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Tax News, Views and Clues

Assessability of Property Distributions by Companies

The Tax Office has issued a taxation ruling which deals with distributions of property from a company to its shareholders.

The ruling provides that where the money value of the distributed property exceeds the amount debited to a share capital account of the company, the excess constitutes a dividend to be included in the assessable income of the shareholder to the extent that it is paid out of profits derived by the company.

➤ **TIP:** The Tax Office considers that, provided the market value of the property exceeds the total liabilities and share capital of the company, the excess will generally be paid out of profits, regardless of the accounting treatment by the company. A dividend would therefore arise.

For example, where the excess amount is debited to an account or reserve that is not a share capital account, the excess may still be included in the shareholder's assessable income regardless of whether it is described as a 'profit and loss' account in the company's accounts.

Attributions of Personal Services Income

The Tax Office has released a new ruling outlining its views on the specific application of personal services income (PSI) measures in certain circumstances.

Broadly, these measures prevent individuals from reducing their tax by alienating their PSI to an associated entity in order to facilitate income splitting, access to the corporate tax rate or to claim business deductions.

Where the PSI measures apply, PSI is included in the assessable income of the relevant individual notwithstanding that it may have been derived by a private company or trust. However, if the income is from conducting a personal services business, the PSI rules do not apply.

The ruling covers the following:

- how the PSI rules apply;
- how amounts distributed from a PSI entity are not taxed twice; and
- how the PSI rules will apply to transactions between entities in certain circumstances.

➤ **TIP:** There are certain tests for determining whether a personal services business is being conducted in which case the PSI rules will not apply. There is a personal services business if one of the conditions below apply:

1. The 'results test' is satisfied. This test is based on the criteria for distinguishing independent contractors from employees. Please refer to the article below.
2. Less than 80% of the PSI is from one source and one of the following additional tests are satisfied:

- an unrelated clients test — services are provided to two or more unrelated clients as a result of offers to the public;
 - employment test — other entities are engaged to perform at least 20% of the principal work; or
 - business premises test — the entity has exclusive use of separate premises in deriving its PSI.
3. A personal services business determination is obtained from the Commissioner.

Please contact us for further information.

CGT Small Business Concession

The Tax Office has released an interpretative decision outlining its view on whether a company that has different classes of shares can have a 'controlling individual' for the purpose of determining whether the CGT small business concessions apply.

Where a small business taxpayer makes a capital gain on the disposal of an asset, it may be eligible to obtain CGT relief under one or more of the following CGT concessions (provided that certain conditions are satisfied):

- The 15-year asset exemption (which provides a full exemption from CGT).
- The 50% active asset reduction (which reduces

the capital gain on active assets by 50%).

- The retirement exemption (which disregards capital gains up to a lifetime maximum of \$500,000 provided the proceeds are used to pay an ETP).
- The asset rollover exemption (which disregards a capital gain made on the disposal of an asset where the asset is replaced. Instead, the gain is used to reduce the cost base of the replacement asset).

If the taxpayer makes a capital gain on the disposal of a share in a company, the 'controlling individual test' must be satisfied in addition to the other conditions.

Broadly, a controlling individual of a company is one who has the right to exercise at least 50% of the voting power in the company and receive at least 50% of any dividend the company may pay.

The Tax Office considers a case where a company has two different classes of shares, each held by different shareholders. A distribution can be made to either class of shares to the exclusion of the other class.

The Tax Office states that, under these circumstances, the company cannot satisfy the controlling individual test because there is no certainty in relation to distribution entitlements.

➤ **TIP:** Significant tax savings can be made if a taxpayer is able to structure transactions

such that one or more of the available concessions apply.

Where a small business taxpayer is an individual or a trust, the general 50% CGT discount may also be available.

Please contact us for further information.

Employee v. Contractor

Whether a person is an employee or a contractor can be a difficult question to answer. An employer/employee relationship is more commonly referred to as a contract of services, whilst a contract for services typifies the relationship between a principal (recipient of services) and a contractor (provider of services).

The answer to the question will impact not only income tax, but also GST, superannuation, workers compensation and payroll tax.

Over time certain indicia have emerged to assist in determining whether a person is an employee or a contractor including, for example, the ability of an employer to direct performance, the ability of the service provider to subcontract the work, the existence of entrepreneurial risk for the service provider and the issue of who provides the necessary tools and/or equipment.

Overall, and perhaps most importantly, it's a question of whether the individual is engaged to produce a result, or to work as directed.

- **TIP:** Due to the complexity in some cases, and the important tax implications, we suggest that advice be sought where the issue is unclear.

Deductions Against Personal Services Income

The Tax Office has released a taxation ruling addressing the deductions available against personal services income (PSI) of individuals and personal services entities (PSE) such as companies, trusts or partnerships that are not conducting a personal services business (PSB).

Broadly, PSI means income that is derived mainly from the personal efforts or skill of an individual. In some cases, the individual may not be an employee but may work solely or predominantly for one entity and may seek to claim deductions that are typically not available to employees.

In other cases, an individual may operate through a company, partnership or trust to derive income that is mainly for the individual's personal efforts or skill.

In such cases, the PSI rules are intended to ensure that the deductions claimed are limited to those that would be available to an employee.

Examples of deductions that will not be allowed include deductions for rent, mortgage interest, rates or land tax that relate to an individual's

residence, and certain superannuation contributions.

Where a PSE's income includes an individual's PSI, the individual and not the PSE is treated as having derived that income.

- **CAUTION:** The PSI rules are complex and result in the disallowance of deductions and the taxing of individuals on PSI otherwise derived by a company, trust or partnership.

Tax Effective Investment Scheme

The Federal Court has ruled that the Part IVA general anti-avoidance rules did not apply to a taxpayer's claims for deductions associated with his investment in a tea-tree farm.

Under the arrangement, although not compulsory, the taxpayer engaged the management company specifically named in the prospectus to manage the growing and harvesting process.

The taxpayer borrowed \$21,750 from a finance company associated with the promoter, of which \$21,000 was used to prepay the management company to obtain a \$1,500 discount.

The taxpayer sought to claim a deduction for the prepaid management fees. The Tax Office disallowed his claim on the grounds that the taxpayer was either not carrying on a business because of his limited involvement or because the

transaction was a scheme entered into for the dominant purpose of obtaining a tax benefit.

Importantly, unlike other tax effective investment schemes, the actual tax savings in this case were less than the cash outlay.

This thereby resulted in a net cash outlay of about \$3,500.

The Federal Court held that the taxpayer was entitled to the relevant deductions on the basis that a business was being carried on.

In reaching this view, the Federal Court was satisfied that although the taxpayer was not actively engaged in the business, this was not essential, particularly given the expertise required.

Importantly, in reaching its decision, the Court found that although obtaining a tax benefit was one purpose of the taxpayer's investment, it was not the dominant purpose for entering into the transaction.

Accordingly, the Part IVA general anti-avoidance rules did not apply to disallow the taxpayer's deductions.

Shareholder Loans: Application of FBT

In a recent Interpretative Decision, the Tax Office considered whether a loan that is not a deemed dividend under shareholder loan rules (Division 7A) may, in certain circumstances, constitute a fringe benefit where the loan has a nil rate of interest.

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The Tax Office considers a case where a private company has lent an amount to an employee, who is also a shareholder of the company. The loan is not a deemed dividend under the Division 7A deemed dividend rules because the loan satisfies the following criteria:

- the loan is unsecured and has a term of less than seven years;
- the interest rate charged on the loan equals the benchmark interest rate (applicable from the year following the year in which the loan is made); and
- a written agreement exists.

According to the Tax Office, where the loan is made to the employee 'in respect of the employee's employment' a loan fringe benefit will arise during the interest-free period. Accordingly, fringe benefits tax will apply.

- **TIP:** Broadly, FBT is a tax applicable to benefits provided by employers to their employees. With this in mind, if the loan was made to the employee in respect of their shareholding or family connection, and not their employment, FBT would not apply.

Please contact us for further information.

Capital Allowances

The Tax Office has recently released an Interpretative

Decision (ID) regarding the deductibility of costs in relation to leased premises.

The ID considers a case where a partnership incurred expenditure to fit out leased premises at the commencement of the lease. On termination of the lease, the partnership ceased business and was required to restore the lease property to its original pre-lease condition.

According to the Tax Office, expenditure to restore leased premises would typically not be deductible under the general deduction provisions. However, the expenditure may be deductible equally over five years under specific provisions that exist in the tax law, on the basis that it is a cost incurred to stop carrying on a business.

- **TIP:** Capital allowance rules enable deductions over a five-year period for capital costs incurred:
 - to establish your business structure;
 - to convert your business structure to a different structure;
 - to raise equity for your business;
 - to defend your business against a takeover;
 - in unsuccessfully attempting a takeover; and
 - to stop carrying on your business.

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