client alert | explanatory memorandum

July 2006

Home Loan Interest Deduction Denied for Unit Trust Arrangement

The Administrative Appeals Tribunal (AAT) has concluded that interest deductions claimed by a taxpayer on funds borrowed to invest in a unit trust to construct a family home were not deductible.

The taxpayer entered into a loan to borrow $182,574. The loan was used in part to pay off an existing mortgage on the family residence, leaving an amount of $141,384 to construct a new residence. The loan was guaranteed by the trustee of the unit trust which mortgaged the new residence to the bank. The taxpayer subsequently moved into the new residence in May 1999 and sold their former home, crediting their loan account with the proceeds of the sale.

In the income years from 1999–2003, the taxpayer claimed deductions for the interest paid on borrowed funds. As such the AAT's main consideration was whether or not the interest was incurred in gaining or producing assessable income. At the time, the sole investment of the family trust was the parcel of land on which the taxpayer was building the family home. As a result, the AAT found it difficult to see the connection between the investment and the likelihood of any income being generated through the investment.

The AAT affirmed the decision of the Tax Office and upheld the Commissioner's assessments. The AAT held that the interest deductions were not allowable and even if there was a nexus between the expense and any likely income, it was of a private or domestic nature with no expectation of producing assessable income through the unit trust.

The AAT further concluded that, had the deduction been allowable, the unit trust arrangement represented a 'scheme' for the dominant purpose of obtaining a tax benefit and accordingly Part IVA of the *Income Tax Assessment Act 1936* would apply to the arrangement. The tax benefit identified was the expectation of a deduction on the interest paid on the borrowing.

Common FBT Return Errors and Misconceptions

As the lodgment deadline for FBT returns has just passed, the aim of this checklist is to highlight common FBT errors and misconceptions, and allow taxpayers to conduct post-lodgment reviews.

To ensure the accuracy of FBT returns and make amendments where necessary, taxpayers should consider the following:

- Ensure commercial vehicles are predominantly used for commercial purposes and only have minimal private usage to qualify for exempt status.
- Ensure when considering whether a car parking benefit arises, that the purpose of any car park located within one kilometre, that charges more than the daily threshold amount, is to provide daily parking and not ancillary car-parking such as in a hospital or shopping centre (the updated car park threshold amount for the 2006/07 income year is $6.62 per day).
- Ensure when using the 50/50 or 12-week method for meal entertainment expenses that the minor exemption or consumption on business premises exemption are not applied.

- FBT-exempt status only applies to peripheral items purchased with a laptop where the purchase is a package deal and a single price is invoiced. Peripheral items which are separately invoiced are not exempt.
- Ensure GST-inclusive values are used when calculating FBT tax values.
- Ensure prior to lodgment that FBT returns and payment summaries match. Where the amounts differ, ensure an adequate reconciliation is on file.
- Rebateable employees need to take extra care in ensuring all data is entered into the return correctly and reviewed by an FBT expert. Incorrect disclosures will cause problems in the Tax Office's processing system and cause unnecessary headaches for the Tax Office and the taxpayer.

False Details on Tax Return

In a recent decision handed down by the AAT, it was held that a taxpayer who had lodged an income tax return with incorrect details through an agent was liable to pay the associated penalties.

The taxpayer's income tax returns were prepared by a registered tax agent, and on his income tax returns it was incorrectly stated that he was an employee of True Blue Industries Pty Ltd, where tax was withheld to the amount of $28,252 over two years. However, the taxpayer had in fact been employed by True Blue Glass and had received commission income of $15,000, which was not assessed.

The AAT suggested that there was no suggestion from the Commissioner of wrongdoing on behalf of the taxpayer, but did note that the actions of the tax agent are the responsibility of the client. It was for this reason that the AAT re-affirmed the Tax Office's disallowance of the taxpayer's objection to pay the penalty.

CGT and Main Residence

As readers would be aware, the sale of their main residence (their family home) attracts no CGT. However, many taxpayers have more than one home, for example, a holiday house. The disposal of that second property will attract CGT.

To receive the main residence CGT exemption, taxpayers must have lived in the dwelling. A vacant block of land does not qualify. Various factors are indicative of what constitutes a main residence:

- The taxpayer must have lived in the home with their family.
- The character of the residence must reflect a home, for example, the taxpayer's belongings and effects are in the house.
- The address is used as the primary address for the taxpayer's mail and also is the residence which is listed with the electoral commission.
- Utilities are connected.

The full main residence exemption is generally available where the following conditions have been satisfied:

- The residence has been the taxpayer's main residence satisfying the above criteria for main residence status.
- The residence has not been used to produce assessable income.
- The residence does not sit on land of an area greater than 2 acres.

Subject to these factors, any capital gain or loss made on the disposal of the residential property will be disregarded.

A taxpayer may also be entitled to a partial exemption where the following occurs:

- partner or dependents have separate homes;
- the residence is used as a main residence for part of the time owned;
- part of the property has been used to produce assessable income, or for part of the time the property has been used has been to produce assessable income; and
- The land area is greater than 2 hectares.

It should be noted that where there is a transition between two properties, the main residence exemption may be claimed for up to six months.

GST — Deposits Held as Security for the Performance of an Obligation

In GST ruling GSTR 2006/2, the Tax Office provides a detailed explanation of the meaning of 'deposits held as security for the performance of an obligation' for the purposes of Division 99 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act). This ruling applies with effect from 1 July 2000. However, if a taxpayer has previously relied on the draft GST ruling GSTR 2005/D1, it is protected in respect of the treatment of transactions that happened prior to 3 August 2005.

Giving a deposit as security does not constitute consideration

Under section 99–5(1) of the GST Act, a deposit held as security for the performance of an obligation is not treated as consideration for a supply, unless the deposit:

a) is forfeited because of a failure to perform the obligation; or

b) is applied as all or part of the consideration for a supply.

This section applies despite the basic rules about the provision of consideration in section 9–15.

Attributing the GST relating to deposits that are forfeited

Section 99–10 of the GST Act provides the GST that is payable by a supplier on a taxable supply, for which the consideration is a deposit that was held as security for the performance of an obligation is attributable to the tax period during which the deposit:

a) is forfeited because of a failure to perform the obligation; or

b) is applied as all or part of the consideration for a supply.

This section applies despite the basic rules about attributing GST for taxable supplies in section 29–5.

What is the definition of a 'security deposit'?

The GST Act does not provide a definition of a 'deposit' or a 'security deposit'. In GSTR 2006/2, the Tax Office provides guidance in relation to what it considers to be a 'security deposit' for the purposes of Division 99 of the GST Act. A brief summary of the ruling follows.

Characteristics of a 'security deposit' under Division 99

According to the Tax Office, in order for a deposit to be a security deposit for the purposes of Division 99 of the GST Act, it needs to have the following characteristics:

- be held as a security for the performance of an obligation;
- the contract, conduct and intent of the parties to the contract must be consistent with the payment being a security deposit;
- be at risk of forfeiture upon failure to perform the obligation; and
- be a reasonable amount.

Held as security for the performance of an obligation

The Tax Office considers that a deposit that is 'held' for the benefit of the supplier to secure the recipient's obligations under the contract is a security deposit for GST purposes. An amount ceases to be held as a security deposit when it is applied as consideration or is forfeited. According to the Tax Office, the accounting treatment may assist in determining whether a deposit has been applied as consideration or is forfeited.

It should be noted that the Tax Office does not consider that a pre-contract deposit is a security deposit. That is, a deposit provided by a potential recipient before an agreement is entered into (e.g. purchase contract or hire arrangement), is not a security deposit as it is held on trust for a specified purpose and remains the beneficial property of the potential recipient. However, a pre-contract deposit may later become a security deposit.

The contract, conduct and intent of the parties to the contract must be consistent with the payment being a security deposit

According to the Tax Office, the nature of the obligations agreed to by the parties depends on the conduct of the parties and the intention of the parties (express or implied). Once the recipient has performed its obligations under the agreement, the supplier must either be required to apply the deposit for the benefit of the recipient or return the deposit to the recipient. However, if the recipient does not perform its obligations under the contract, as required, the deposit must be at risk of forfeiture in order to be a security deposit.

At risk of forfeiture upon failure to perform the obligation

The Tax Office considers that it is imperative that both parties understand at the commencement of a contract that the deposit is at risk of forfeiture if the recipient does not perform its contractual obligations. Without this intention, a deposit cannot be a security deposit.

Further, in order for a deposit to be a security deposit, it is not relevant whether the supplier actually enforces the forfeiture if the recipient does not perform its obligations under the contract. However, if the commercial practice of the supplier is to not enforce the forfeiture and the recipient is aware of this, the deposit will not be seen to be at risk and as such will not be considered to be a security deposit for the purposes of Division 99 of the GST Act.

A reasonable amount

The Tax Office agrees with the Courts in that it believes that a deposit is an 'earnest' that is paid to 'bind the bargain'. Customarily, a security deposit equal to 10% is considered to be reasonable. However, if the supplier requests a deposit that is higher than 10%, it is required to demonstrate that special circumstances exist which warrant the larger security deposit. The reasonableness of a deposit will need to be considered on the facts of each case, as it arises, as well as the relevant industry practices and norms. In its ruling, the Tax Office provides a number of factors that may be considered in order to determine whether an amount paid as a security deposit is considered to be reasonable. These factors include (but are not limited to):

- duration of the contract and the time over which payment is to occur (this may increase the risk of loss or devaluation of the asset by neglect, illegal act, mismanagement or adverse conditions during that period);
- the uniqueness of the goods or the process involved in the supply, including:
  - unusual designs or sizes that make a completed product difficult to sell in the event of default;
  - the use of special materials that cannot be used on other jobs; and
  - the purchase of highly specialised equipment which can only be used in the performance of the contract at risk;
- the vulnerability of the goods to a loss in value; or
- other extraordinary conditions of the contract.

In relation to hire arrangements, an amount is considered to be reasonable if it acts as an inducement for the recipient to return the hired goods without undue wear and tear and does not include the hire fee within it.

A deposit that exceeds what is considered to be reasonable is not an earnest and is not a security deposit for GST purposes.

For further information, please view GST ruling GSTR 2006/2 — Goods and Services Tax — deposits held as security for the performance of an obligation, at:

http://law.ato.gov.au/pdf/gst06-02.pdf

Also refer to AAT Case *Reliance Carpet Company Pty Ltd and Commissioner of Taxation* [2006] AATA 486 (5 June 2006), Ref No: VT2005/345, at:

http://austlii.edu.au/au/cases/cth/aat/2006/486.html

In this case, the AAT considered whether GST is payable on a forfeited deposit relating to the recision of a contract for the sale of real property (land). It was held that the company was liable for GST on the forfeited deposit.

CGT Treatment of Deceased Estate Transfers

The Tax Office has recently released an interpretative decision regarding pre-CGT shares and their CGT treatment upon transfer from a deceased estate.

Broadly, when a transfer occurs as a result of a death, CGT event A1 is triggered on the disposal of the pre-CGT shares to a beneficiary, as there is an effective change of ownership. However, there is CGT rollover relief available on this disposal through Division 128 of the *Income Tax Assessment Act 1997*, which subsequently disregards capital gains arising from the disposal of a CGT asset as a result of the taxpayer's death.

Ordinarily, the disposal of pre-CGT shares held by a taxpayer would also trigger CGT event K6. CGT event K6 occurs where, just before the disposal, the market value of the post-CGT property of the company is at least 75% of the net value of the company. However, CGT event K6 does not happen if rollover is available from another CGT event.

The interpretative decision indicates that where there is a transfer of shares from a deceased estate to a beneficiary, CGT event A1 is triggered but disregarded under Division 128. As a result, CGT event K6 is also disregarded because a rollover has been triggered under the CGT rules on the disposal of the shares.

For further information please review ATO ID 2006/139 — Capital Gains Tax: Deceased estate transfers private company shares to beneficiary, at:

http://law.ato.gov.au/atolaw/print.htm?DocID=AID%2FAID2006139%2F00001

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