then determine further strategies.

**Tip:** Given the Tax Office's activity in this area, and the approaching year-end, now is the perfect time to address shareholder loan (and payment and debt forgiveness) situations.

## New Penalty — Late Lodgement

The Tax Office has announced that, on 1 July 2002, it will introduce a penalty for failure to lodge tax returns, activity statements and GST annual returns on time. The penalty will apply for each 28-day period (or part thereof) by which the relevant deadline is missed.

## Consolidations

Parliament has passed the first tranche of consolidation legislation, and a second tranche has been introduced for debate.

Contrary to public perception, the consolidation rules will have broad impact for both large and small taxpayers, potentially applying whenever a company wholly owns one or more other companies or unit trusts.

The basic features of these rules are as follows:

- Applicable from 1 July 2002.
- One consolidated tax return will be lodged for each consolidated group (CG).
- Losses and franking credits are transferred into the CG.
- Intra-group transactions, including dividends, are ignored.
- Consolidation is optional but intercorporate CGT rollover relief, loss transfers and dividend rebates will not be available to non-consolidated groups after 1 July 2003.
- An election to consolidate can be made before lodging a tax return for the relevant year.

- **TIP:** There are a range of planning opportunities that taxpayers should consider before electing to consolidate. Contact our office for assistance.

## Shareholder Loan Developments

### Distributable Surplus

Under shareholder loan rules, a loan by a company to a shareholder or their associate can be deemed to be a taxable dividend in certain circumstances, limited to the amount of the company's *distributable surplus*.

The distributable surplus is reduced by, amongst other things, the company's *present legal obligations*.

In a recent case the Administrative Appeals Tribunal found that a provision for tax was a *present legal obligation* that reduced the *distributable surplus* and the ultimate deemed dividend. This was a great win for taxpayers.

### Benchmark Interest Rate

Certain private company loans to shareholders or associates are not deemed to be a dividend provided the loan is made under a written agreement, the interest rate equals or exceeds the *benchmark interest rate*, the term does not exceed the prescribed maximum, and the required interest and principal repayments are made.

The Tax Office has announced that the *benchmark interest rate* for the 2003 income year is 6.3%.

## Trust to Company Rollover

Parliament has passed legislation providing CGT rollover relief for assets transferred from a fixed trust to a company.

CGT rollover will apply where:

- a fixed trust disposes of all of its assets to a company; and
- the beneficiaries' interests in the trust are exchanged for shares in the company.

The rollover will be available for both the trust and its beneficiaries, however it will not apply to discretionary trusts.

The trust must cease to exist within six months of the initial asset transfer, although this period can be extended in limited circumstances.

This measure applies to assets disposed of under a trust restructure starting on or after 11 November 1999.

## Asset Register Ruling

Taxpayers may satisfy CGT substantiation rules by keeping an asset register.

The Tax Office has issued a ruling concerning whether a register complies with these rules.

If a complying register is kept, original documents need only be kept for five years after valid certification.

Otherwise, original records must be kept for five years after disposing of the relevant asset.

- **CAUTION:** In many cases, the time and cost associated with maintaining a complying register may outweigh the benefits of the concession.

## Work Related Expenses

Employees beware. The Tax Office intends to take a closer look at work related expenses.

Employees should ensure that sufficient evidence of claims is maintained to satisfy substantiation rules.

A detailed receipt will typically suffice, although this will not be necessary where total claims are less than \$300.

## Partnership Tax Avoidance

A recent Taxpayer Alert describes an arrangement whereby a professional taxpayer who earns income from personal services enters into a partnership with similar unrelated taxpayers.

The intention of the arrangement is to characterise income as partnership income to enable the taxpayer to split their income with a spouse or related party.

The Commissioner is considering in these circumstances whether there is a genuine partnership, whether a business is being carried on through the partnership, whether the arrangement circumvents *personal services income rules*, and the potential application of *general anti-avoidance* provisions.

- **CAUTION:** Taxpayers should steer clear of tax planning arrangements which appear artificial and contrived.

## No Deduction for Exclusive Right Payments

The Full Federal Court has confirmed that 'special rental' payments made by a casino operator under an agreement with the Queensland State Government, were of a non-deductible capital nature.

Although described as 'special rental', the payments were made in exchange for exclusive rights to operate a casino in the Brisbane area.

It was held that the exclusive rights were an advantage of an enduring kind and that the outgoings related to the character and organisation of the profit-earning business, and were therefore incurred on capital account.

➤ **CAUTION:** Deductibility depends on the substance of transactions, rather than the description given to them.

## Personal Services Income

The Tax Office has released a draft ruling concerning the alienation of personal services income measures. Under these rules individuals may be attributed with and taxed on income derived by their company or trust from the provision of their personal services, unless a personal services business is conducted.

The draft ruling considers the application of the attribution rules in various circumstances.

## Interest Not Deductible

In a recent Federal Court case a company has been denied deductions for interest on borrowings on-lent interest free to an associate, to fund the acquisition of a business property.

The property was purchased for redevelopment, and was acquired by the associate rather than the company for asset protection reasons. However, by the time of the redevelopment, the company had sold its retail business.

The key issue was that the borrowing company did not charge interest on its loan to the related entity, which in turn did not charge rent.

Accordingly, the Court found that the interest incurred did not have a sufficient nexus to assessable income.

➤ **TIP:** This case highlights the need for related parties to deal on commercial terms and to document arrangements between them.

## Simplified Dividend Imputation

The Government has introduced new franking rules applicable to companies, corporate unit trusts, public trading trusts and limited partnerships. The new rules apply from 1 July 2002. The key features of the legislation are as follows:

- An entity's franking account will operate on a 'tax paid' basis, i.e. \$1 of tax paid generates a \$1 franking credit. Franking account balances will be converted accordingly from 1 July 2002.
- Entities may frank dividends subject to a *benchmark rule* which provides that all dividends paid within a franking period must be franked to the same extent. Breaches may result in penalties.
- Certain payments made to 'non-share equity interest holders' will also be caught by the new rules.
- Similar to existing rules for individuals and trusts, entities will be required to gross up dividends received by the imputation credit and then claim the credit as a tax offset.
- The intercorporate dividend rebate has been abolished (although benefits may be preserved by electing to consolidate).
- New reporting requirements will apply.
- Anti-avoidance provisions exist to prevent the streaming

of dividends to members.

Entities making frankable distributions must provide a distribution statement in the 'approved form'.

It is understood that the Tax Office will issue a Fact Sheet outlining the 'approved form'. The Tax Office intends this to be an interim measure until it issues a tax ruling. We will advise of any developments.

## Interest Deductible Under Split Loan

The Full Federal Court has allowed taxpayers a deduction for compounding interest claimed under a split loan facility.

Under the split loan facility, borrowings were split into two accounts, one for private use, and one for investment purposes.

This allowed the taxpayers to stream all repayments to the private account. Compounding interest accrued on the investment account so the private component diminished over time and the investment component grew.

The Full Federal Court found that Part IVA general anti-avoidance rules did not apply, as the dominant purpose of the arrangement was to borrow money, and not to obtain a tax benefit. Accordingly, the interest was allowed as a deduction.

The Tax Office has sought special leave to appeal this decision.

➤ **CAUTION:** Taxpayers should take great care when entering into split loan arrangements, particularly pending the outcome of the Commissioner's application for special leave.

## Trust Loans

If a trust has declared distributions of income to a company which have not yet been paid, and the trust makes a loan to a shareholder in the company (or their associate), a deemed dividend can result from the

company to the shareholder or associate. The dividend is unfrankable, but the company's franking account is debited regardless.

However, if the shareholder or associate is another company, an intercompany exemption applies. The Tax Office has now issued a Taxation Determination confirming that position.

- **TIP:** While the deemed dividend can be very difficult to avoid, there are some planning opportunities. Call our office for assistance.

## Lease Incentive Payment Assessable

In a recent case, the Federal Court held that a lease incentive payment made to a partner in an accounting firm should be included in his assessable income.

The Court found that the financial incentive offered played a very significant role in the decision-making process of the firm to lease the premises, and that the agreement was entered into with a view to profit or gain. In addition, the incentive payment was held to be an ordinary incident of the taxpayer's business. Accordingly, it was ordinary income of the business.

- **CAUTION:** Lease incentives often result in particularly complex tax issues. Lease arrangements should be carefully structured to ensure appropriate tax outcomes.

## Service Trust Review

The Tax Commissioner has warned professional service firms that service trust arrangements will be subject to review.

Service trusts are often used by professional services firms to provide administrative services, and effectively shift a profit element on those services to the

trust. In particular, the Commissioner suggested that the review will focus on whether service trust arrangements are explicable on commercial grounds.

## GST Year-end Reviews

As part of the year-end accounting and tax compliance function, taxpayers should consider reviewing GST liabilities and input tax credit claims to ensure that GST obligations have been accurately met. This is particularly relevant following a recent Tax Office announcement that it is focusing heavily on this area.

- **TIP:** Any errors identified whilst undertaking the review should be corrected in a timely fashion to mitigate any penalties that may be applied. Taxpayers should also look out for any overpaid GST which could be refundable.

## Penalties for Improper Early Release of Superannuation Benefits

From 3 July 2002, individuals who improperly access superannuation benefits prior to retirement may lose an entitlement to concessional tax treatment (for example, if a person improperly claims to have retired). This may result in the payment of those benefits being taxed at 48.5%.

Trustees of superannuation funds may face up to five years' imprisonment or fines of up to \$220,000 or both (\$1.1m for corporate trustees), where they have allowed improper access to superannuation benefits.

- **TIP:** Individuals may apply on compassionate grounds, or on grounds of severe financial

hardship, to access their superannuation benefits prior to retirement without losing access to the concessional tax benefits.

## Amnesty Sought re Family Trust Elections

The professional bodies have asked for an amnesty for taxpayers affected by the family trust election provisions whilst the Tax Office clarifies the operation of these provisions, in particular, the consequences for taxpayers of making an election.

Presumably relief is being sought from various adverse tax outcomes including the operation of family trust distributions tax, and the denial of franking credits and company and trust losses.

We will advise of any developments.

## Supplies of Goods and Delivery Charges

Complex GST issues surround the treatment of delivery services provided by businesses that sell taxable and non-taxable goods. The Tax Office has released a Draft Determination to help clarify the issue.

According to the Draft Determination, where the delivery service is a 'separately identifiable supply' (e.g. customers have the choice of paying for delivery), the delivery service will be taxable regardless of whether the goods supplied are GST-free or taxable.

Otherwise, if the goods supplied are GST-free or input taxed, then the delivery fee will also be GST-free or input taxed. However, where the supply includes both taxable and GST-free goods, the delivery fee must be apportioned, and GST will be payable on the delivery fee relating to the taxable goods.

Please contact our office for further details.

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# 2002 Tax Return Client Checklist

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## Important Tax Changes

The following important tax changes may have an impact on your 2001/02 tax return. *Please contact us to ascertain whether these changes affect you.*

## 2002 — Individual Tax Returns

### Income

- Gross salary, wages, allowances, benefits, earnings, tips and directors' fees.
- Income from business activities.
- PAYG Payment Summary amounts.
- Details of any non-cash benefits received.
- Lump sum and termination payments. All documentation should be provided including an ETP Payment Summary from the employer or fund.
- Government Social Security payments, including pensions and unemployment and sickness benefits.
- Details of any CGT asset sales (e.g. shares and real estate). Please include dates of, and costs associated with, acquisition and disposal. Don't forget, whether you're an individual, company, trust or superannuation fund, you can

save tax if you qualify for the various CGT concessions.

- Annuities, including allocated pensions.
- Income from trusts and partnerships. Statements of distribution should be provided where appropriate.
- Rental income.
- Interest and dividends received and any tax deducted. Include details of franked dividends.
- Foreign source (employment and pension) income and details of any foreign tax credits attached to that income.
- *Personal services income rules:* individual contractors who operate through a company or trust can potentially be taxed on their income as an individual (*not* the company or trust).

### Deductions

- Investment and property expenses (carefully detail interest claims).
- Subscriptions (not including sporting or social clubs).
- Expenditure records related to a taxpayer's employment, such as work-related motor vehicles, self-education, protective clothing and uniform expenses.
- Donations of \$2 and over, depending on the recipient.
- For self-employed persons and those without employer superannuation support, details of superannuation contributions made.
- Tax agent's fees and other accounting and tax audit fees.

- Special deductions (Australian films, investment shelters and forestry-type schemes).
- Bank fees and financial institutions duty (where the credit or deposit represents assessable income).
- Unrecouped prior year losses.
- *Non-commercial losses:* Individuals must satisfy one of four tests to offset losses from business activities against other income. A prime example is an employee who seeks to offset farming or other business losses against salary or investment income.

### Rebates

- Details of private health insurance, unless your premium is net of the rebate.
- Details of superannuation contributions where no tax deduction can be claimed.
- Any changes in dependants (income of spouse should be provided).
- Details of any income received in a lump sum which was accrued in earlier income years (e.g. assessable pensions).
- Net medical expenses if they exceed \$1,250 in total.
- Superannuation contributions made by employees with employer superannuation support *and* an assessable income of less than \$31,000.

**Note:** Taxpayers with a dependent child (under 21) or qualifying dependent student should check to see if they are eligible for Family Tax Assistance.

## 2002 — Companies, Partnerships, Trusts and Other Businesses

### Income

- Trading income.
- Other income (e.g. rent, interest, royalties).
- Stock on hand (and basis of valuation) — note any obsolete stock.
- Work in progress.
- Primary producer subsidies (if assessable).
- Details of CGT assets (e.g. stock and real estate) sold, including dates of, and costs associated with, acquisition and disposal.
- Dividends, including de-tails of franking credits.
- Income from foreign sources, including details of foreign taxes paid.

### Deductions

- Repairs and maintenance.
- Salaries, including fringe benefits.
- Fringe benefits tax paid.
- Rates, land taxes and insurance premiums.
- Advertising expenses.
- Interest on borrowed monies.
- Deductions relating to foreign-source income.
- Prepaid expenses (subject to transitional rules).
- Retirement payments and golden handshakes.
- Bad debts actually written off during the year.
- Donations of \$2 and over, depending on the recipient.
- Commissions.
- Legal expenses.
- Lease documents for motor vehicles, premises and equipment.
- Losses of previous years (or intra-group transfers).
- Superannuation contributions.

- Subscriptions.
- Car expenses (remember to include petrol, repairs and parking and maintain a log book where necessary).
- Tax agent's fees and other accounting and tax audit fees.
- Royalties paid.
- Details of the purpose and destination of any inter-state or overseas trip. Expenses must be fully documented where travel involves at least one night away from home. Travel diaries should be included where travel exceeds five nights.
- Research and development expenditure.
- Bank fees and FID (where the credit or deposit represents assessable income).

### Liabilities

- New loans taken out during the year and their purpose, including any new lease or hire purchase agreements.
- Statements from the lending authority detailing the opening and closing balances of existing loans during the financial year
- Provisions for long service leave and annual leave.
- Creditors on hand at the end of the financial year.
- Details of loan accounts to directors, shareholders, beneficiaries and partners.
- Accrued expenses (e.g. audit fees, interest payments).
- Commercial debts for-given.

### Assets

- Details of depreciable assets acquired and/or disposed of during this income year, including:
  - type of asset;
  - date of acquisition/ disposal; and
  - consideration received/paid.
- Lease commitments.
- Debtors on hand at the end of the financial year.
- Commercial debts for-given.

### Additional Information

#### Required

- Franking account details/movements.
- Overseas transactions, exchange gains/losses.
- Private companies — remuneration or loans to directors, shareholders and their relatives.
- Changes to the capital of the company.
- Whether family trust elections have been made in relation to trusts.