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CHARTERED ACCOUNTANTS

CLIENT ALERT

TAX NEWS | VIEWS | CLUES

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CGT on Land Sold Pursuant to a Court Order

In a recent Administrative Appeals Tribunal (AAT) case, a taxpayer failed in her claim that capital gains tax (CGT) was not payable on the sale of land.

The taxpayer and her former husband were joint owners of a block of land. They sold the land to a third party pursuant to an order of the Family Court.

The taxpayer attempted to rely on a provision in the law that disregards a capital gain that arises where assets are transferred between spouses or former spouses pursuant to a court order under the *Family Law Act 1975*.

The AAT held that the provision related exclusively to a transfer of assets between spouses and former spouses that arises because of a Family Court order. In this case, although the land was sold pursuant to an order of the Family Court, the land was not sold to a spouse or former spouse. Therefore, the provision did not apply.

The AAT found that the taxpayer's share of the capital gain from the sale was subject to CGT.

Consumer Loyalty Points

The Tax Office has held that an employee who used their personal loyalty program points to acquire an airline ticket for work related purposes is not entitled to a tax deduction for the value of the airfare.

Although the law allows a deduction for consideration paid otherwise than in cash, the consideration paid must have a money value.

The Tax Office formed the view that the money value of the loyalty points used by the employee was nil because the loyalty points cannot be transferred or assigned and are not convertible into cash.

CGT: Main Residence Exemption

The Tax Office recently released an Interpretative Decision (ID), which considers the application of the capital gains tax (CGT) main residence exemption where a taxpayer has used their main residence to produce assessable income.

A capital gain or loss arising on the disposal of an

individual's main residence is typically ignored for income tax purposes. However, a gain or loss may arise where an individual has been absent from their main residence and uses it to produce assessable income during that period.

In such cases, the law allows the individual to gain access to the main residence exemption, but only where certain conditions are satisfied.

Please contact us for further information.

GST Treatment of Residential Premises

The Federal Court has dismissed a taxpayer's appeal that the sale of a strata-titled unit was an input taxed supply for GST purposes.

Broadly, the sale of premises used for residential accommodation is input taxed. However, the sale of residential premises that are 'commercial residential premises' such as hotels, motels, etc. are subject to GST. Likewise, new residential premises will be subject to GST where the vendor is registered for GST.

In the case under review, the taxpayer was a member of a GST-registered partnership. A

motel was purchased by the partnership with a view to using it as residential apartments. Following the conversion of the motel, one of the newly fitted apartments was sold at a price excluding GST.

The taxpayer argued that the sale was input taxed as the apartment was not 'new residential premises', as it had been previously sold as residential premises.

The Tax Office disagreed and argued that the original sale of the motel was not a sale of residential premises and accordingly, the sale was not input taxed. GST was therefore to be applied on the sale of the apartment on the basis that it was 'new residential premises' when the apartment was sold.

On appeal, the Federal Court held that the prior use of the premises as a motel did not meet the definition of 'residential premises' as the term 'residence' requires a degree of permanent or long-term commitment which are not characteristics of a motel.

➤ **TIP:** This case highlights the complexities with property development and the availability of input tax credits. Some careful planning and advice may save businesses thousands of dollars.

Grant Held to Be Assessable Income

In a recent case, the Administrative Appeals Tribunal (AAT) has rejected a taxpayer's objection and affirmed that a grant received by the taxpayer was assessable income.

The taxpayer, engaged in a fabrication workshop business, applied for and received a Commonwealth Dairy Regional Assistance Program (DRAP) grant as a contribution to the construction cost of a larger workshop. The aim of a DRAP grant was to assist businesses in rural areas provide work for unemployed dairy workers.

The taxpayer argued that the grant was capital in nature as it was provided for the purpose of building and fitting out a new workshop. The taxpayer sought a private ruling from the Tax Office. The Tax Office ruled that the grant was assessable income as it constituted a bounty or a subsidy and was received in relation to carrying on a business.

The taxpayer subsequently objected and the case was brought before the AAT.

In the judgment, the AAT upheld the Tax Office's assessment and ruled that the grant constituted a subsidy received in relation to carrying on a business. Accordingly, the grant formed part of the taxpayer's assessable income.

Deducting Tax Losses

Broadly, the law prohibits a company from deducting a tax loss unless:

- it has the same owners throughout the period from the start of the loss year to the end of the year in which the loss is deducted. This is commonly referred to as the continuity of ownership test (COT); or
- it carries on the same business for the period

starting just before the COT was failed through to the end of the year in which the loss is deducted.

Specifically, where a loss company fails both tests in the year in which an overall loss is made, the law requires the loss company to divide the income year into periods. The dividing point between periods is the time(s) where the ownership test was failed. The company is required to treat each period as if it were a separate income year and work out the notional loss or notional taxable income for each period.

A notional loss calculated in a period after the change of ownership can then be carried forward and offset against future years' taxable income subject to satisfying the COT or same business test through to the end of the year in which the loss is deducted.

Please contact us for further information.

CGT Main Residence Exemption

The Tax Office has released an Interpretative Decision considering the application of the capital gains tax main residence exemption, where a taxpayer has converted their main residence into business premises.

Where a taxpayer has been absent from their main residence and has used it for the purpose of producing assessable income, a partial or full exemption from capital gains tax may be available. This rule is broadly referred to as the 'absence rule'.

In the case under review, the taxpayer vacated their main residence and immediately began a process of converting it into business premises. At the end of the conversion, the taxpayer rented the property out and subsequently sold the property for a capital gain.

At the time the taxpayer disposed of the property, he wished to take advantage of the 'absence rule'.

The Tax Office denied the taxpayer's application of the 'absence rule' on the basis that the property could no longer be considered a dwelling as it was no longer suitable as residential accommodation.

Consequently, the taxpayer was only entitled to a partial exemption for the period preceding the conversion into commercial premises.

Tax Deductible Gifts

The Tax Office has released a draft tax ruling explaining when a gift will be an allowable deduction.

The draft ruling describes a gift as having the following characteristics:

- the gift results in a transfer of beneficial interest in property;
- the transfer is actually made (i.e. it is not an anticipated or planned gift);
- the transfer is made voluntarily;
- the transfer arises by way of benefaction (i.e. the recipient is advantaged in

a material sense as a result of the transfer); and

- no material benefit or advantage is received by the giver by way of return.

Special anti-avoidance rules may also deny a deduction. For example, no deduction is available where the gift recipient bears responsibility as a result of the transfer, so that the recipient ultimately receives a benefit that is considerably less than the nominal value for which the giver seeks a tax deduction.

A deduction may also be denied where the giver or an associate of the giver retains the right to use the donated property.

- **TIP:** Examples of gifts that may be allowable deductions include money and various types of property (including trading stock).

Tax Office to Investigate Cash Economy Industries

The Tax Office has announced plans to conduct a strong compliance drive in industries that are susceptible to cash payments, non-lodgment, failure to register for GST, poor record keeping and over-claimed input tax credits. The compliance drive will focus on micro-businesses (annual turnover of less than \$2 million) in the following industries:

- tourism and hospitality;
- horse racing and export;
- restaurants, cafes and takeaway shops;

- licensed hotels and registered clubs;
- adult entertainment; and
- motor vehicle trading and wholesaling.

In addition, the Tax Office plans unannounced registration checks of businesses, desk audits and expanded data-matching procedures to check for lodgment compliance and accurate reporting of income.

Streaming of Franking Credits

The Commissioner may penalise a company for making a distribution of franking credits to a class of members that receives a greater benefit from the franking credits than the members excluded from the distribution would have. This is known as streaming.

A typical situation is where franked dividends are distributed to Australian resident members in preference to non-resident members, as the Australian shareholders potentially gain the greatest benefit from franking credits.

The Commissioner, when determining whether a distribution is streamed, will generally consider the members':

- tax residence status;
- entitlements to franking credits; and
- ability to pass on franking credits (companies only).

Broadly, if all members would benefit from franking credits evenly, then the company would not be considered to be streaming.

GST and Long-term Contracts

The GST laws provide that supplies made under contracts that were entered into prior to the introduction of GST will be

GST-free until 1 July 2005.

Recent amendments to the GST laws now allow suppliers and recipients to revise the prices associated with certain long-term non-reviewable contracts to incorporate GST. This provides the supplier of goods or services under such a contract with an opportunity to recover from the recipient the GST payable after 1 July 2005.

There are three options the supplier and recipient can choose in regard to the GST position of long-term non-reviewable contracts:

1. The price remains the same and the supplier accounts for GST on 1/11th of this price.
2. The contract price is revised and the supplier accounts for 1/11th of the revised price.
3. The contract price is not revised and the recipient of the supply pays 10% GST on top of the price under the contract.

If both parties cannot agree, an arbitration process with an independent assessor will commence.

The new laws represent an opportunity for suppliers to clarify GST recovery issues with recipients of existing

long-term contracts. However, varying a contract by increasing the price of supply may result in the imposition of stamp duty.

Travel Deductions: Cents per Kilometre

The Tax Office has released the 2004/05 cents per kilometre rates.

Taxpayers who use their car for business purposes, and choose the cents per kilometre method for claiming travel expenses, can use these rates to determine the amount of their deduction for the 2004/05 income year.

The 2004/05 rates for non-rotary engine cars are:

- 0–1,600 cc — 52 cents per kilometre;
- 1,601–2,600 cc — 62 cents per kilometre; and
- 2,601+ cc — 63 cents per kilometre.

➤ **CAUTION:** Taxpayers electing the cents per kilometre method can claim up to a maximum of 5,000 business kilometres.

Year-end Tax Planning

As another income year comes to a close on 30 June 2005, it is important that taxpayers take the time to focus on tax planning and the tax issues that affect their business.

Some of the key tax issues to consider are outlined below.

Deferring Income

When considering the deferral of income, note the following points:

- As directed by the *Arthur Murray* principle, taxpayers may be able to

defer recognition of income received before year-end for services not yet performed.

- Most taxpayers will not be assessable on interest, dividends or rent until they are received (unless otherwise paid or credited on the taxpayer's behalf). Therefore, such income may be deferred.
- In general, assessability of income may be deferred until the following year. For example, where taxpayers who record income on a cash/receipts basis bill clients on 30 June, assessable income will not arise until after year-end.

Conversely, taxpayers on an accruals method may choose to perform services after year-end.

- Royalties and insurance proceeds are typically assessable on a cash basis.
- The work in progress (WIP) of professional practices will not be assessable until there is at least an entitlement to bill.

Maximising Deductions

Some initiatives to consider to accelerate deductions are:

- Review debtors and write off bad debts before year-end.
- Realise foreign exchange losses and defer the realisation of gains.
- Bring forward the outlay for deductible expenses.
- Value stock at the lower of replacement value or market value, where appropriate.
- Scrap stock, plant or equipment of nil value

before year-end, where possible.

- Ensure that audit fees are incurred before year-end, based on Taxation Ruling IT 2625.
- Use a low value pool, where appropriate, for depreciation of plant and equipment.
- Ensure that all superannuation contributions are paid by year-end.

Capital Gains Tax

Some strategies to minimise CGT include:

- utilising the CGT small business and retirement concessions;
- considering the availability of rollover relief for disposals to related parties;
- matching gains and losses, where possible, to avoid carrying forward a capital loss;
- deferring a disposal to ensure that the asset has been held for at least 12 months. This will potentially allow individuals and trusts to benefit from the 50% CGT discount;
- considering whether non-deductible costs may be included in an asset's cost base;
- considering whether it is most beneficial to utilise the 50% discount, where available, or frozen indexation; and
- deferring a disposal to the subsequent income year.

Tax Consolidation

- Consider whether an election to form a consolidated group should be made for tax purposes.
- If an allocable cost amount is to be used, or if there are losses, consider whether valuations should be obtained as part of the consolidation process.
- Review the potential tax treatment of losses within company groups.

Trust Distributions

- Make sure a trustee resolves to distribute the net income of the trust before 30 June 2005, or by 31 August 2005 if relying on ATO administrative concessions.
- Remember that year-end trust distributions and income injections may affect a trust's ability to recoup prior year tax losses and bad debt deductions.

Family Trust Elections

- Consider whether a family trust election should be made because of losses or bad debts in trusts.
- Ensure optimum utilisation of franking credits and consider making a family trust election where a trust Make sure no distributions are made outside the family group to avoid any potential liability for family trust distributions tax.
- Where a company is owned by discretionary trusts, there may be a need for family trust elections at the trust level if the company has losses. Elections may also be required for use of

franking credits as noted above.

Simplified Imputation

- Ensure all dividends paid within a franking period have been franked to the same extent.
- Ensure a company paying a franked dividend has issued a distribution statement in the approved form. Otherwise, the recipient will be unable to claim the imputation credit as a tax offset.
- Is there any entitlement to a refund of excess franking credits?

Other Issues

Other important matters include the following:

- Consider the effective lives of depreciable assets.
- Where individuals incur losses from business activities, the non-commercial loss rules should be considered because, under those rules, such losses may not be eligible for offset against other assessable income during the year.
- Consider whether any debts have been forgiven, as certain tax attributes such as carry-forward tax losses and depreciation on plant may be reduced, or a capital gain could arise.
- Where a private company provides loans to shareholders, a careful review of the loan arrangement must be undertaken, as certain rules may deem the loan to be an unfranked dividend.
- Ensure that any minimum prescribed repayments are made on private company loans.

- Where an individual applies personal efforts and skill in performing services to third parties through an interposed entity (e.g. a company), the personal services income (PSI) rules may deem the individual to be assessable on the income generated. Careful consideration should be given to such arrangements to avoid the application of the PSI rules.

International

- Plan to utilise foreign tax credits against Australian tax on foreign income of the same class.
- Consider international related party transactions — whether arm's length prices have been charged, and whether there are transfer pricing issues to address.
- Try to match foreign source income of a particular class with related expenditure, to avoid a quarantined foreign loss.
- Identify and address other international tax issues such as permanent establishments and controlled foreign companies.

Compensation Payments

In a recent case, the Administrative Appeals Tribunal (AAT) has confirmed that compensation payments received by a taxpayer after turning age 65 were assessable income even though the taxpayer argued

that they were capital in nature.

The taxpayer was unable to work due to ill health and received fortnightly compensation payments. Upon turning age 65 in March 1994, the taxpayer's payments continued to be taxed as income. The taxpayer objected on the grounds that the receipts represented payment of a capital sum for loss of earning capacity.

In response, the Tax Office argued that the payments were ordinary income in the hands of the taxpayer regardless of age and should therefore be included in assessable income. The Tax Office argued that payments were ordinary income because they were received periodically, on a regular basis, and they supplemented income.

The AAT agreed with the Tax Office's arguments and held that the payments were assessable income. The AAT held that the amount could not be capital as it was not a fixed sum and it was unable to be redeemed (i.e. received as a capital lump sum).

Small Business CGT Concessions

Certain small business taxpayers may be entitled to CGT concessions on disposal of their CGT assets.

In order to apply the small business CGT concessions, the asset disposed of must have satisfied the active asset test. The test requires that the asset must have been an active asset in the taxpayer's business just before the earlier of:

- its disposal; and
- the cessation of the relevant business (if the

relevant business has ceased in the previous 12 months before the disposal).

In regard to the second requirement, the Tax Office has declared in a recent Interpretative Decision (ID) that the sale of shares in the relevant business is not a *cessation* of that business.

Foreign Rental Income

The Tax Office has recently released an Interpretative Decision (ID), which considers whether rental income from property outside of Australia is assessable income of Australian tax residents.

The assessable income of an Australian resident includes income from all sources, whether in or outside of Australia. However, in relation to foreign-sourced income, a Double Tax Agreement (DTA) between Australia and the contracting nation must be considered, as the DTA typically takes precedence.

Where foreign tax has been paid on income subject to Australian tax, a foreign tax credit is typically available against the Australian tax payable.

➤ **CAUTION:** It is critical to receive professional taxation advice when dealing with foreign income to ensure that correct tax is paid and any available foreign tax credit is claimed.

Changes to GST Laws on Property Sales

The Federal Government has recently introduced a number of important changes to the GST laws, which will impact

the sale and purchase of real property.

It is very important that sellers of residential properties undertake a review of their structures and operations in order to ensure that there are no adverse GST implications or 'hidden' GST costs.

- **CAUTION:** GST needs to be carefully considered prior to completing any sales or purchase of real property.

Evidence for Expenses Substantiation

The Tax Office has recently released a Practice Statement (PS) providing guidance to individual taxpayers as to generally accepted documentation that may be used to substantiate deductions in the tax return.

The PS outlines that individuals without a receipt for work-related expenses may still be able to claim a deduction by maintaining other records, which include:

- online banking and credit card statements;
- online, email and photocopied receipts; and

- BPay records.

Superannuation Choice of Fund

You might have noticed the government advertisements advising that the Choice of Superannuation Fund Legislation will commence from 1 July 2005. There are various obligations for both employers and employees and if you would like to know more, please contact us.

FEDERAL BUDGET

Personal Tax Cuts

The 2005/06 Federal Budget includes the most significant personal tax cuts seen for many years.

The tax rates for 2004/05, 2005/06 and 2006/07 are summarised below.

Current Tax Year

| Income Range \$ | Tax Rate % |
|--------------------|---------------|
| 0 – 6,000 | 0 |
| 6,001 – 21,600 | 17 |
| 21,601 – 58,000 | 30 |
| 58,001 – 70,000 | 42 |
| 70,001+ | 47 |

2005/06

| Income Range \$ | Tax Rate % |
|--------------------|---------------|
| 0 – 6,000 | 0 |
| 6,001 – 21,600 | 15 |
| 21,601 – 63,000 | 30 |
| 63,001 – 95,000 | 42 |
| 95,001+ | 47 |

2006/07

| Income Range \$ | Tax Rate % |
|--------------------|---------------|
| 0 – 6,000 | 0 |
| 6,001 – 21,600 | 15 |
| 21,601 – 70,000 | 30 |
| 70,001 – 125,000 | 42 |
| 125,001+ | 47 |

Non-residents — CGT

It is proposed that CGT will no longer apply to a broad range of assets owned by non-residents.

In future (following legislation) CGT will only apply to Australian real property and certain business assets owned by non-residents.

CGT will no longer apply to other Australian assets owned by non-residents, such as shares in Australian companies.

Surcharges Abolished

The superannuation surcharge and termination payments surcharge will be completely abolished from 1 July 2005. The surcharges currently apply at a rate of 12.5% once

adjusted taxable income exceeds \$99,710.

Foreign Loss Quarantining

Overall losses incurred in deriving foreign source income are currently quarantined and cannot be offset against Australian assessable income.

The Government has announced that quarantining will be abolished when proposed new legislation receives Royal Assent.

GST Changes

In relation to GST, the budget foreshadowed changes including increased audit activity concerning imported goods, anti-avoidance measures covering certain sales of real property and a range of incidental amendments.

Tax Exemption for Temporary Residents

The Government has announced a four-year tax exemption for most foreign source income derived by temporary Australian residents, including capital gains on foreign assets.

CGT & Marriage Breakdown

Assets transferred between spouses on marriage breakdown will now be

subject to broader CGT rollover relief.

Sundry Tax Changes

- The tax law will be amended to deny deductions (and CGT cost bases) for expenditure incurred in relation to illegal activities.
- To be FBT exempt, contributions to approved worker entitlement funds will no longer need to be made under an industrial instrument.
- The Medicare levy low-income thresholds have been increased for individuals, families and pensioners from 1 July 2004.
- Superannuation Guarantee (SG) support will apply to the payment of wages made after employment ceases.
- The Government has introduced a number of changes in relation to franking deficits tax (FDT) with effect from 1 July 2002.
- The share capital tainting rules will no longer be triggered for certain transfers to share capital accounts as a result of debt/equity swaps.
- Effective life depreciation will now apply to film copyright expenditure incurred

on or after 1 July 2004.

Non-commercial Loans

From 1 July 2004, private companies now have until their tax return lodgement due date for a loan to a shareholder to be repaid or put on commercial footing to avoid the operation of the deemed dividend provisions.

Superannuation – Choice of Fund Rules

Following the introduction of the choice of fund rules, employers can continue to contribute to existing superannuation funds until 30 June 2008 if an employee has not chosen a fund and the existing fund does not meet the choice of fund insurance requirements.

Cosmetic Procedures Excluded

From the 2005/06 income year, purely cosmetic procedures will be excluded from the medical expenses offset.

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