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Tax News, Views and Clues

Company Losses

Taxpayers often do not realise that there are special tests to be satisfied where a company has incurred tax losses, if the company is owned by discretionary trusts.

Broadly, in order to utilise the losses, a number of conditions must be satisfied. Most notably, the discretionary trusts which own shares in the company may need to satisfy onerous tests under the trust loss rules, as if the trusts, rather than the company, had incurred the losses. These tests include a pattern of distribution test, a 50% stake test and a control test.

Where a family trust election is made in relation to the discretion-ary trusts, these tests do not apply and the company losses are potentially much easier to access and utilise.

Taxpayers should therefore consider a family trust election in these circumstances.

Readers will recall that the Tax Office has recently announced an opportunity for retrospective elections where required.

- **TIP:** Taxpayers should seriously consider family trust elections where a discretionary trust owns a company incurring tax losses.

**Motor Vehicle Expenses:
Interest Deductions**

Taxpayers may use one of four different methods to calculate the allowable deduction for car expenses.

The methods are:

- log book;
- one-third of actual expenses;
- cents per kilometre; or
- 12% of cost.

A car expense includes a car-related loss or outgoing, such as fuel receipts or maintenance, and interest paid on money borrowed to purchase a car.

In a recently issued Interpretative Decision, the Tax Office considered the issue of whether a taxpayer who uses the one-third of actual expenses method can claim interest incurred on a loan to purchase a car, the cost of which exceeds the car limit.

The car limit applies to limit the depreciation deduction available to taxpayers. For the 2004/05 financial year, the car limit is \$57,009. Provided that the taxpayer incurs interest on an amount borrowed to purchase a car that is used to produce assessable income, the interest deduction is not reduced by application of the car limit.

**Property Tax Deductions
Targeted**

The Tax Office has recently announced plans to review depreciation and capital allowances applying to the \$300 billion commercial property sector. The review is expected to involve the reclassification of many items currently deemed to be plant for tax purposes.

After the Tax Office's recent targeting of residential investment property depreciation and capital allowance claims, the Tax Office aims to simplify the laws and streamline the tax treatment of depreciating assets.

The review will involve reclassifying assets such as fire extinguishers and air conditioning ducts that have been previously defined as plant.

The reclassification of such items is likely to reduce the after-tax cash flows of investors as deductions related to buildings are spread over a longer period of time.

Under the present definitions, the plant content of a commercial building can be substantial, ranging from 25–80% depending on the type of building.

GST: Recent Cases

Contributions to Body Corporate Subject to GST

The Administrative Appeals Tribunal (AAT) has held that contributions made to a body corporate are subject to GST.

In a recent case, the taxpayer was a body corporate whose members (owners of lots in an apartment complex), made contributions into the sinking and administrative funds administered by the GST-registered body corporate.

The AAT held that such contributions are subject to GST as the body corporate was obliged to perform tasks in administering the common property and assets of the lot members and these were made in the course or furtherance of the body corporate's enterprise.

- **TIP:** Body corporates that are not registered for GST should consider if they are required to register for GST, based on the above decision.

Sale of Land Contract Not Subject to GST

It has been recently held that a contract for the sale of land allowed for the recovery of GST

from the buyer in the absence of the sale being subject to GST.

The sellers were unsure if the sale of land would be subject to GST and included the clause 'unless otherwise agreed the purchase price includes any GST liability of the vendor' within the contract of sale.

A private ruling obtained from the Tax Office by the sellers after the execution of the contract provided that the sale was not subject to GST.

The court held that the appellant would not be able to recover the GST portion purported to be paid by them and that the sellers were not required to issue a 'tax invoice' to the buyer.

- **CAUTION:** Buyers and sellers of property should ensure that there are appropriate GST recovery clauses and warranties in the contracts of sale.

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.

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.

Interposed Entity Elections

Readers will recall that the trustee of a discretionary trust will often make a family trust election. The benefit of doing so is that tax losses are typically easier to carry

forward and utilise, and beneficiaries may have greater access to franking credits arising on trust distributions of dividend income.

Where a family trust election is made, any distributions of income or capital outside of a defined family group (including certain family owned entities and charities) attract family trust distribution tax at the top marginal rate. So, the trustee's distribution flexibility is strictly limited to family members and family entities.

Another trust or a company can make an interposed entity election (IEE) so that it is included in the family group and can receive distributions without penalty tax. An entity that makes an IEE is subject to the same distribution restrictions as the family trust.

However, the making of an IEE does not assist a trust with utilisation of its tax losses (if any) and does not allow beneficiaries greater access to franking credits.

Therefore, where a trust is required to make an IEE to be included in a family group because of another trust's family trust election, that trust should also consider making a family trust election. That way, it takes on no additional restrictions, but benefits in relation to tax loss and franking credit utilisation.

- **TIP:** The Tax Office has provided a one-off opportunity for tax-payers to lodge retrospective elections. Taxpayers who are required to lodge a tax return for the 2004 income tax year will be required to provide details of their election when they lodge that return. Taxpayers not required to lodge a 2004 return were required to provide details of the election and declaration within two months of the end of the 2004 income year.

Superannuation Tax Reduction Strategies

The Tax Office has recently confirmed that several commonly used superannuation tax reduction strategies will not attract the anti-avoidance provisions of the law. Two of the strategies that are allowable under the law include:

- an individual taxpayer withdrawing an Eligible Termination Payment (ETP) from their superannuation fund and then re-contributing a similar amount to the same fund or another fund (e.g. a spouse's fund) for the purpose of establishing a superannuation pension; and
- an individual taxpayer making a large undeducted contribution to their superannuation fund before they receive an ETP.

Both strategies take advantage of the law's concessional ETP treatment. The first strategy reduces the assessable portion of the annual pension while the second reduces the amount of the tax payable on the ETP.

CAUTION: The Tax Office has warned superannuation contributors to beware of promoters offering early access to superannuation funds to pay for homes, cars, boats and to pay off loans. The Tax Office believes these arrangements are an attempt to get around laws that preserve and encourage superannuation savings.

CGT a Major Focus for ATO in 2004/05

The Tax Office has announced that capital gains tax (CGT) will be a major area of focus in its 2004/05 compliance program. All taxpayers, from individuals, to small and large businesses, stand to be affected. Major areas of increased CGT scrutiny include:

- The Tax Office believes that some legal practitioners may not fully consider the implications of CGT and CGT record keeping when advising clients.
- Real property transaction data matching is already in place and the Tax Office plans to expand its operations with several state revenue offices in order to ensure that capital gains are being correctly disclosed by taxpayers.
- The incorrect use of Small Business CGT concessions by micro-businesses and small and medium enterprises will be examined.
- The sale of 'high value/high growth' properties will be scrutinised where signs of deliberate evasion may be present.

GST Refunds

The Tax Office has issued a media release reminding businesses that there is a four-year limit on making a GST refund claim.

As the GST is now in its fifth year, the limit stands to affect all businesses that lodged business activity statements from the beginning of the New Tax System.

In particular, businesses that lodged a quarterly BAS for the September 2000 quarter will now be affected.

CGT Main Residence Exemption

The Tax Office has recently released an Interpretative Decision (ID) concerning the capital gains tax (CGT) main residence exemption in a deceased estate situation.

The ID considers a case where the deceased lived in a dwelling acquired before the introduction of CGT until the time of their death in December 1999. Under the deceased's will, the dwelling was to be sold and the proceeds held on trust for the benefit of the deceased's children and grandchildren.

One of the deceased's children was dissatisfied with the terms of the will and lodged a claim in the Family Court. The Court granted the person a right to reside in the property from the date of the deceased's death until the trustee sold the dwelling.

The sale of the dwelling by the trustee would typically attract CGT. The law, however, provides an exemption from CGT where the dwelling was also the main residence of an individual who had a right to occupy the dwelling under the deceased's will. Other conditions also apply.

The Tax Office formed the view that the exemption still applied in this case, although the right to occupy the deceased's dwelling was granted by court order.

Excess Franking Credits

Where a company receives a franked dividend, its assessable income is grossed-up by tax paid on the relevant profits and a corresponding tax credit is allowed. Where the company is unable to use the credits because its tax payable is insufficient, the excess credit is converted to an additional tax loss, which can

be carried forward with other losses.

The Tax Office has released a relevant Interpretative Decision (ID). The ID considers whether a company that has prior year tax losses can choose to deduct some of those losses, eliminating taxable income so that credits can't be used, therefore creating an excess franking offset. This would freshen up tax losses.

An excess franking offset will arise where the amount of tax payable by a company is less than the franking credits it receives during the year, so that the offsets can't all be used.

In broad terms, the law does not allow a company to deduct an amount of prior year tax losses where it would result in the company having an amount of excess franking offsets for that income year. So prior year losses can only be deducted on the basis that adequate tax payable remains to utilise franking offsets.

Investigation of DIY Super Funds

The Tax Office has announced plans to double its superannuation fund audits to identify non-complying funds.

The Tax Office is concerned that a number of self-managed funds may not be complying fully with the superannuation laws. Common breaches include:

- a fund having more than four members;
- using an invalid trustee, such as a trust or partnership; and
- using the fund's investment money to purchase items not solely for the members' retirement.

The funds most likely to come under the scrutiny of the Tax Office include funds with offshore investments and those in operation for more than five years.

Funds in breach of the law could have their earnings taxed at 47% or 48.5% rather than the usual 15%. The increased tax rate would also apply to the capital of the fund.

Please contact us for further information.

- **CAUTION:** Ownership of items such as artwork, holiday or recreational properties, jewellery or other items which may not be strictly for commercial investment should be avoided unless you have obtained specific specialist advice and that advice has been reviewed recently.

What is land tax?

Land tax is a tax on the ownership of land in NSW. Land Includes:

- Vacant land, including vacant rural land
- Land where a house, residential unit or flat has been built
- Company title units
- Residential, commercial or industrial units
- Commercial properties, including factories, shops and warehouses.

Who is liable to pay land tax?

If you own any property that is not your principal place of residence, including a holiday house or unit, you may be liable to pay land tax. This includes property that does not earn any income.

The amount of land tax payable depends on the combined value of any taxable land you own or

have an interest in, excluding exempt land. The value of taxable land does not include any structural improvements, such as a house. Also, you do not pay land tax in NSW on any properties you own outside on NSW.

What is exempt from land tax?

You principal place of residence is generally exempt from land tax. You can usually only claim an exemption for a principal place of residence on one property.

If you use your land as your principal place of residence and for non-residential purposes, (for example, if you run a business on your land), you may be eligible for a reduction of land tax for the portion used as your residence.

Land zoned as rural and used mainly for primary production is exempt from land tax. Land zoned non-rural must be used for the business of primary production to qualify for the primary production exemption.

How is land tax calculated?

For the 2005 land tax year, land tax is calculated on the combined value of all the taxable land you own at midnight of 31 December 2004.

Total Value of Land	Rate of land tax payable
Not more than \$400 000	0.4 cents for each \$1
More than \$400 000 but not more than \$500 000	\$1600 plus 0.6 cents for each \$1 over \$400 000 up to \$500 000
More than \$500 000	\$2200 plus 1.4 cents for each \$1 above \$500 000

What should you do if you think you are liable for land tax?

If you own a property other than your principal place of residence and you think you might be liable for land tax, you need to fill in a registration form (initial return). You can do this by:

- completing you registration form online at OSR's website, www.osr.nsw.gov.au
- printing a copy of the registration form located on the OSR website, or
- contacting OSR or us to arrange for a form to be posted to you.

How is the value of your land determined?

Annual valuations of land tax are made by the Valuer General on 1 July preceding each land tax year. These valuations are separate from those made approximately every three years for local government ratings purposes. For more information about land valuations, contact the Department of Lands:

Phone 1800 110 038 (NSW only)
(02) 8258 7400 (interstate)
8.30am-4.30pm (Mon-Fri)
Internet: www.lands.nsw.gov.au

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.

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.

Determining Residency Status

In a recent Taxation Ruling (TR), the Tax Office considered when a company, not incorporated in Australia, is a tax resident of Australia.

Australian tax residents are taxed on both their Australian

and foreign-sourced income, while non-residents are taxed only on income that is sourced in Australia.

In addition to several alternative tests, a company is an Australian tax resident if it carries on business in Australia and its central management and control (CM&C) is located in Australia.

Broadly, the TR provides that a company that has significant operational activities, such as trading and manufacturing, relevant to its entire business, carries on business in the country where those operational activities take place.

A company whose activities are passive in nature will be regarded as carrying on a business in the place where the investment decisions are made.

A company's CM&C refers to the making of high-level decisions such as general policies and strategic directions. Typically, the company's board of directors makes those decisions.

Accordingly, the ruling provides that the CM&C of the company will, in most cases, be deemed to be in the country in which board meetings are held.

- **CAUTION:** Taxpayers should be aware that the Tax Office could question the location of a company's CM&C where the circumstances appear artificial or contrived.

R&D Claims under Review

The Tax Office has announced that it is reviewing claims for certain research and development (R&D) expenditure. The review has resulted from the Tax Office's examination of R&D schedules lodged for 2003 and its management of follow-up risk assessments.

The Tax Office is focusing on issues such as:

- whether all expenditure claimed in relation to the R&D concession was actually incurred; and
 - whether the expenditure was incurred by the company claiming the deduction and not by another member within a non-consolidated group.
- **CAUTION:** It is very important that companies applying for R&D tax concessions keep accurate records of projects and expenditure in order to substantiate their claims.

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 prior approval. This firm respects your privacy. You have received this communication because you are currently on our mailing list. If you wish to be removed from our mailing list and receive no further communications of this nature in the future, please contact our office.