

Rental Property Deductions

For further information please refer to the Tax Office announcement: Deductions for rental properties, at:

<http://www.ato.gov.au/corporate/content.asp?doc=/content/76069.htm&pc=001/001/017/003&mnu=24009&mfp=001&st=&cy=1>

Trust Cloning – Potential Exception to CGT Events E1 and E2

The Tax Office has recently released Taxation Ruling TR 2006/4, which outlines the circumstances in which two trusts are deemed to be the same for the purposes of applying an exception to CGT events E1 and E2. The ruling was originally issued as Draft TR 2005/D15 and is essentially unchanged from the earlier version.

Broadly, CGT event E1 occurs where a trust is created over an asset. CGT event E2 occurs where a CGT asset is transferred from one trust to an existing trust. The exception is triggered where the asset is transferred to the trust from another trust and the beneficiaries and terms of both trusts are the same.

The conditions for this exception to be applicable must be met at the time the asset is transferred, or more specifically, immediately before the asset is transferred from the original trust and immediately after the transfer to the new trust.

The transfer of assets from the existing trust to the new trust will not be subject to either CGT event if the beneficiaries and terms of both trusts are the same. The following provides a brief summary of the conditions set out in the ruling, which apply to deem two trusts to be the same.

Beneficiaries

‘Beneficiaries’ refers to the direct beneficiaries of the trust. The exception is not satisfied where the indirect or ultimate beneficiaries of each trust are the same but the direct beneficiaries are not.

Neither is this condition satisfied where a beneficiary of both trusts acts in a different capacity with regard to each trust. For example, the individual is a beneficiary of one trust but a trustee of the other trust.

It should be noted that even where the differences between the two beneficiaries are considered to be minor, this will still prevent the application of the exception.

Terms

The terms of the trust include those set out in the trust deed and those implied by statute and the general law. The terms include items such as the powers, duties, and discretions of the trustee and of any appointer or guardian.

For the terms of the two trusts to be the same the new trust must contain all of the terms contained in the original trust and no others. Whether the terms and conditions of the two trusts have the same meaning and effect will be determined on a case-by-case basis.

In deciding whether two trusts are the same, TR 2006/4 provides some factors to consider:

- **Trustees, appointers and guardians:** The trustees need not be the same; however, if the original trust has an appointer the new trust must also have an appointer or an individual in a similar role. If the original trust has an appointer the identity of the appointer must be the same for both trusts, along with any guardians or protectors.
- **Beneficiaries' rights and entitlements:** Each beneficiary must possess the same rights, entitlements and interests in both trusts. This includes, but is not limited to, direct interests in the assets of the trust and the rights to benefit from those assets.
- **Vesting and termination dates:** The time at which the interests in the trust are to vest or the time at which the trust is to terminate are considered to be terms of the trust and hence required to be the same.
- **State laws:** The same state laws must govern each trust.
- **Family trust and interposed entity elections:** If the original trust has made a family trust election or interposed entity election the new trust must also make the same elections. If the election is a family trust election each election must specify the same 'test' individual. Moreover, if interposed entity elections are made, those elections must be in respect of the same family trust election and each must specify the family group of the individual specified in the family trust election.

Having satisfied the above conditions, the ruling specifies that the following items need not be the same:

- the name of the trust;
- the commencement or establishment dates of the two trusts;
- the settlor; and
- the trust property (provided that the transferred asset is an asset of both trusts in the respective time periods).

For further information please review TR 2006/4 — Income tax: capital gains: meaning of the words 'the beneficiaries and terms of both trusts are the same' in paragraphs 104–55(5)(b) and 104–60(5)(b) of the *Income Tax Assessment Act 1997*, at:

<http://law.at0.gov.au/atolaw/print.htm?DocID=TXR%2FTR20064%2FNAT%2FATO%2F00001>

CGT and Foreign Residents

On 22 June 2006 the Taxation Laws Amendment (2006 Measures No. 4) Bill 2006 was introduced into the House of Representatives.

The main change to come from the new Bill is the treatment of capital gains and losses in the hands of foreign residents. The changes were originally announced in the 2005 Federal Budget and have been brought about in an effort to align Australian domestic tax legislation with that of Australia's tax treaties.

The reforms make two major changes to the current CGT regime as it applies to foreign residents:

- narrows the range of assets that are subject to CGT to Australian real property which is directly held by a foreign resident and any CGT asset used by a foreign resident in carrying on a business through a permanent establishment in Australia; and
- applies CGT to foreign residents who have a non-portfolio interest through an interposed entity (including foreign interposed entities). This is where more than 50% of the value of the interposed entities' assets are attributable (directly or indirectly) to Australian real property.

Given the above changes, a foreign resident can disregard a capital gain or loss arising from a CGT event in relation to a CGT asset that is not classified as taxable Australian property. With regard to an Australian permanent establishment, a gain or loss can be reduced where the CGT asset was not used for carrying on the business of the permanent establishment for part of the period.

The current law defines a capital gain or loss arising from a CGT asset where it is deemed to have a 'necessary connection with Australia'. There are a raft of items in the *Income Tax Assessment Act 1997* that characterise how a necessary connection is determined. The new law simplifies the characterisation by only looking at gains and losses made on CGT assets that are taxable Australian property and the business assets of an Australian permanent establishment.

'Taxable Australian real property' generally refers to real property that holds its ordinary meaning. The meaning of taxable Australian real property has also been expanded to include a mining, quarrying or prospecting right, where the minerals, petroleum or quarry materials are situated in Australia.

The new Bill also includes a taxing right over indirect real property interests, which ensures that a disposal of an interest in Australian real property is subject to CGT regardless of whether it is held directly or indirectly. There are two tests that determine whether a foreign resident holds an indirect interest in Australian real property and they are as follows:

- the non-portfolio interest test; and
- the principal asset test.

For an interest to be an indirect Australian real property interest both of the abovementioned tests must be passed. The non-portfolio interest test, consistent with current law, is passed where the sum of the direct participation interests of the foreign resident is 10% or greater in the public company or unit trust. A membership interest held by a foreign resident (a holding entity) in another entity (a test entity) passes the principal asset test if more than 50% of the value of the test entity's assets is attributable to taxable Australian real property. A CGT liability will arise for the foreign resident where there is a disposal of the taxable Australian real property and both tests are satisfied.

It should be noted that rollovers available on taxable Australian property between an Australian resident and foreign resident or between two foreign residents will continue to be available.

Tax Implications of Government Payments to Industry

The Tax Office has recently released Taxation Ruling TR 2006/3 that discusses the Commissioner's view on government payments to industry, which aid in continuing, ceasing or commencing business.

In the ruling the Commissioner indicates that a payment to a company to continue its business should be included in assessable income. Examples of such payments include:

- the provision of income support;
- assistance with operating costs;
- a payment to encourage business expansion;
- a payment to undertake research and development activities; and
- a payment to allow potential re-structuring to remain viable.

However, where the payment is made in agreeing to give up or sell part of the profit yielding structure of the business, it may be considered capital in nature and not included as assessable income.

Payments made to commence or cease a business are not ordinarily assessable as income. However, it is recognised that these payments may be considered assessable recoupments and included in assessable income. The ruling identifies certain payments to industry as being assessable recoupments, such as:

- a payment received to assist the recipient to commence the business with the purchase of a depreciating asset. The business will be able to claim a deduction for the decline in the value of the asset under the capital allowances provisions in Division 40 of *Income Tax Assessment Act 1997* (ITAA 1997). Where the payment is recoupment for the depreciation cost of the asset it will be included in assessable income under Subdivision 20-A of ITAA 1997;
- a payment made to cease or commence a business that reimburses the cost of professional taxation advice. Where the business can claim deductions for the cost of the advice it will be included in assessable income as assessable recoupments under Subdivision 20-A of ITAA 1997; and

- a payment made to finalise business costs operations where a deduction can be claimed under section 40–880 of ITAA 1997. Where the payment is in effect a re-imburement of costs, where a deduction is allowable, this payment will be included in assessable income as assessable recoupments under Subdivision 20–A of ITAA 1997.

For further information please review TR 2006/3 — Income Tax: government payments to industry to assist entities (including individuals) to continue, commence or cease business, at:

<http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~TR~basic~exact:::AND~2006%2F3~basic~exact&target=EA&style=java&sdocid=TXR/TR20063/NAT/ATO/00001&recStart=1&recnum=2&tot=12&pn=ALL:::ALL>

Share Capital Tainting Rules

Taxation Laws Amendment (2006 Measures No. 3) Bill makes amendments to the *Income Tax Assessment Act 1997* regarding a company's share capital account. The provisions introduced by this Bill will apply from 25 May 2006. The former share capital tainting rules were repealed on the introduction of the simplified imputation system and have not been reintroduced until now. Broadly, the new rules are largely a rewrite of the old rules, with a few minor changes that include:

- Australian Equivalents to International Financial Reporting Standards (AIFRS) accounting entries made between 1 July 2002 and 25 May 2006 will not trigger the share capital tainting rules;
- a transfer to the company's share capital account will trigger a franking debit to arise in the company franking account at the end of the franking period and not the day of the transfer;
- transfers from an option premium reserve have been added as an exclusion to the operation of the rules;
- with respect to a debt for equity swap arrangement, the new rules will only apply to the extent where the transferred amount exceeds the market value of the extinguished debt;
- a dividend which is debited against a disqualifying account is still deemed to be an unfrankable distribution; and
- transitional rules are included in the Bill to enable the untainting of accounts that became tainted under the former rules, which had not been untainted before 1 July 2002.

A company's share capital account will become tainted if a transfer is made from any other account, other than:

- an amount that has been identified as share capital;
- certain amounts that are transferred under debt/equity swaps;
- an amount that is transferred by a non-Corporations Act company to remove shares with a par value;
- certain amounts that are transferred from an option premium reserve;
- certain amounts that are transferred in connection with the demutualisation of a non-insurance company;
- certain amounts that are transferred in connection with the demutualisation of an insurance company at the time of demutualisation; and
- certain amounts that are transferred in connection with the demutualisation of an insurance company, but after the demutualisation.

If an amount from an account other than those listed above is transferred into the share capital account, it will cause the account to become tainted. If a company's share capital account becomes tainted, a franking debit will arise in the company's franking account. Any distributions made from the tainted share capital account are taxed as unfranked dividends in the hands of the shareholder.

The amount of the franking debit is calculated in accordance with the following formula:

$$\text{transferred amount} \times \frac{(\text{corporate tax rate})}{100\% - \text{corporate tax rate}} \times \text{applicable franking percentage}$$

The applicable franking percentage is the company's benchmark franking percentage. If the company has not set a benchmark franking percentage at the end of the franking period it is taken to be 100%.

The company may choose to untaint its share capital account, but once this choice is made it will be irrevocable. As a result of choosing to untaint its share capital account, a company may be liable for an additional franking debit at the end of the franking period in which the choice to untaint is made. There may also be a liability to untainting tax at this point.

With respect to a consolidated group or MEC group, if a subsidiary member transfers an amount to its share capital account that causes the account to become tainted, only the subsidiary member's share capital account is tainted. The single entity rule does not apply to deem the head company's account to become tainted as a result. However, as only the head company operates a franking account, at the time of tainting, franking debits will arise in the franking account of the head company.

GST and Contracts

For further information please review *Kiwi Munchies Pty Ltd v. Nikolitsis (Retail Tenancies) (2006) VCAT 929* (29 May 2006) at:

<http://www.austlii.edu.au/cgi-bin/disp.pl/au/cases/vic/VCAT/2006/929.html?query=VCAT%20929>

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