

client alert | explanatory memorandum

April 2007

CGT and Forward Purchase Agreements

In a recent decision in *Lend Lease Custodian Pty Limited v. Deputy Commissioner of Taxation* [2006] FCA 1790, the Federal Court overturned an earlier decision of the Administrative Appeals Tribunal (AAT), finding that a scheme of arrangement involving the issue of a forward purchase agreement for the sale of shares did not give rise to a capital gain in the hands of the taxpayer.

The case raises questions about whether, and under what circumstances, a contractual right can be considered 'property other than money' for capital gains tax purposes.

The taxpayer, Lend Lease Custodian Pty Limited (Custodian), purchased 172 million fully-paid Westpac Bank (Westpac) ordinary shares at \$3.53 per share in May 1993. In mid-1995, Custodian discussed exiting a large portion of this shareholding with Westpac.

To this end, Custodian entered into an arrangement in 1996 to sell down its shareholding by way of a forward purchase agreement (FPA). An FPA allows an entity to lock in a price for sale or purchase today, although the transaction may be completed at a future date.

The facts of the actual arrangement are complex. Custodian locked in the sale price in 1996, although the sale of the shares would not be completed until January 2000. In doing so, Custodian would guarantee it could lock in a sale price and also, as part of the arrangement, retain its entitlement to receive fully franked dividends for the next four years.

In the first instance, Custodian granted a warrant over \$100 million worth of shares in a public book-build (an invitation to participate in a competitive tender for shares). This measure effectively ensured the arm's length nature of the transaction between Custodian and County Natwest (County), which was intending to buy the \$100 million worth of shares on offer. The scheme further allowed Custodian to remain beneficial owner of the shares until completion of the contract in January 2000, including rights to vote and rights to any dividends attached to the shares.

The Commissioner did not accept that the consideration for the shares could simply be the amount set by the FPA, and sought to assess Custodian on an amount of additional 'non-cash consideration' — for example, the additional proceeds received by way of the right to retain beneficial ownership of the shares over four years. The Commissioner contended that the taxpayer received something more than cash and that the contractual rights created as part of the transaction carried an inherent value, which was of additional consideration.

The Commissioner determined a value for the rights by calculating the net present value of the dividends over the four years to completion. In order to determine Custodian's capital gain, the Commissioner compared its cost base for the shares to the amount payable under the FPA plus the value of the rights to retain beneficial ownership.

Custodian argued that there was no amount of additional consideration received pursuant to the FPA as a result of the rights. It argued that for the contractual benefit to be deemed to be property, it would need to be property which Custodian had received or was entitled to receive, which was not the case. In particular, the rights over the shares were already held by Custodian and remained its legal property until completion of the agreement in January 2000. Therefore, no new or additional rights were created or transferred.

The Court agreed with the taxpayer and held that the Commissioner's contention that the rights represented 'property other than money' was incorrect. It follows that the additional capital gain that the Tax Office sought to assess was invalid.

In addition, the Court held that dividends receivable by Custodian were fully rebateable. The Commissioner's alternative argument that the payment of the dividend was the disposition of a right and should be assessed as a gain was rejected by the Court, which found no evidence to suggest that this was the correct view.

The Tax Office has appealed to the Full Federal Court.

Family Trust and Interposed Entity Elections

More information on the procedures for lodging family trust elections (FTEs) and interposed entity elections (IEEs) under the lodgment opportunity in Practice Statement PS LA 2004/1 (GA) can be found on the ATO website at <www.ato.gov.au/print.asp?doc=/content/47655.htm>.

Work-related Expense Errors Persist

For more information about work-related expenses and the Tax Office's compliance program, visit the ATO website at <www.ato.gov.au/content/downloads/2006-05_annual_report_Commish_Review_web.pdf> on pages 138–139.

Remission of Penalties — Tax Invoices and Adjustment Notes

In Practice Statement Law Administration PS LA 2007/3, the Tax Office details its policy concerning the remission of penalties imposed for situations where there has been a failure to issue a tax invoice or adjustment note as required by the GST legislation. It also covers cases where both an entity and its agent have issued separate tax invoices or separate adjustment notes contrary to the requirements set out in the GST legislation.

According to the Tax Office, tax invoices and adjustment notes are key integrity measures under the GST system and penalties apply in all cases where taxpayers fail to comply with their tax invoice or adjustment note obligations under the GST legislation.

To read the full text of Practice Statement PS LA 2007/3, visit the ATO website at <http://law.ato.gov.au/pdf/ps07_003.pdf>.

Commissioner's discretion

The Commissioner has a broad discretion, under subsection 29–70(1) of the GST legislation, to accept documentation as a tax invoice although it does not conform to the requirements set out in that section. A similar discretion also exists in relation to adjustment notes. However, by exercising this discretion, it does not abolish the supplier's liability to penalties as the supplier has still failed to issue a tax invoice or adjustment note according to section 29 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).

How and when remission of the penalty is warranted

The Commissioner is obligated to consider the remission of administrative penalties in all cases where the entity has failed to comply with the legislative requirements in relation to tax invoices, adjustment notes or when both the entity and its agent issue certain documents. Where the Commissioner has exercised the discretion to treat documents as tax invoices, the administrative penalties should generally be remitted in full. In such circumstances where the Commissioner rejects the full/part remission of penalties, the entity has the opportunity to object to this decision.

The Commissioner's decision in respect of remission of administrative penalties has a direct relationship to the entity's 'compliance attitude'. For example, where entities show signs of fraud or deliberate avoidance of their obligations, the penalties will not be remitted. According to the Tax Office, the appropriate level of remission will be determined by whether the entity is making a genuine effort to comply or whether they are making little or no effort to comply with their obligations in relation to the GST legislation.

Where the supplier fails to comply with its tax invoice or adjustment note obligations in relation to more than one taxable supply or adjustment event, a penalty is imposed for each occasion that the supplier has not complied. However, the Commissioner may determine that these multiple failures to comply are the result of a single offence, resulting in a penalty being imposed on that single event. This will not be the case if the entity has a past history of not complying with its tax invoice/adjustment note obligations, where the Commissioner may penalise the entity on each occasion the entity failed to comply.

In the situation where the supplier fails to issue a tax invoice on the basis of a genuine belief that the supply is not taxable, the Commissioner can give the supplier a period of up to 28 days, from the date that the decision is communicated, to issue a tax invoice.

Settlement Payment to Partner Assessable

In *McNally v. Commissioner of Taxation* [2007] FCA 51, the Federal Court overturned an earlier decision of the AAT, finding that a settlement payment made to a partner on his termination from a partnership was in fact assessable income.

The taxpayer was a partner of a large accounting firm and following a dispute arising over his removal from the partnership, he was paid a settlement amount of \$500,000. The amount was paid as if he had retired on the day of the payment, and the taxpayer did not include any of the settlement amount in his assessable income. However, upon receiving information from the firm, the Commissioner amended the taxpayer's assessment including the entire settlement amount in the taxpayer's return, which was made up of a gratuitous partnership profit distribution and opening timing differences for work in progress payments.

The AAT originally viewed the settlement amount as a non-assessable un-dissected lump sum, however the AAT also concluded that the portion of the payment that represented timing differences should be included in the taxpayer's assessable income.

The Federal Court overturned the AAT's decision, finding that the AAT had erred in law when approaching the matter from the perspective of determining whether the settlement payment was ordinary income in the hands of the taxpayer. The Court determined that the correct approach was to view the settlement amount as representing net income of the partnership to which the taxpayer was entitled. The taxpayer objected, arguing that the amount represented a settlement from legal proceedings and not an interest with respect to his share of the partnership's net income.

The Commissioner contended, and the Court agreed, that while a partnership must furnish a return of its income, it is not liable for tax on that income. According to section 92 of the *Income Tax Assessment Act 1936* (ITAA 1936), the assessable income of a taxpayer shall include 'so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to the period when the partner was a resident'.

The Court also held that the AAT erred in law when assessing the taxpayer on the timing differences representing work in progress. The Court concluded that merely because they had been brought to account for fiscal purposes did not mean that they were a part of the net income of the partnership. Therefore, both appeals were allowed, and the Court remitted the taxpayer's application back to the AAT for reconsideration given the new findings.

Share Buyback Arrangement

In a recent decision, the High Court overturned a decision by the Full Federal Court, finding that the sale of sell-back rights granted by St George Bank (St George) are assessable as ordinary income to a taxpayer involved in the arrangement. The litigation has been treated as a test case, and the Commissioner has indicated the decision affects over 80,000 taxpayers.

The taxpayer held a parcel of ordinary shares in St George which were subject to an off-market share buyback in February 2001. The arrangement provided that one sell-back right would be issued for every twenty St George ordinary shares held. This sell-back right would entitle the shareholder to sell back shares to St George at a fixed price, which was above the current market value of the shares. The market value of the shares on the date of the scheme was in the range of \$14.45 to \$14.64 per share. As part of the agreement, St George offered shareholders the opportunity to sell one share for a set price of \$16.50, and fixed an agreed market value of one sell-back right at \$1.89. This amount represented the positive difference between the fixed price offered by St George on the sell-back right, as compared to the highest market price that St George's shares had traded at, on the scheme date.

The Commissioner sought to assess the taxpayer on the value of the sell-back right either as ordinary income under section 6-5 of the *Income Tax Assessment Act 1997* (ITAA 1997) or as a capital gain. However, it was noted that if the amount represented assessable income, the anti-overlap provision in section 118-20 of ITAA 1997 would operate to reduce the capital gain to nil — subsequently only assessing the ordinary income.

The High Court, in coming to its decision, confirmed that:

- the character of a particular receipt is dependant on its quality in the hands of the recipient and not the character of expenditure by the other party; and
- a gain derived from property has the character of income which includes gains where the owner has waited passively for the return from property.

The Court agreed with the Commissioner that while the share buyback arrangement involved a capital restructuring by St George and the conferral of an entitlement on the taxpayer as a result of the re-structure, it did not explain the character of the taxpayer's sell-back rights. In addition, the Court found that while the rights were a result of the taxpayer's shareholding, they arose under an arrangement which was severed from the shareholding.

The taxpayer argued that the sell-back rights did not provide the necessary severance or detachment from the existing shareholding and therefore were not ordinary income in accordance with case law pertaining to the issue. The taxpayer further argued that there was no requisite detachment from the rights of holding St George ordinary shares, the entitlement to the sell-back right went hand in hand with holding the shares and the taxpayer contended the Commissioner erred in finding that this right could be separated.

On the contrary, the Court found that the sell-back right was not provided 'in satisfaction' of the rights held by the taxpayer in holding the ordinary shares, as the scheme was separate from the normal operation of the shares listed on the ASX.

The taxpayer further argued that the income was specifically excluded on the grounds that sell-back rights fell outside of any dividend provisions listed in the income tax law, and a conflict between the specific provisions arose as a result of their operation. The Court rejected this argument, indicating that the income tax law includes gross income from all sources both direct and indirect in the definition of assessable income, and the sell-back right is not specified as exempt income and therefore should not be excluded on any other ground.

In conclusion, the High Court accepted the Commissioner's argument that the Full Federal Court had erred in law. When the taxpayer was issued with the sell-back right, for the 'absolute benefit' of the taxpayer, there was a derivation of income which was represented by the market value of the rights.

For more information see Class Ruling CR 2001/75 on the ATO website at <<http://law.ato.gov.au/pdf/cr01-075.pdf>>.

Changes to Small Business Taxation

For more information about the changes to small business taxation detailed in the recently released Exposure Draft Tax Laws Amendment (Small Business) Bill 2007, visit the Treasury website at www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1229.

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