



Mitchell & Partners
CHARTERED ACCOUNTANTS

CLIENT ALERT

TAX NEWS | VIEWS | CLUES

WINTER 2007

This document includes:

| | |
|--|----------|
| – Alerts..... | 3 |
| ○ PSI Test- Separate Business Premises | |
| ○ Year-end Tax Planning | |
| ○ Timing of Asset Depreciation | |
| ○ Small Business CGT Changes | |
| – Tax Return Checklist..... | 6 |
| ○ 2007 - Individual Tax Returns | |
| ○ 2007- Companies, Partnerships, Trusts and Other Businesses | |
| – Federal Budget 2007..... | 9 |

| | | |
|--|--|--|
| A: Level 7, 10 Barrack Street, Sydney, NSW, 2000, Australia | Mailing: GPO Box 5460, Sydney, 2001 | |
| TELEPHONE: 02 9392 8686 | FACSIMILE: 02 9299 8195 | EMAIL: reception@mitchellpartners.com.au |

www.mitchellpartners.com.au

ALERTS

PSI Test- Separate Business Premises

Personal services income (PSI) is included in an individual's assessable income if it is mainly derived from an individual's personal exertion, whether the income is received directly by the individual or by an interposed entity. However, this does not apply to income derived by a personal services business (PSB).

There are several tests to determine whether a PSB exists, one of which is the 'business premises' test.

In a recent decision, the Federal Court found that the Administrative Appeals Tribunal (AAT) made an error of law in finding that the business premises test had been satisfied on the basis of exclusive use of premises which were physically separate from premises used for private purposes in a case where areas of the property such as the driveway and gate were shared between the business and home.

The taxpayer company conducted a business from a separate two storey building on the same land that the private dwelling of the controller of the taxpayer was also situated. The controller was employed by the taxpayer entity and provided business-consulting services to the taxpayer's clients.

The taxpayer had successfully argued to the AAT that the business premises were separate from the controller's residence and hence the taxpayer was operating a PSB and not merely deriving PSI.

The Federal Court found that the AAT failed to reach a clear position concerning whether the business had 'exclusive use' of a shared garage, and that the required physical separation of the premises had been met.

Accordingly, the AAT's earlier decision was overturned, and the Commissioner's original assessment was upheld.

Year End Tax Planning

As another income year comes to a close on 30 June 2007, 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 it is received (unless otherwise paid or credited on the taxpayer's behalf). Therefore, such income may be deferred.
- In general, income may be deferred until the 2007/08 year, significantly delaying tax payments. For example, where taxpayers on a cash/receipts basis of income 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.
- Work-in-progress of professional practices will not be assessable until there is a recoverable debt (e.g. a bill has been issued).

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 a lower replacement value or market value, where appropriate.
- Ensure that audit fees are incurred before year-end, based on Taxation Ruling IT 2625.
- Where depreciable assets have been installed for use but are no longer expected to be used, consider 'mothballing' the assets to trigger a balancing adjustment event.

Superannuation

- Ensure that employers pay all superannuation contributions by year-end to maximise deductions and avoid potential exposure to the non-deductible superannuation surcharge.
- Consider using the superannuation contribution window, created by the recent changes to the superannuation legislation, to maximise tax effective superannuation contributions in the current year.
- Ensure awareness of reforms set out in the recent changes to the superannuation legislation effective from 1 July 2007.

Blackhole expenditure

- Review expenditure to ensure that any deductible 'blackhole' expenditure is identified.
- The types of expenditure to consider include: expenditure on a business plan, the establishment of business premises, research into likely markets or profitability of a business, capital investment in assets of the business, and liquidation and deregistration costs.

Capital Gains Tax

Some strategies to minimise CGT are:

- Utilise the CGT small business and retirement concessions.
- Consider the availability of rollover relief for disposals to related parties.
- Match gains and losses, where possible, to avoid carrying forward a capital loss.
- Defer a disposal to ensure the asset has been held for at least 12 months. This will potentially allow individuals and trusts to benefit from the 50% CGT discount.

- Review the cost base of assets to ensure all expenditure available under the expanded definition is included. Such expenditure includes, for example, certain selling costs, capital costs of ownership, and expenditure to preserve, move or install assets.
- Consider whether non-deductible costs may be included in an asset's cost base including, for example, holding costs such as interest that are non-deductible.
- Consider whether it is most beneficial to utilise the 50% discount, where available, or frozen indexation.
- Defer a disposal to the subsequent income year where a gain is anticipated. Consider bringing forward a loss transaction if there are gains to offset.

Bonuses

Taxpayers should ensure that where a bonus has not been paid at year-end, they are able to establish a clear binding commitment to the expense at the time. The key indicators of a definitive commitment are:

- the bonus entitlement is included in the contracts of employment; and
- a formula is in place which is not subject to management's discretion.

Tax consolidation

- Consider whether an election to form a consolidated group should be made for tax purposes.
- If ACA 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. In particular, consider whether tax losses should be best applied within a consolidated group (subject to available fractions) or whether the group should remain unconsolidated.
- If a loss group consolidates, consider the potential impact of capital injections into the group, which may reduce access to losses.

Trust distributions

- Make sure a trustee resolves to distribute the net income of the trust before 30 June 2007, or by 31 August 2007 (relying on Tax Office 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.

- Where the trust has derived capital gains, consider the Tax Office's Practice Statement in relation to the taxation of beneficiaries and the trustee on the trust income and capital and the different potential approaches available.

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 holds shares acquired post-31 December 1997.
- 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 to enable utilisation of franking credits as noted above.

Simplified imputation

- Ensure all dividends paid within a franking period have been franked to the same extent.
- Ensure that there are adequate franking credits.
- Ensure a company paying a franked dividend has issued a distribution statement in the approved form.

Other key issues

Other important matters include the following:

- Consider the effective lives of depreciable assets using the Tax Office's updated Taxation Ruling TR 2006/15.
- Where individuals incur losses from business activities, the non-commercial loss rules should be considered because, under the rules, such losses may not be eligible for offset against other assessable income during the year.
- 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. It may be necessary to ensure appropriate loan agreements are in place and repayments are made.
- Review any similar loans by trusts where a corporate beneficiary has an unpaid present

entitlement to trust income. These loans can also result in deemed dividends.

- 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 rules may deem the individual to be assessable on the income generated. Careful consideration of such arrangements should be undertaken to avoid the application of the rules.

Timing of Asset Depreciation

In a recent Taxation Determination, the Tax Office provided guidance in relation to when a depreciating asset is considered to begin its decline in value.

The determination indicates that a depreciable asset does not begin to decline in value until it is installed and ready for use. Merely holding a depreciating asset in anticipation of using it in carrying on a business is not sufficient to constitute use of the asset and hence the business cannot commence to depreciate the asset.

Small Business CGT Changes

Readers may remember that the Government was aiming to pass a raft of changes to the small business capital gains tax concessions making it easier for taxpayers to gain access to them.

These amendments received Royal Assent on 12 April 2007, and were largely unchanged from when they were first reported.

Approximately 32 amendments to the legislation have been made, which are all designed to improve accessibility to the concessions and reduce the compliance burden for small business taxpayers.

The concessions allow small business taxpayers crystallising a gain on or after 21 September 1999 to discount that capital gain by 50%, provided they satisfy the relevant conditions and the asset has been held for longer than 12 months.

The amendments, which will apply retrospectively from 1 July 2006, affect the entry criteria to access to the concessions.

The 'controlling individual' (50% ownership) test has been replaced with a 'significant individual' (20% ownership) test. This test includes an interest in the voting power, and dividends and capital distributions of the entity. Subsequently this test provides more stakeholders in the business the ability to access the concessions.

The maximum net asset value test totalling \$5 million now includes the negative asset values of

the taxpayer (and a connected entity). This means that where a taxpayer has a company whose liabilities are greater than its assets, this negative value can be included as part of the taxpayer's net asset value calculation.

A subsequent amendment to the legislation, announced in a recent treasurer's press release, should also see the maximum net asset value test threshold increase to \$6 million from 1 July 2007.

TAX RETURN CHECKLIST

2007- Individual Tax Returns

Income

- Gross salary, wages, allowances, benefits, earnings, tips and director's fees
- Income from business activities
- PAYG payment summary amounts
- 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, unemployment and sickness benefits
- Capital gains from CGT asset sales (e.g. shares and real estate) [Information relating to dates and costs associated with acquisition and disposal will be required to determine the capital gain (if any). Remember that individuals, companies, trusts and superannuation funds can save tax if they qualify for the various CGT concessions]
- Annuities, including allocated pensions
- Income from trusts and partnerships [Statements of distribution should be provided]

- Rental income
- Interest and dividends (franked or unfranked) including any tax deducted [Dividend distribution statement will be required to confirm the dividend received]
- Foreign source (employment and pension) income [Details of any foreign tax paid will be required]
- Personal services income [Individual contractors who operate through a company or trust can potentially be taxed personally on the income instead of income being taxed at the company or trust level]

Deductions

- Investment and property expenses [Carefully detail interest claims]
- Professional 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, uniform expenses and home office expenses
- Donations of \$2 and over, depending on the recipient
- Superannuation contributions made by self-employed persons and those without employer superannuation support

- Tax agent's fees and other accounting and tax audit fees associated with managing tax affairs
- Special deductions (e.g. Australian films, investment shelters and forestry-type schemes)
- Bank fees (where the credit or deposit represents assessable income)
- Un-recouped prior year losses
- Non-commercial losses [Individuals must satisfy one of four tests to offset losses from certain non-commercial business activities against other income. A prime example is an employee who seeks to offset hobby-type farming or other business losses against salary or investment income]
- Sickness and accident insurance premiums, provided the premium incurred is against the loss of income

Rebates

- Details of private health insurance, unless the premium is net of the rebate [Statement from health insurance provider will be required to determine entitlement to rebate]
- Details of superannuation contributions where no tax deduction can be claimed (maximum rebate of \$540 for \$3,000 superannuation spouse contribution)
- Any changes in dependants [Income of spouse will be required]
- Details of any income received in a lump sum which was accrued in earlier income years (e.g. assessable pensions)
- Details of medical expenses where the total exceeds \$1,500 [Tax offset of 20% available]
- Superannuation co-contributions for contributions made by eligible employees [Assessable income must be less than \$58,000]
- **Note:** Low income taxpayers with a dependent child (under 21) or qualifying dependent student should

check to see if they are eligible for Family Tax Assistance.

2007- 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)
- Capital gains from CGT assets sold (e.g. real estate) [Documentation should include dates and costs associated with acquisition and disposal]
- Dividends [Details of any franking credits will be required]
- Income from foreign sources [Details of foreign tax paid will be required]

Deductions

- Losses can no longer be transferred between group companies
- Repairs and maintenance (not capital)
- 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 are only deductible against foreign income of a similar class
- Prepayments are no longer immediately deductible, unless under \$1,000 or required to be prepaid by law
- 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 (not capital)
- Lease expenses for motor vehicles, premises and equipment
- Losses from previous years
- 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 [Only deductible where withholding tax has been paid]
- Travel expenses [Details of the purpose and destination of any interstate or overseas trip should be provided. 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]
- Eligible research and development expenditure by registered R&D company
- Bank fees (where the credit or deposit represents assessable income)
- Borrowing costs which are deductible over the shorter of five years or the life of the loan/facility
- Blackhole expenditure which may be deductible over five years
-

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 and bonuses) and unearned revenue
- Commercial debts forgiven

Assets

- Details of depreciable assets acquired and/or disposed of during this income year, including:
 - type of asset
 - date of acquisition/ disposal
 - consideration received/paid
- Details of CGT assets acquired, including the purchase price and other related costs
- Lease commitments
- Debtors on hand at the end of the financial year
- Commercial debts forgiven
- Division 7A interest and repayments made on any prior year loans to shareholders and associates

Other Information Required

- Franking account details/movements
- Overseas transactions with related parties
- 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
- Consider if a group of companies should consolidate for tax purposes

FEDERAL BUDGET

Personal Income Tax Cuts Improve Australia's Competitiveness

Australian taxpayers will share in tax cuts worth \$31.5 billion over the next four years.

The 30% threshold will increase from \$25,001 to \$30,001 on 1 July 2007.

From 1 July 2008, the 40% threshold will increase from \$75,001 to \$80,001 and the top marginal rate (45%) threshold will increase from \$150,001 to \$180,001.

The tax rates for the 2007 to 2009 years will now be as follows:

| 2006/07 Current | |
|--------------------|------|
| \$ Income | Rate |
| 6,001–25,000 | 15% |
| 25,001–75,000 | 30% |
| 75,001–150,000 | 40% |
| 150,001+ | 45% |

| 2007/08 From 1 July 2007 | |
|-----------------------------|------|
| \$ Income | Rate |
| 6,001–30,000 | 15% |
| 30,001–75,000 | 30% |
| 75,001–150,000 | 40% |
| 150,001+ | 45% |

| 2008/09 From 1 July 2008 | |
|-----------------------------|------|
| \$ Income | Rate |
| 6,001–30,000 | 15% |
| 30,001–80,000 | 30% |
| 80,001–180,000 | 40% |
| 180,001+ | 45% |

Medicare Levy

From 1 July 2006, the Medicare levy low income thresholds have increased to \$16,740 for singles and \$28,247 for families.

Dependent Spouse Rebate

The dependent spouse rebate will increase from \$1,655 to \$2,100 from 1 July 2007.

Simpler Tax for Small Business

It will now be easier for small businesses to meet their tax obligations as follows:

- Businesses with turnover of less than \$75,000 will no longer be required to register for GST.
- The GST registration threshold for non profit bodies will be increased to \$150,000.
- Purchases by businesses of less than \$75 will no longer require an approved tax invoice to claim an input tax credit.
- The eligibility criteria for a variety of small business concessions covering GST, CGT, the Simplified Tax System, FBT and PAYG will be streamlined so they all apply to businesses with a turnover of less than \$2 million.

Superannuation Reforms

Broader superannuation CGT roll-over relief will apply in the event of marriage breakdowns to encompass asset transfers from a self managed super fund to another complying fund (effective 1 July 2007).

One-off doubling of government superannuation co-contributions will apply for eligible contributions made in 2005/06.

Company Loss Recoupment Rules

Same Business Test (SBT)

- Companies whose total income exceeds \$100 million will once again be able to access the SBT in recouping carried forward losses, effective from 1 July 2005.
- The SBT applying to consolidated groups has also been clarified. The entry history rule, which applies the pre-consolidation history of a subsidiary member to the head entity, will be disregarded in applying the SBT with effect from 1 July 2002.

Continuity of Ownership Test (COT)

- Companies will not fail COT simply because they have multiple classes of shares, with effect from 1 July 2002.
- The meaning of 'voting power' has been defined to mean the power to vote on a poll for the election of a director to a company, with effect from 1 July 2007.

Forestry Managed Investment Schemes

From 1 July 2007, investors in forestry managed investment schemes (MISs) will only be entitled to immediate upfront deductions where at least

70% of the expenditure is directly related to developing forestry.

In addition, existing and future investors will be allowed to trade their interests in forestry MISs provided that the initial investors held their interests for at least four years.

Thin Capitalisation

The thin capitalisation three-year transitional period introduced as a result of the adoption of IFRS has now been extended by one year. Taxpayers will be able to determine their allowable debt using Australian General Accepted Accounting Principles as they existed pre-1 January 2005. This will be available until 30 June 2009 (or substituted accounting period).

In addition, measures will be introduced to ensure that taxpayers are not disadvantaged by the exclusion of certain equity interests from the thin capitalisation rules.

Venture Capital

Tax concessions for foreign residents investing in venture capital limited partnerships (VCLPs) and Australian venture capital funds (AVCFs) will be relaxed, effective from 2007/08:

- up to 20% of committed capital in VCLPs and AVCFs can be invested in companies and unit trusts located outside Australia; and
- eligible partners in conditionally registered VCLPs and AVCFs that become fully registered will be exempt from tax on gains derived from investments made while conditionally registered.

Certain investment restrictions will apply to ensure that investments made by early stage VCLPs are channelled toward early stage capital activities.

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.