client alert | explanatory memorandum

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Main Residence CGT Exemption — Burden of Proof

In a recent decision in *Erdelyi and Commissioner of Taxation* [2007] AATA 1388, the Administrative Appeals Tribunal (AAT) held that a family of taxpayers failed to prove that a dwelling they had constructed and occupied was their main residence, and therefore eligible for concessional capital gains tax (CGT) treatment on sale.

In 2002, the taxpayers purchased a vacant block of land to build a residence on. Shortly after the house was built, the taxpayers moved into the new residence with the intention of selling their existing family home. When the taxpayers moved into the new residence, they took with them only what was necessary to reside in the house, leaving much of their old furniture and white goods to enhance the sale of their former residence.

However, soon after realizing their former residence was going to take longer than expected to sell, they listed their new residence for sale. After the sale the taxpayers did not include the net capital gain in their tax return for the 2004 year, as they were of the belief that the house was their main residence, having lived in it for a few months just prior to the time selling the property.

The Commissioner sought to assess the taxpayers on the net capital gain on the sale of the residence, and imposed penalty and interest charges. The taxpayers appealed this decision, contending that the sale of the house should not attract a capital gain as it was their main residence prior to its sale.

The Commissioner argued several points to demonstrate that the residence could not be considered the taxpayers' main residence at the time of sale. He indicated that the electricity usage was lower than normal as compared to ABS statistics for an average family household and there had been no change to the taxpayers' billing addresses or electoral roll. The Commissioner indicated that while there is no set definition of 'main residence' some factors lend themselves to provide guidance with respect to the definition including:

- the length of time the taxpayer has lived in the residence;
- the place of residence of the taxpayer's family;
- whether the taxpayer has moved his or her personal belongings into the residence;
- the address to which the taxpayer has their mail directed;
- the taxpayer's address on the electoral roll;
- the connection of services such as electricity & gas and telephone; and
- the taxpayer's intention on occupying the dwelling.

The AAT agreed with the Commissioner, finding that it was the taxpayer's responsibility to prove that a residence was their main residence, and in this case the taxpayers' actions seemed inconsistent with that conclusion.

Work Deductions Disallowed

In a recent decision in *Staker and Commissioner of Taxation* [2007] AATA 1442, the AAT disallowed part of a taxpayer's work expense deductions incurred by the taxpayer in working as a fitness instructor.

The taxpayer was employed as a fitness instructor at a prestigious resort complex. The taxpayer, as part of her 2005 income tax return, claimed approximately $16,500 of work-related expense deductions. The taxpayer was later audited and all of the expenses were disallowed.

The taxpayer objected to the disallowance of the expense amounts and lodged an appeal with the AAT, contending that her expenses were in direct relation to her employment. As an employee of this resort complex, the taxpayer undertook work in several areas, including personal training, taking classes and rehabilitation work, to which she worked up to nine hours per week, doing up to three different activities a day over three days a week.

The taxpayer indicated that at all times she was required to be well presented and appropriately dressed for the particular activity at hand. This required her to shower and change her clothing, up to three times per day, and the expenses in question were a part of her maintaining high personal grooming standards in an effort to build client loyalty and goodwill.

Generally, a work-related expense will be deductible where it can be found that it is incurred in gaining or producing the taxpayer's assessable income, but not in relation to expenditure that is of a private, capital or domestic nature. Prima facie, one might expect the taxpayer's activities to be deductible, however in Taxation Ruling IT 2198, the Commissioner has indicated that expenditure is deductible where it is something that is ordinarily expected to occur in carrying out the duties of the taxpayer's employment. In addition, in several taxation rulings including TR 96/18, TR 95/10 and TR 95/19, the Commissioner has indicated that expenses incurred in relation to personal grooming expenses are generally not deductible even though the taxpayer may be required to maintain a high standard of appearance.

The AAT explored the facts advanced by the taxpayer, with specific reference to *Commissioner of Taxation v. Frances Margaret Edwards* (1994) 49 FCR 318, where the personal secretary to the wife of the Governor of Queensland was required to dress for a variety of engagements, in concert with the Governor's wife. The taxpayer in this case identified that her on the job clothing requirements were completely different to her own personal use clothing when 'off duty'.

The AAT however found differences in the two cases, which did not support the taxpayer's arguments. Specifically, the daily clothes she wore were not in the nature of a uniform which otherwise had no use to her. The Court also found that the claims were exaggerated and it seemed that the purchases in question may have been all of the taxpayer's expenditure in the year as opposed to that which related specifically to her employment.

In this regard, the AAT remitted the issue back to the Commissioner for the purpose of making an amended assessment.

Taxpayer Alert TA 2007/5

The Tax Office has released Taxpayer Alert TA 2007/5: *Arrangements designed to avoid the operation of Division 7A through the use of a Corporate Limited Partnership*, which is intended to be an 'early warning' of significant new and emerging high-risk tax planning issues or arrangements that the Tax Office has under risk assessment.

The alerts are written principally for taxpayers and their advisers, and also serve to inform Tax Officers of new and emerging high-risk tax planning issues.

This alert considers different scenarios where a Corporate Limited Partnership (CLP) is used as a means of avoiding the application of Division 7A.

A CLP is an association of persons carrying on a business as partners or in receipt of ordinary or statutory income, where the liability of at least one of the partners is limited. The CLP is treated as a company for taxation persons. This means that any distribution made by a CLP to one of the partners is deemed to be a dividend, except where the distribution is attributable to profits or gains of an income year in which the partnership was not taxed as a company.

Division 7A will apply to loans or payments made to a shareholder or an associate of a shareholder and to the forgiveness of loans in certain circumstances.

Division 7A will also apply where a trust has conferred a present entitlement to trust income for a corporate beneficiary and the trust then loans an amount to a shareholder or associate of that corporate beneficiary.

Where Division 7A applies, the company will be taken to have paid a dividend to the shareholder to the extent to the company's distributable surplus. However, a dividend will not be taken to be paid if a complying loan agreement is entered into between the company and the shareholder. Certain other exemptions can also apply in limited circumstances.

The Taxpayer Alert highlights a couple of arrangements as summarised below. To read the full text of the alert, visit the ATO website at:
<http://law.ato.gov.au/atolaw/view.htm?docid=TPA/TA20075/NAT/ATO/00001>.

Arrangement 1

The first arrangement involves the issue of shares in a company that has accumulated profits (Profit Company) to a CLP. Profit Company then pays a dividend to the CLP to reduce its distributable surplus. The CLP will then either lend the cash to a shareholder or associate of Profit Company or loan the cash to Profit Company who then makes a loan to the shareholder of associate. As the distributable surplus of Profit Company has been reduced, there will be no deemed dividend.

Arrangement 2

A discretionary trust has created an unpaid present entitlement to Profit Company that has accumulated profits. A CLP is then created and added as an object of the discretionary trust. The trustee then distributes income to the CLP who in turn lends the funds to a shareholder or associate of Profit Company.

The arrangement may be varied where the trustee only creates a present entitlement in the CLP and does not pay the funds over. Instead, the trust lends that amount to a shareholder or associate of Profit Company.

Issues to consider

The Tax Office considers that the following taxation issues should be considered:

- the partners must be carrying on a business in common for there to be a CLP;
- the interposed entity provision of Division 7A may apply;
- the provisions of the Value Shifting Regime in Divisions 725 and 727 may apply to arrangement 1; and
- the general anti-avoidance provision in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) may apply.

Failure to Lodge BAS on Time — Penalties Upheld

In a recent decision in *Sharkey and Commissioner of Taxation* [2007] AATA 1435, the AAT held that prolonged and knowing non-compliance with the obligation to lodge Business Activity Statements (BASs) on time justifies the application of administrative penalties, unless the taxpayer can prove otherwise.

Facts

Mr Sharkey was a solicitor in Frankston until February 2005. He registered for GST from 1 July 2000 and acquired the required computer equipment and software in order to comply with the GST.

As Mr Sharkey had registered for GST from 1 July 2000 and was due to account for GST on a quarterly basis, his first BAS (for the September 2000 quarter) was due for lodgment by 28 October 2000. However, Mr Sharkey did not lodge any BASs until December 2004, when he lodged the BASs for the quarters ended December 2000 to June 2004 (a BAS was not lodged for the September 2000 quarter). The BASs for the quarters ended December 2004 and March 2005 were lodged in January 2006, while the BAS for the September 2004 quarter was only lodged in October 2006.

Mr Sharkey's non-compliance with reporting requirements led to penalties totalling $10,450 being imposed by the Commissioner for the period July 2000 to June 2005. Mr Sharkey applied to the Commissioner to have the penalties remitted on the basis of the following arguments:

- difficulties with the honesty, competence and reliability of persons he had employed to attend to his business accounting;
- the pressure of work associated with his busy criminal and family law litigation practice as a solicitor;
- pressures of work and related financial difficulty associated with his involvement in a farming partnership;
- a claimed family and personal history of alcoholism and depression; and
- a deterioration in his physical health, which led to his decision to cease practice as a solicitor and significantly modify his personal lifestyle.

Mr Sharkey also argued that he had a mental illness (supported by a psychologist's report) which did not allow him to attend to his personal affairs, including tax obligations and that he had not been able to open his personal mail for long periods of time (two to three years).

The Commissioner refused to remit the penalties on the basis that he did not consider that:

- the delay in lodgment occurred due to circumstances beyond the control of the taxpayer; and/or
- it would be fair and reasonable to do so.

Mr Sharkey then applied to the AAT for the Commissioner's decision to be reviewed.

Legislation

Under the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act), an entity that is registered or required to be registered for GST must provide a GST return to the Commissioner for each tax period, regardless of whether or not the entity's net amount is zero or the entity is not liable for GST on any supplies that are attributable to the tax period (section 31–5). The GST return must be in the approved format (section 31–15 and section 388–75 of Schedule 1 of the *Taxation Administration Act 1953*) and can be lodged electronically (section 31–25). Where the taxpayer accounts for GST on a quarterly basis, the GST return is to be lodged with the Commissioner within 28 days after the end of the quarter (section 31–8).

Section 16-150 of Schedule 1 to the *Taxation Administration Act 1953* (TAA), provides that where an entity is required to make a payment to the Commissioner, the Commissioner must be notified on or before the due date for payment. The notification must be in the approved form and can include a BAS (section 388–50 of the TAA).

Section 286–75(1) of Schedule 1 to the TAA imposes an administrative penalty where the taxpayer does not provide the returns to the Commissioner in a timely manner. A taxpayer that is not a medium or large withholder is subject to a base penalty of one penalty unit for each 28-day period of delay in lodgment, with a maximum penalty of five penalty units. The current penalty unit is provided by section 4AA of the *Crimes Act 1914*, and is currently $110. The Commissioner must provide written notice of the penalty (section 298–10 of Schedule 1 to the TAA) and the Commissioner has discretion to remit the penalty. The taxpayer can object to the penalty imposed, but must do so within 60 days after notice having been served (as required by section 14ZW(1)(bb) of the TAA).

Decision

The AAT was of the view that the taxpayer was well enough to continue the operation of his or her ordinary business activities, stating:

> *the taxpayer's poor health and personal circumstances… [are] accorded little weight in the principled exercise of the discretion to remit penalties … unless there is significant evidence to demonstrate that the taxpayer's personal circumstances had a direct and significant impact upon either the taxpayer's awareness of their lodgment obligations or their ability to discharge them…particularly… where the taxpayer's default is prolonged and repeated.*

It was also clear that Mr Sharkey did not seek any assistance from his accountant, computer accounting consultant or a competent employee, which was seen by the AAT as a "prolonged and knowing refusal to attend to the discharge of his lodgment obligations". The AAT also noted that the circumstances of his non-compliance were not beyond Mr Sharkey's control (as finally conceded by the taxpayer) and that he was aware of his non-compliance and did not take action to remedy the non-compliance. Accordingly, the AAT affirmed the decision of the Commissioner to impose penalties for prolonged non-compliance.

Tax Compliance Tools

The Tax Office recently released three web-based decision tools to assist employers in understanding how to meet their tax and superannuation obligations. These tools include:

- an employee/contractor decision tool, which can be accessed on the ATO website at: <http://www.ato.gov.au/print.asp?doc=/content/00095062.htm>;
- a superannuation guarantee eligibility decision tool, which can be accessed on the ATO website at: <http://calculators.ato.gov.au/scripts/axos/axos.asp?CONTEXT=&KBS=SGEligibility.xr4&go=ok>; and
- a superannuation guarantee contributions calculator, which can be accessed on the ATO website at: <http://calculators.ato.gov.au/SGCalculatorWeb/GetSGContribution.aspx>.

Benchmark Interest Rate

The Tax Office recently released the benchmark interest rate for the 2007/08 income year for the purposes of the shareholder loan rules. The new rate is 8.05%, which is up from 7.55% for the prior year.

To read the full text of Taxation Determination TD 2007/23: *Income tax: what is the benchmark rate of interest applicable for the year of income that commenced on 1 July 2007 for the purposes of Division 7A of Part III of the* Income Tax Assessment Act 1936 *and how is it used?* visit the ATO website at: <http://law.ato.gov.au/atolaw/view.htm?docid=TXD/TD200723/NAT/ATO/00001>.

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