

Transfer of Assets between Trusts

The Tax Office has recently released ATO ID 2005/175, which outlines when the CGT exemption available under paragraph 104–60(5)(b) of the *Income Tax Assessment Act 1997* may be applied to a transfer of an asset between two discretionary trusts.

Under subsections 104–60(1) and 104–60(2), CGT event E2 occurs when a CGT asset is transferred to an existing trust. In the event that the asset is transferred from one trust to another, the taxpayer may be exempt from CGT if the situation meets the requirements of paragraph 104–60(5)(b). The exemption requires that the beneficiaries and terms of both the transferor and transferee trust be exactly the same. Basically, the trust deeds of both trusts must be identical, but the establishment date may be different.

The ID considers a situation where the two trusts have the same beneficiaries and trust deeds, but different appointors. As the appointor has the power to appoint and remove a trustee, it is considered that the identity of the appointor is a term of the trust. If the two trusts have different appointors, the terms of the trust are deemed not to be identical. Consequently, the exemption under paragraph 104–60(5)(b) may not be applied.

For further information, please review ATO ID 2005/175 Capital Gains Tax: application of CGT event E2 — discretionary trust transfers assets to another discretionary trust, at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005175/00001>.

Service Trusts

The Tax Office has recently released a guide concerning the use of service arrangements by professional firms and other organisations. The release of the guide follows the release by the Tax Office of Draft Taxation Ruling TR 2005/D5, which concerns the deductibility of service fees paid to associated entities under a ‘Phillips arrangement’. The guide aims to provide a practical approach for taxpayers to ensure that they comply with the approach accepted by the Tax Office.

The guide states that its role is to provide guidance as to whether payments made under a service arrangement are commercially realistic and reasonably connected to the main business of the professional firm or other related entity.

Arrangements Covered by the Guide

Typically, a service arrangement considered in the guide concerns a taxpayer who carries on a professional practice. The taxpayer may be a sole practitioner, a partner in a partnership or a company that provides professional services. The guide may also apply to other organisations that charge for staff and services between related entities

The taxpayer enters into an agreement (service agreement) with a service entity. The service entity is generally a trust or a company. Under the agreement, the service entity agrees to provide professional services to the taxpayer in return for a fee. The taxpayer will then claim a tax deduction for the fees paid and the service entity will include the fees received in its assessable income. The fees charged by the service entity are usually based on a mark-up on costs and result in a profit to the service entity.

Who Should Review their Arrangements?

Practically, the guide recommends that taxpayers should review their service agreement arrangements if they have not previously considered the issues raised by the Tax Office in the guide.

The taxpayer should specifically review:

- the fees and charges for the service provided, particularly if the fees are disproportionate or excessive in relation to the benefits provided to the taxpayer;
- the manner in which the fees are calculated;
- whether the business of the service entity is separate from that of the taxpayer; and
- whether there is adequate documentation to evidence all aspects of the taxpayer's arrangements.

What Does the Taxpayer Need to Show?

The guide outlines the aspects of a service arrangement that the taxpayer needs to demonstrate in order to support the deduction for fees paid to the service entity.

The taxpayer should demonstrate that the service arrangement helps or adds benefit to the partnership or taxpayer, by:

- identifying the commercial benefits to the taxpayer from the arrangement;
- showing how the services provided by the service entity improve the quality or value of the products and/or services provided by the taxpayer;
- addressing how the underlying economic and legal responsibilities, and risks and benefits arising from the service agreement are allocated between the partnership and the service entity, e.g. who has responsibility for the human resources function in relation to employees of the service entity; and
- identifying personnel and/or resources employed by the service entity to deliver the contracted services.

Calculation of Service Fees

The taxpayer must also show that the service entity's charges are commercially realistic. In doing so, the taxpayer is required to consider what an independent person would pay in the circumstances. In preparing guideline mark-ups, the Tax Office has reviewed publicly available information regarding the profits earned by public companies providing labour hire services.

The Tax Office considers that the following represents a realistic mark-up for the different services provided by service entities:

- labour hire of temporary staff — a net mark-up of less than or equal to 5% on the direct and indirect operating costs associated with on-hiring temporary staff;
- labour hire of permanent staff — a net mark-up of less than or equal to 3.5% on the direct and indirect operating costs associated with on-hiring permanent staff;
- recruitment — a net mark-up of less than or equal to 5% on the direct and indirect operating costs associated with recruitment activities;
- equipment hire — hire fees that result in the service entity deriving a return on assets of less than or equal to 9% of the written-down value of assets used in the hiring activity; and
- rental — rent at market value (plus finder fees where appropriate).

Going Forward

The guide and TR 2005/D5 have been released by the Tax Office as a result of a series of tax audits conducted by the Tax Office in the legal and accounting sectors. The Tax Office states in the guide that it will continue its audit program and will be targeting taxpayers where services fees paid by the professional firm to the service entity are over \$1 million. In order for the Tax Office to investigate, the amount paid must be greater than 50% of the gross fees earned by the professional firm. It will also target firms where the service entity arrangements raise serious questions as to their commerciality.

The Tax Office has stated, however, that its general approach is to allow taxpayers a period of 12 months to review their arrangements in light of the guide.

For further information please review TR 2005/D5 at:

<<http://law.ato.gov.au/pdf/tr05-d05.pdf>>, and the service arrangements guide at:

<<http://www.ato.gov.au/businesses/content.asp?doc=/content/60979.htm>>

Family Trust Elections

The Tax Office has recently released ATO IDs 2005/173 and 2005/174, which discuss the meaning of ‘family group’ in relation to a family trust.

Under the trust loss rules contained in Schedule 2F of the *Income Tax Assessment Act 1936* (ITAA 1936), a trust is required to satisfy certain ownership rules in order to carry forward income tax losses incurred by the trust. Often, a non-fixed trust may be unable to satisfy the ownership rules (including a strict pattern of distributions test) and may be required to make a family trust election in order to carry forward any tax losses. A non-fixed trust is defined in section 266–30 as a trust that is not a fixed trust. A non-fixed trust includes both a discretionary trust, and a unit trust that has discretionary units, which provide that income of the trust may be distributed to entities other than the ordinary unit holders.

The ‘45 day rule’ contained in the franking credit rules in Division 1A of Part IIIA of ITAA 1936 provides that franking credits will only be available to a taxpayer where the taxpayer has held the shares ‘at risk’ for 45 days. Under section 160APHL, shares owned by a non-fixed trust are deemed not to be held at risk unless the trust makes a family trust election. Therefore, in order for the trust to be able to distribute the franking credits attached to dividends that it receives, it is required to make a family trust election.

Section 272–80(3) provides that the trust must nominate a *test individual* in order to make a family trust election. The family trust will be unable to distribute outside of the family group of the test individual. If the trust does distribute outside of the family group, the distribution will attract family trust distribution tax by operation of section 271–15.

The family group is defined in section 272–90 to include:

- specified members of the test individual’s family group; and
- companies, trusts and partnerships that have made an interposed entity election to be included within the family group.

The trust must also pass the control test outlined in section 272–87 at the time of making the family trust election. The trust will pass the test if it is controlled by a group that comprises one of the following:

- the test individual and members of the test individual’s family; or
- any of the persons listed above and the family’s legal or professional adviser; or
- the trustees of one or more of the family’s trusts and any of the test individual or members of the test individual’s family.

Where a company or trust makes an interposed entity election to be included in the family group, the election must specify the test individual in relation to the family trust.

Different Primary Individuals

ATO ID 2005/174 provides that a family trust which has made a family trust election in respect of a test individual may also make an interposed entity election in respect of another family trust and test individual. However, the two test individuals must be part of the same family group, so that the control test is passed in respect of both family trusts. The example given in the ID provides that the test will be passed where the two test individuals are brothers, and therefore the trusts are controlled by members of the same family group.

For further information, please review ATO ID 2005/174 Family trusts making interposed entity elections: different primary individuals, at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005174/00001>.

Definition of Family

A family group is defined in section 272–90 to include the test individual’s spouse, a child, grandchild, parent, grandparent, brother, sister, nephew or niece of the individual or of the individual’s spouse, and the spouse of such a child, grandchild, parent, grandparent, brother, sister, nephew or niece.

A child is defined under the law to include an adopted child, a stepchild or an ex-nuptial child.

ATO ID 2005/173 considers whether a stepchild of a test individual will remain within the family group if the spouse of the test individual dies. The Tax Office considers that the child will no longer be part of the family group as the relationship between a stepparent and stepchild ceases when the spouse dies.

For further information, please review ATO ID 2005/173 Family Trust Election: definition of family — stepchild, at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005173/00001>.

CGT — Cost Base Following Demerger

The Tax Office has recently released ATO ID 2005/134, which states that, following a demerger, an averaging method of calculation must be used to determine the adjusted cost base of shares held in the head company (Head Co) and the demerged company (Sub Co). Furthermore, the adjusted cost base should be the same for all the shares even if the pre-demerger cost bases of shares are different.

The taxpayer held two parcels of post-CGT shares in Head Co, which were acquired at different times and for different amounts. Head Co subsequently demerged a subsidiary (Sub Co). For each share held in Head Co, the taxpayer was entitled to receive one share in Sub Co. The taxpayer chose to apply the CGT rollover relief in subsection 125–55(1) of the *Income Tax Assessment Act 1997*.

For the purposes of subsection 125–80(3), it was determined that the market value of Head Co shares relative to the market value of Sub Co shares be represented by the ratio 3:1. This ratio was accepted by the Tax Office as reasonable.

As the taxpayer held one parcel of 1,000 shares in Head Co with a cost base of \$4 and a further parcel of 100 shares in Head Co with a cost base of \$15, the taxpayer calculated the adjusted cost base per parcel. As the relative market valuation ratio was 3:1, the taxpayer calculated the adjusted cost bases for the new shares in Sub Co as 25% of the cost base of corresponding Head Co shares. The Head Co shares were also adjusted accordingly.

Parcel 1:

75% of 1,000 Head Co shares @ cost base \$4 = \$3,000 (∴ deemed cost base = \$3 per share)

25% of 1,000 Sub Co shares @ cost base \$4 = \$1,000 (∴ deemed cost base = \$1 per share)

Parcel 2:

75% of 100 Head Co shares @ cost base \$15 = \$1,125 (∴ deemed cost base = \$11.25 per share)

25% of 100 Sub Co shares @ cost base \$15 = \$375 (∴ deemed cost base = \$3.75 per share)

The Tax Office stated that this method was incorrect, as the law does not permit the use of more than one cost base for shares of the same class held in the one company.

As the Head Co shares are of the same class, the correct method under subsection 125–80(2) involves the taxpayer calculating the cost base of the company shares by determining the combined value of the two parcels of Head Co shares and then dividing it by the number of shares. This is the same method used to determine the cost base of the shares in Sub Co.

The resulting cost bases just after the demerger would be as follows:

Adjusted Head Co cost base

$\$4,000$ (1,000 Head Co shares @ cost base $\$4$) + $\$1,500$ (100 Head Co shares @ $\$15$) = $\$5,500$

$(75\%$ of $\$5,500$) / 1,100 shares = $\$3.75$ per share

Adjusted Sub Co cost base

$\$4,000$ (1000 Sub Co shares @ cost base $\$4$) + $\$1,500$ (100 Sub Co shares @ $\$15$) = $\$5,000$

$(25\%$ of $\$5,500$) / 1,100 share = $\$1.25$ per share

For further information please review ATO ID 2005/134 — Capital Gains Tax: demerger — cost bases of ownership interests, at:

<http://law.ato.gov.au/atolaw/view.htm?find&docid=AID/AID2005134/00001>

GST on Property

In recently released ATO IDs 2005/182 and 2005/183, the Tax Office considers whether the supply of a call option, over commercial and residential properties respectively, is an input taxed financial supply under section 40–5, or a taxable supply under section 9–5 of the GST Act.

Broadly, the supply of an option over real property (commercial or residential) consists of the following arrangement:

- The supplier of the real property is registered for GST.
- The supplier grants the purchaser an option to purchase a property for a specified amount up until a specified date.
- The purchaser pays a specified percentage of the purchase price of the property for the option.

Broadly, under section 9–5 an entity makes a taxable supply if:

- it makes a supply for consideration;
- the supply is made in the course or furtherance of an enterprise that it carries on;
- the supply is connected with Australia; and
- the entity is registered or required to be registered for GST.

The supply is not a taxable supply to the extent that it is GST-free or input taxed.

Under subsection 40–5(1) of the GST Act, a financial supply is input taxed. The table in sub-regulation 40–5.09(3) lists items that are considered financial supplies. Item 11 in the table lists a derivative. The option described above falls within the definition of a derivative.

However, the table in regulation 40–5.12 lists items that are deemed not to be financial supplies. Item 7 lists an option, right or obligation to make or receive a taxable supply.

In the case where an option is over a commercial property, item 7 of the table is satisfied and the option would therefore not be input taxed. The supplier is deemed to be making a taxable supply under section 9–5.

An option over a residential property would not fall into item 7 of the table where it is in respect of a supply of residential premises that is itself an input-taxed supply. Consequently, a call option over input taxed residential premises is an input taxed supply under subsection 40–5(1).

For further information on commercial property options, please review ATO ID 2005/182 — Goods and Services Tax: GST and supply of a call option over commercial property, at:

<http://law.ato.gov.au/atolaw/view.htm?find&docid=AID/AID2005182/00001>.

For further information on residential property options, please review ATO ID 2005/183 — Goods and Services Tax: GST and supply of a call option over residential premises at:

<http://law.ato.gov.au/atolaw/view.htm?find&docid=AID/AID2005183/00001>.

Credit Arrangement

In ATO ID 2005/194 the Tax Office considers whether the following credit arrangement is an input taxed supply under subsection 40–5(1) of the GST Act.

The credit arrangement consists of the following:

- The entity is a property investor which is registered for GST, and it sells a residential property to a buyer.
- The entity and the buyer enter into an instalment contract, by which the entity provides the buyer with a credit arrangement to enable the buyer to purchase the property.
- Under the credit arrangement the buyer agrees to pay monthly instalments and interest over an extended period of time.
- The buyer has the right to occupy the property from the day the contract is signed up until the final instalment is paid (settlement date).
- The title of the property does not pass to the buyer until settlement date.

Under subsection 40–5(1), a financial supply is input taxed.

Sub-regulation 40–5.09(1) of the GST Regulations provides that the provision, acquisition, or disposal of an interest mentioned under sub-regulation 40–5.09(3) or 40–5.09(4) of the GST Regulations is a financial supply if:

(a) the provision, acquisition or disposal of that interest is:

- for consideration;
- in the course or furtherance of an enterprise; and
- connected with Australia; and

(b) the supplier:

- is registered or required to be registered for GST; and
- is a financial supply provider in relation to supply of the interest.

The entity is registered for GST. The supply is made for consideration in the course of its enterprise and is connected with Australia. The table in sub-regulation 40–5.09(3) lists items which are considered financial supplies. Item 2 lists a credit arrangement.

Schedule 1 of GSTR 2002/2 defines a credit arrangement as ‘an arrangement under which an entity lends money on terms that include deferred repayment, or under which payment of a debt owed by one entity to another is deferred or time is allowed to pay’.

The above arrangement falls into the definition of a credit arrangement; therefore, the above credit arrangement is an input taxed financial supply and GST will not apply on the interest component of the credit arrangement.

For further information, please review ATO ID 2005/194 — Goods and Services Tax: GST and a credit arrangement by way of an instalment contract for the sale of residential premises, at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005194/00001>.