

Sale and Leaseback Arrangements

The Tax Office recently finalised Taxation Ruling 2006/13 (TR 2006/13), previously released as Draft TR 2006/D5 concerning financing arrangements involving depreciating assets subject to Division 40 of the *Income Taxation Assessment Act 1997* (ITAA 1997).

The ruling outlines the income tax consequences of sale and leaseback arrangements involving depreciating assets (which generally follow a two party arrangement), where the owner of an asset disposes of that asset (either through the sale of the physical asset or the right) and continues to use the asset as the lessee from the acquirer.

The ruling identifies that such an arrangement has economic effects similar to providing a loan to the lessee, where the present value of the lease payments is more attractive than the prevailing market debt interest rate.

The ruling also states that the Commissioner will accept a sale price representing the market value of the asset at the time of sale. In a situation where there is an identifiable market, the market value will be the selling price in that market at the appropriate time. In situations where the market is not as well established the Commissioner will accept the adjustable value of the asset.

Hence, where an arrangement is legally characterised as a sale and leaseback, the Tax Office believes the following tax consequences apply.

Balancing Adjustment Event

When a depreciating asset is sold or the rights have been transferred, a balancing adjustment event occurs. If the sale price is greater than the asset's adjustable value immediately before the sale, the lessee includes an amount in their assessable income. If the sale price is less than the asset's adjustable value, this amount becomes an allowable deduction to the lessee.

Deduction for Decline in Value

When the lessor is the legal owner of the asset in accordance with section 40–40 of ITAA 1997, they are able to claim an amount equal to the decline in value of the asset as a deduction. This decline in cost is reflective of the cost to the lessor, not the lessee.

Lease Payments

The lease arrangement will involve periodic payments by the lessee to the lessor, which the lessee will be able to deduct and the lessor will derive as income. Any additional payments made to the lessor on termination or expiry of the lease to make up the residual value of the asset are also generally considered to be on revenue account as they relate to the lease payments.

Proceeds on Sale by Lessor

When the lease expires, the lessor may sell the asset, in which case a balancing adjustment will occur. Similar to when the depreciating asset is sold, either an amount of income will be derived or an allowable deduction will arise as a result of the sale. If at the end of the lease, the lessor takes possession of the asset, then for the purposes of Division 40 of the ITAA 1997, they are taken to hold the asset. At this point, the lessor may continue to claim a deduction for the asset's decline in value, provided it continues to be used for a taxable purpose.

Alternative Tax Consequences

Under some circumstances, the above tax treatment will be altered. This will occur:

- when the depreciating asset is a fixture, consideration must be given to whether or not the item is a fixture on land; and
- if the arrangement includes an option or an obligation or contingent obligation for the lessee to re-purchase the asset, then the lease may be characterised as a hire purchase agreement subject to Division 240 of ITAA 1997. Therefore, what happens at the end of the lease period may affect how the entire arrangement is treated at law.

Part IVA

In some cases, where the relevant documentation properly reflects the characterisation of the transactions as a sale and leaseback, Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) may also apply. This will be the case where the Tax Office considers that the arrangement is contrived.

The Commissioner will allow the taxpayer to apply for a private ruling in relation to whether or not Part IVA of the ITAA 1936 applies to a particular arrangement. PS LA 2005/24 describes the processes and procedures concerned when applying to the Commissioner for a Ruling on the application of Part IVA.

Provided that the sale and leaseback follows standard commercial arrangements, the Tax Office should not be too concerned about the arrangement. However, aspects of a sale and leaseback which are likely to raise concern with the Tax Office include:

- an appropriate balancing adjustment not being included in the assessable income of the lessor or lessee;
- where appropriate values are not used;
- the sale and leaseback is not designed to provide a positive cash flow for the lessor before factoring in the tax benefits;
- evidence of an intention to assign the income stream arising from ownership of the leased asset; and
- the arrangement does not provide the full value of the asset's purchase price to the vendor lessee when the asset is sold for leaseback.

For further information, please review *TR 2006/1 — Income tax: sale and leasebacks* at <http://law.ato.gov.au/pdf/tr06-013.pdf>.

Non-commercial Loss Rules Deny Promotion Business Losses

In a recent decision ([2006] AATA 859), the Administrative Appeals Tribunal (AAT) found that the non-commercial loss rules contained in Division 35 of the *Income Tax Assessment Act 1997* (ITAA 1997) applied to prevent a taxpayer claiming a deduction for losses in connection with sales promotion activities.

The taxpayer conducted sales promotional activities on behalf of overseas clients during the 2003 Rugby World Cup in Australia. He incurred substantial losses in the 2002 and 2003 income years, writing off over \$50,000 because he was unable to recover the invoiced amounts from clients.

The taxpayer sought formal legal advice as to the nature of the bad debt and the likelihood of recovering the debt, and the agencies employed deemed the debts to be unrecoverable. The taxpayer then wrote off these amounts in his 2002 and 2003 personal income tax returns, claiming that as the company he operated had unrecoverable debts arising from the promotional activities, he in turn could not be paid for his consultancy services.

The Commissioner denied the 'write off', indicating that the taxpayer had failed to satisfy the criteria to write off the bad debt under section 25–35 of ITAA 1997, and issued amended assessments for the 2002 and 2003 income tax years. The Commissioner further stipulated that the taxpayer had not met the requirements to be entitled to the deduction for the business losses under the non-commercial loss provisions.

AAT Decision

The issues under consideration by the AAT were:

- whether the taxpayer derived income on a cash or accruals basis;
- whether the taxpayer was entitled to a bad debt deduction; and
- whether the non-commercial loss provision under Division 35 applied.

The AAT affirmed the Commissioner's decision. The AAT established that the taxpayer would most appropriately account for his income on a 'receipts' basis. This was determined by the taxpayer's method by which he completed his income tax return as well as the fact that he derived any income exclusively from his own personal exertion.

As a result of this conclusion, the AAT denied the taxpayer a bad debt deduction under section 25–35 of ITAA 1997, and made the following comments:

- the taxpayer had not established that a debt owed to him existed in either of the 2002 or 2003 income years;
- the taxpayer had not established that the debt was bad and that he had written off the debt as bad in either of the 2002 or 2003 income years; and
- no amount was included in the taxpayer's assessable income in respect of a debt written off as bad in either of the 2002 or 2003 income year.

The Commissioner, following on from the above, correctly indicated that the taxpayer's income in the 2002 and 2003 years was in fact nil.

The taxpayer sought to use section 35–30 of ITAA 1997, which states that section 35–10 does not apply to a business activity for an income year if:

- the amount of assessable income from the business activity for the year; or
- you start to carry on the business activity, or stopped carrying it on, during the year — a reasonable estimate of what would have been the amount of that assessable income if you had carried on that activity throughout the year;

is at least \$20,000.

The AAT applied Division 35 to the taxpayer and found that it was unable to assist him as he returned nil income for the 2002 and 2003 income years.

The only other provision under Division 35 which would lend itself to the taxpayer's situation was section 35–55. Broadly, this section allows the Commissioner to apply his discretion in view of the taxpayer's situation. The AAT concluded that there was no evidence of any special circumstances in relation to the taxpayer's business activity that would justify exercising the Commissioner's discretion. A 'non payment' of amounts owing by clients is not considered to be a special circumstance as set out in the section. Examples of special circumstances in the section include drought, flood, bushfire or some other natural disaster.

Hence, the AAT concluded that the taxpayer should be denied a deduction for the losses incurred in the business that resulted from non-recovery of amounts outstanding from clients.

For more information, see *Delandro and Commissioner of Taxation* [2006] AATA 859 (6 October 2006) at: <www.austlii.edu.au/au/cases/cth/aat/2006/859.html>.

PSI Provisions Apply to Computer Consultant

In a recent decision ([2006] AATA 808 *Re Fowler and Commissioner of Taxation*), the Administrative Appeals Tribunal (AAT) found that the personal services income (PSI) provisions contained in Division 84 to 87 of the *Income Taxation Assessment Act 1997* (ITAA 1997) applied to a taxpayer who derived consultancy income through his company.

The taxpayer was the sole director, shareholder and employee of DK Consulting Pty Ltd. DK Consulting provided computer consultancy services to end users. During the 2001–2003 tax years the company entered into several contracts with labour hire firms agreeing to provide the taxpayer's consultancy services for a set period at an hourly rate.

In the 2001–2003 income years, the company disclosed in its tax returns the following income: \$156,444, \$155,084 and \$56,084 respectively.

However, rather than returning the entire amount as income, the taxpayer declared salary and wages paid to him in his capacity as an employee and director of DK consulting of \$86,624, \$60,000 and \$6,000 respectively. The Commissioner issued amended assessments for the income years in question, contending that each of the amounts included amounts of PSI derived by the company, adjusted for deductions under section 86–20 of ITAA 1997.

The taxpayer argued that the company was the only entity that could have derived the income as it held all the trade debts and all other business assets. However, the AAT stated that it did not understand how it was only the company which could have derived all the income given the facts and in relation to the provisions of Part 2–42 of ITAA 1997. The AAT further indicated that the taxpayer had not sought a PSI determination from the Commissioner under section 87 as it would have been unlikely to be successful.

The AAT stated that the inquiry was a two-stage process, questioning whether:

- the income in question was 'personal services income' of the individual; or 'mainly a reward for the personal efforts or skills' of the individual; and
- the income was derived by a 'personal services entity'; namely the entity was 'a company, partnership or trust whose ordinary or statutory income includes the personal services income of one or more individuals'.

The AAT found that the taxpayer was caught squarely within the PSI provisions, indicating that the income in question arose solely as a result of the taxpayer's consulting services. The provisions are clearly designed to tax income in the hands of a taxpayer whose exertion caused its receipt, even though the contractual terms are with another entity.

The AAT looked into all aspects of Part 2–42 of ITAA 1997, most notably the following excerpt from the operative provision in Division 86:

'The object of this Division is to ensure that individuals cannot reduce or defer their income tax (and other liabilities) by alienating their personal services income through companies, partnerships or trusts that are not conducting personal services business.'

Therefore the AAT rejected the arguments of the taxpayer, reiterating that personal services income is income which is mainly a reward for an individual's personal efforts or skills, regardless of whether it is income of another entity. The AAT upheld the Commissioner's decision to assess the taxpayer on the difference between what the taxpayer returned as personal income and the income derived by the company less any allowable deductions.

The taxpayer has appealed.

For further information, see *Fowler and Commissioner of Taxation* [2006] AATA 808 (21 September 2006) at: <www.austlii.edu.au/cgi-bin/disp.pl/au/cases/cth/aat/2006/808.html?query=fowler>.

GST — Sale of Land Part of the Sale of a Going Concern

In a recent decision ([2006] AATA 886 *Debonne Holdings Pty Ltd and Commissioner of Taxation*), the Administrative Appeals Tribunal (AAT) found that the GST-free going concern provisions applied to the sale of a hotel business even though separate contracts had been entered into for the sale of the business assets and land.

On 5 November 2002, Castle Rock Enterprises Pty Ltd (Castle Rock) entered into two contracts with Debonne Holdings Pty Ltd (Debonne) for the sale of the Bassendean Hotel (located in Bassendean, a suburb of Perth).

The 'Contract for Sale of Land' related to the land and improvements to the land, the purchase price for which was \$1,200,000. This contract stated that 'unless otherwise agreed the Purchase Price includes any GST liability of the Vendor' and 'unless expressly stated in the Contract the Purchase Price does include GST'.

The other contract, titled 'Agreement to Purchase a Business (As A Going Concern)', related to the goodwill (including the business or trade name, if any), plant, furniture, fittings, chattels, stock-in-trade and other assets, the purchase price for which was \$150,000. Clause 24 of this contract stated the following:

'GST (SALE AS A GOING CONCERN)

- i. In this clause 'GST' refers to goods and services tax imposed by *A New Tax System (Goods and Services Tax) Act 1999* ('the GST Act') and the terms used here have the same meaning as those defined in the GST Act.
- ii. The Vendor and the Purchaser agree that the sale of the business in this agreement is the supply of a going concern.
- iii. The Purchaser represents and warrants that the Purchaser is registered or required to be registered under the GST Act.
- iv. The Vendor agrees that it will carry on and conduct the business as a going concern until the date that settlement of this sale actually occurs.
- v. The Vendor and the Purchaser have entered into this agreement on the basis that the supply is GST-free and the Purchase Price is exclusive of GST.'

Both contracts required 'simultaneous settlement', which took place on 11 April 2003. No tax invoice was issued by Castle Rock or requested by Debonne at, or prior to, settlement. Debonne claimed the land acquisition as a creditable acquisition in its Business Activity Statement for the quarter ending 30 June 2003. At approximately the same time, Debonne requested a tax invoice from Castle Rock, who refused to supply one.

The Commissioner rejected Debonne's claim (he was of the opinion that a supply of a going concern had been made) and issued a notice of assessment of GST on 13 October 2003, as well as imposing an administrative penalty (which has since been waived).

The specific issue that was considered as part of this case was whether Debonne was entitled to input tax credits on the purchase of the land (Debonne would only be entitled to input tax credits if the supply of the land to it was a taxable supply).

The Decision

Under the GST Act, a supply of a going concern is GST-free if the supply is made for consideration to a recipient that is registered or required to be registered for GST, and the supplier and the recipient have agreed in writing that the supply is of a going concern. In this case, the business sale contract stated ‘that the sale of the business in this agreement is the supply of a going concern’, while the land sale contract stated that ‘unless otherwise agreed the Purchase Price includes any GST liability of the Vendor’.

However, there cannot be a supply of a going concern unless ‘the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise’. The AAT found that the going concern clause included in the business sale contract was relevant for the sale of both the business assets and land, as ‘the business or enterprise of a hotel cannot be conducted without land from which to conduct it’. Therefore, the total sale was held to be GST-free and Debonne was not entitled to an input tax credit for the purchase of the land.

The Act

Under section 9–5 of the GST Act, a supply is a taxable supply if:

- it is made for consideration;
- in the course or furtherance of an enterprise that is carried on by a supplier;
- is connected with Australia; and
- the supplier is registered or required to be registered for GST,

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

Section 38–325(1) of subdivision 35–J provides that the supply of a going concern is GST-free if:

- it is made for consideration;
- the recipient is registered or required to be registered for GST; and
- the supplier and the recipient have agreed in writing that the supply is of a going concern.

Section 38–325(2) explains that a supply of a going concern is a supply under an arrangement in which:

- the supplier supplies to the recipient all of the things that are necessary for the continued operation of an enterprise; and
- the supplier carries on, or will carry on, the enterprise until the day of the supply (whether or not as a part of a larger enterprise carried on by the supplier).

Accordingly, the supply of a going concern will be a taxable supply, unless all of the criteria in section 38–325 are satisfied, which will make the supply GST-free.

The Reasoning

The taxpayer argued that there were two contracts of sale, each of which contained a provision relating to GST. Specifically, Debonne argued that the going concern clause only applied in relation to the business sale contract and that GST applied on the sale of the land, as the land sale contract specifically provided that ‘the Purchase Price does include GST’ and also referred to ‘any GST liability of the Vendor’.

The Commissioner was of the opinion that there was really only one transaction for the sale of the business and that the going concern clause in the business sale contract should apply to both the business assets and the land. Alternatively, the Commissioner argued that if the transactions were separate transactions, the going concern clause should still apply to both transactions.

The AAT considered that even though it may appear that the Debonne argument is correct, on a closer analysis, one would establish that the contract provides that the purchase price includes GST, but only if the Vendor is actually liable to pay GST. The AAT agreed with the Commissioner that even though there were two contracts, there was in fact only one dealing — the licence to carry on the hotel business was attached to the land, hence, the need for simultaneous settlement.

The critical provision that the AAT focused on was section 38–325(2), which provides that the supplier must supply ‘to the recipient all of the things that are necessary for the continued operation of an enterprise’. Debonne conceded that the land was one of the things that was necessary for the continued operation of the hotel business. As the business sale contract dealt with GST and the sale of the business as a going concern (as defined in the GST Act), the AAT was of the opinion that the parties intended the sale to be of a going concern. In order for the sale to be the sale of a going concern, the supplier needed to supply ‘all the things that are necessary for the continued operation of the enterprise’, which includes the land. Thus, the AAT held that the whole of the sale is GST-free.

For further information, see *Debonne Holdings Pty Ltd and Commissioner of Taxation* [2006] AATA 886 (19 October 2006) at: <www.austlii.edu.au/au/cases/cth/aat/2006/886.html>.

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