

client alert | explanatory memorandum

July 2008

2008-09 Federal Budget follow-up

Entrepreneurs' tax offset

In the 2008-09 Budget, the Government announced that it would introduce a family income test for the entrepreneurs' tax offset with effect from 1 July 2008. However, the threshold for single taxpayers remains uncertain.

The Treasurer's press release accompanying the Budget measure states that singles with an adjustable taxable income of more than \$70,000 per income year are not eligible for the offset. However, Budget Paper No. 2 states that the threshold is \$75,000.

The Government has not provided confirmation on what the correct threshold is.

Introduction of 2008-09 Federal Budget measures

Budget Measures Bill 2008

The Government has introduced *Tax Laws Amendment (Budget Measures) Bill 2008* into the House of Representatives, which contains the following amendments to implement some of the measures announced in the 2008-09 Federal Budget:

- FBT: meal cards and work-related items;
- employee share schemes: changes to method of making the 'discount' election and removal of double taxation; and
- depreciation rate for in-house software.

FBT: meal cards and work-related items

Removal of exemption on meal cards

The Bill amends section 41 of FBTA 1986 so that an FBT exemption for food or drink provided to an employee will not be available if:

- an employee has agreed to receive the food or drink in return for a reduction in the employee's entitlement to receive salary or wages and this would not have happened apart from the agreement; or
- it is reasonable to conclude that the employee's salary or wages would be greater if the food or drink were not provided as part of the employee's remuneration package.

For these purposes, salary sacrifice arrangements include 'meal card' arrangements whereby an employee forgoes salary and wages to have food and drink supplied to them on their employer's premises. However, it does not apply to a subsidised canteen which is available to all employees and which does not form part of a salary sacrifice arrangement.

The amendment will apply to food and drink provided after 7.30pm AEST on 13 May 2008. However, if an employee has entered into an agreement with their employer prior to that time, any food or drink that relates to an existing balance at that time will not be subject to FBT if the food and drink is provided before 1 April 2009. Any food or drink purchased with additional credits ('top-ups') that occur after 13 May 2008, however, will be subject to FBT.

Current law

Currently, an FBT exemption is available for property provided to an employee and consumed on the employer's business premises on a working day.

FBT and work-related items

The Bill amends FBTAA 1986 to ensure that the FBT exemption on eligible work-related items will only apply if the following items are primarily for use in the employee's employment: a portable electronic device, an item of computer software, an item of protective clothing, a briefcase, and a tool of trade.

In addition, the exemption will be limited to one of each of the listed eligible work-related items per employee per FBT year unless the item is a replacement item. Furthermore, the restriction on the exemption for these items will be extended to items that have a substantially identical function.

The Bill also ensures there is no deduction available under Division 40 of ITAA 1997 for a decline in value of eligible work-related items that are exempt.

The amendment will apply to eligible work-related items acquired after 7.30pm AEST on 13 May 2008 other than items acquired under a contract entered into at or before that time. If the asset was acquired at or before that date, a decline in value deduction can be claimed for the 2007-08 income year, but not for later income years.

Current law

Currently, an FBT exemption applies for an expense payment, property or residual benefit that is an eligible work-related item, including:

- a mobile phone (that is primarily for use in the employee's employment);
- protective clothing (that is required for the employee's employment);
- a briefcase;
- a calculator;
- a tool of trade;
- computer software (for use in the employee's employment);
- an electronic diary;
- a laptop computer or similar portable computer; and
- a portable printer.

A work-related requirement only applies to mobile phones, protective clothing and computer software.

The FBT exemption for a laptop computer or similar portable computer is limited to the purchase or reimbursement of one computer per FBT year for each employee.

In addition, an employee is allowed a deduction for depreciation in his or her individual income tax.

Employee share schemes

Making of 'discount' election

The Budget Measures Bill replaces section 139E(2) of ITAA 1936 with a new method of making an election for employee share schemes (ESS). Under the changes, a taxpayer must make an election to be assessed on the discount by both making the election and also including the amount of the discount in the income tax year of the year of acquisition of the qualifying shares or rights. If the value of the discount is \$1,000 or less and the taxpayer is eligible for the \$1,000 exemption under section 139BA(2) of ITAA 1936 because the exemption conditions under section 139CE are satisfied, then the taxpayer will be taken to have made the election.

The Commissioner's existing discretion to allow additional time to make an election will continue, and a taxpayer seeking an extension of time must make the request in writing in an approved form.

The amendment will apply to assessments for the 2008-09 and later income years.

Current law

An election to be taxed upfront in relation to shares or rights is made under section 139E by making an election in writing before lodging the tax return for the year in which the shares or rights are acquired. In addition, the election is not required to be lodged with the tax return or otherwise provided to the Commissioner.

Double taxation

The Bill amends section 130-90(3) of ITAA 1997 so that relief from double taxation will apply if:

- the shares are acquired as a result of exercising a right acquired under an ESS; and
- the shares are acquired as a result of exercising a right, which was acquired as a result of a corporate takeover or restructure, and section 139DQ of ITAA 1936 applies to treat the right as a continuation of the right that existed before the corporate takeover or restructure.

The amendment will apply to CGT events happening at or after 7.30pm AEST on 13 May 2008.

Current law

Under the current law, Subdivision 130-D of ITAA 1997 provides CGT relief if ESS shares or rights are held by a trustee before being passed to an employee (both in relation to the tax-upfront concession and the tax-deferred concession). It ensures that the trustee or beneficiary will not be taxed on a capital gain that reflects either a discount that is assessed to the employee under Division 13A or a capital gain that arises later when a CGT event occurs in relation to the shares.

However, this double taxation relief does not apply where an employee acquires shares from the trustee of an employee share trust on the exercise of rights that they acquired under an ESS. This is because the CGT relief only applies where the shares or rights held by an employee share trust were acquired under an ESS. In short, the CGT relief does not extend to shares held in the trust that the employee acquires by exercising rights they acquired under an ESS.

Depreciation rate for in-house software

The Budget Measures Bill amends ITAA 1997 to increase the period over which taxpayers write off depreciable in-house software from 2½ years to 4 years. However, the requirement that in-house software be depreciated using the prime cost method is unchanged.

In-house software is essentially software that is used in-house, rather than as trading stock, and that is a capital asset, rather than fully deductible in the year of purchase. It includes software, or a right to use software, that the taxpayer has acquired, developed or has had another entity develop.

The new statutory effective life applies from 7:30pm AEST on 13 May 2008, in relation to newly held software assets.

Current law

Currently, the effective life for in-house software is 2½ years and is deductible in accordance with the following schedule:

Income year	Amount of expenditure deductible for that income year
Year 1	Nil
Year 2	40%
Year 3	40%
Year 4	20%

Medicare levy surcharge thresholds

The Government has introduced Tax Laws Amendment (Medicare Levy Surcharge Thresholds) Bill 2008, which will increase the Medicare levy surcharge threshold as announced in the 2008-09 Federal Budget.

The amendments will increase the levy for individuals from \$50,000 to \$100,000, and for families from \$100,000 to \$150,000.

The increase to the Medicare levy surcharge will take effect from 1 July 2008.

Current law

Under the current law, if a taxpayer is single and has no dependent children, the threshold is \$50,000.

If the taxpayer is a member of a couple and has no dependent children, the family surcharge threshold is \$100,000. If there is only one dependent child, the threshold is \$100,000. This threshold is increased by \$1,500 for each extra dependent child after the first.

Tax laws amendments

The Government has introduced Tax Laws Amendment (2008 Measures No. 3) Bill 2008 into the House of Representatives, which seeks to amend:

- ITAA 1997 to amend shareholders' and unitholders' rights in relation to call options and put options; and
- TAA 1953 to correct a deficiency in the GST refund restrictions. This measure also addresses the deficiencies in the four-year time limit on indirect tax and fuel tax credit to ensure that the amendment period applies as it was intended.

A brief discussion of the proposed amendments follows.

Call options and put options

The Bill amends ITAA 1997 to:

- ensure that no amount is included in the assessable income of a shareholder in a company or a unitholder in a unit trust as a result of acquiring certain rights issued by the company to acquire further shares or by the trustee of the unit trust to acquire further units; and
- ensure that an amount that is included in the assessable income of a shareholder as a result of acquiring rights issued by the company to dispose of shares is appropriately reflected in the cost base of the rights.

These amendments will apply to rights issued on or after 1 July 2001.

Call options

The Bill provides that if a company or trust issues call options, no amount will be included in assessable income at the time of issue, which is achieved by inserting new section 59-40 into ITAA 1997. Specifically, this new section ensures that the market value of the rights, as at the time of issue, will be non-assessable non-exempt income if:

- the taxpayer must already own an interest in the issuing entity (known as original interests) at the time of issue;
- the rights must be issued to the taxpayer because of their ownership of the original interests;
- the original interests and the rights must not be revenue assets or trading stock at the time the rights are issued;
- the rights must not have been acquired under an employee share scheme;
- the original interests and rights must not be traditional securities; and
- the original interests must not be convertible interests.

The Explanatory Memorandum (EM) to the Bill explains that if the market value of the rights is not included in a taxpayer's ordinary income at the time of issue, then it will not be included in the taxpayer's assessable income again at any other time.

In relation to CGT, a capital gain or loss will only arise when a CGT event happens to the rights or shares acquired as a result of the exercise of the rights. Furthermore, the amount of any capital gain is not reduced by the amount that is non-assessable non-exempt income because of the operation of section 59-40. Likewise, CGT events E4 and G1 will not happen in relation to rights issued to a taxpayer to which the new section applies (i.e. there will be no reduction in the cost base of units or shares for the value of the rights issued to the taxpayer).

Put options

The No. 3 Bill provides that if a company issues to the company put options to dispose of shares in the company, CGT event H2 will not apply. In addition, the market value substitution rule will not apply in relation to a CGT asset that is a right to dispose of a share in a company if the right was issued by the company and the right was exercised either by the shareholder or by another entity that became the owner of the right.

The EM also provides that if a company issues tradeable put options to a shareholder, the market value of the options at the time of issue is included in the shareholder's assessable income. But to ensure that this amount is not taxed again when the shareholder makes a capital gain or loss when a subsequent CGT event happens to the rights or to the shares disposed of as a result of the exercise of the rights, the cost base of a right to dispose of a share in a company that a taxpayer acquires as a result of CGT event D2 happening will be the sum of:

- the amount included in the taxpayer's assessable income as ordinary income as a result of acquiring the right; and
- the amount, if any, paid by the taxpayer to acquire the right.

Current law

Call options

Under the current law, the tax treatment for rights issued by an entity to its shareholders or unitholders to acquire relevant interests in the entity can be summarised as follows:

- an amount equal to the market value of the right may be included in assessable income at the time the rights are issued; and
- a capital gain or loss may also arise when a CGT event subsequently happens to the rights or to the relevant interests acquired as result of the exercise of the rights.

Put options

Currently, the tax treatment for rights issued by a company to its shareholders to dispose of shares to the company can be summarised as follows:

- the market value of the rights is included in assessable income at the time the rights are issued; and
- the market value substitution rule generally applies to give the shareholder a market value cost base for the rights, for the purpose of calculating a capital gain or loss, when a CGT event subsequently happens to the rights or to the shares disposed of as a result of the exercise of the rights.

GST refunds and amendment time limit

Restriction on refund

The No. 3 Bill amends TAA 1953 to ensure that a business is only entitled to a refund of overpaid GST if the business has first refunded the overpaid amount to the affected customer.

The restriction on a refund of overpaid GST applies whether or not a transaction is subsequently held to be a supply. In addition, the restriction applies if:

- input taxed or GST-free supplies are incorrectly treated as taxable supplies and GST has been remitted; or
- an amount of GST on a taxable supply has been remitted that exceeds the amount of GST correctly payable on that taxable supply.

The amendment is intended to apply broadly and to ensure that it is the actions of an entity in treating an arrangement as a supply that result in the restriction on refund provisions applying rather than any requirement that it must correctly be a supply for GST purposes.

The amendment applies to tax periods commencing on or after 1 July 2008.

Current law

Currently, the restriction on refunds does not apply to overpaid GST if the transaction is later held not to be a supply. That is, a taxpayer is not required to first refund the overpaid amount to any affected customers before the entitlement to a refund arises.

Time limit on recovery of liabilities

The No. 3 Bill also amends TAA 1953 to ensure that a four-year time limit on refunds relating to indirect taxes applies irrespective of whether the refund results from a reduction in the amount of a taxpayer's indirect tax liability or an increase in their refund entitlement. The indirect taxes affected include GST, wine equalisation tax, luxury car tax and fuel tax credits.

The amendment to the four-year time limit applies on and after 1 July 2008.

Example

Mark Enterprises lodged its June 2008 quarterly BAS reporting GST of \$50,000 on sales and input tax credits of \$30,000 on creditable acquisitions, and remitted \$20,000 to the Commissioner on 28 July 2008.

On 15 November 2012, Mark Enterprises realised it had made an arithmetic error and that the correct amount of GST payable on its sales was \$45,000 and the net amount payable was \$15,000. Mark Enterprises seeks to claim a refund of \$5,000 for the amount of overpaid GST.

Mark Enterprises is not entitled to a refund because four years have elapsed since the end of the June 2008 tax period.

Current law

A four-year time limit applies on refunds relating to indirect tax, input tax credits or fuel tax credits. However, the time limit may not apply if the refund results from a reduction in the amount of a taxpayer's indirect tax liability or fuel tax credit related liability.

(These measures were announced in the 2008-09 Federal Budget.)

Division 7A

Loan agreements

In Taxation Determination TD 2008/8, the Tax Office states the essential information a loan agreement for the purpose of section 109N(1) of Division 7A of ITAA 1936 must contain.

The loan agreement between the private company and the shareholder (or their associate) must be in writing and include the following essential information:

- the names of the parties;
- the loan terms;
- the parties' agreement to the terms; and
- the execution date of the written agreement.

The requirement for the loan agreement to be in writing would also be sufficiently satisfied if there is written confirmation of the existence of the agreement and the essential information, the Determination states.

The Determination states that if a formal written loan agreement between the parties does not contain all the essential information, the requirements of section 109N(1) may still be satisfied, provided there is supporting written evidence of the essential elements.

Explanation

The definition of a loan, which is contained in section 109D(3) of ITAA 1936, includes:

- an advance of money;
- a provision of credit or any other form of financial accommodation;
- a payment of an amount for another person if there is an obligation to repay the amount; and
- a transaction that is in substance a loan.

A private company will be deemed to pay an unfranked dividend at year-end under section 109D if a loan is made by the company to a shareholder (or their associates), unless one of the exclusions in Subdivision D of Division 7A of ITAA 1936 applies. The unfranked dividend is assessable income to the shareholder (or their associate).

Under Subdivision D, a loan will not be taken to be a dividend in an income year if there is a loan agreement that meets the criteria for minimum interest rate and maximum term (section 109N(1)).

Under section 109N(1), the following criteria must be satisfied before the exclusion can apply:

1. the agreement that the loan is made under is in writing;
2. the interest rate on the loan for the years of income after the year in which the loan is made equals or exceeds the benchmark interest rate; and
3. the maximum term does not exceed:
 - 25 years for a loan fully secured by a real property mortgage, or
 - 7 years for all other loans.

However, the section does not prescribe the essential information that the loan agreement must contain.

The loan agreement must be in place by the earlier of the actual lodgement date or due date for lodgement of the company's tax return for that year.

Date of effect

The Determination applies to all income years, both before and after its date of issue.

Tips and warning

1. There is no requirement for a company and its shareholder (or their associate) to formalise a written loan agreement.

This viewpoint is reaffirmed at paragraph 28 of the Determination where it states that there must be a binding agreement for the repayment of the loan by the shareholder (or their associate). Further, the Commissioner expresses the view that the requirement for a loan agreement to be in writing will be satisfied if there is:

- a formal written agreement containing all the terms of the loan and it is signed and dated by the parties; or
- a written confirmation of the existence of the loan agreement and its essential terms.

The Tax Office states that whether or not there is a binding obligation to repay a loan depends on the facts of each case.

2. For a loan fully secured by a real property mortgage, the market value of the property at the time the loan is made must be at least 110% of the loan amount. There is no requirement to revalue the property each year for the life of the loan. However, a charge will need to be registered over the property.
3. A shareholder (or their associate) can convert an unsecured loan to a secured loan, and vice versa.
4. A loan agreement that does not contain the essential information, which is stated in the Determination, will not satisfy the requirements of section 109N(1), albeit the agreement was in place by the earlier of the actual lodgement date or due date for lodgement of the company's tax return for that year.

Clarification of expression

In Taxation Determination TD 2008/14, the Tax Office states its view on the meaning of 'because' in the context of the expression 'because the entity has been such a shareholder or associate at some time' in relation to payments, loans and debt forgiveness made by a private company to the entity.

According to the Determination, the word 'because' in this context means by reason that. The Tax Office states that the reason must be a real and substantial reason for the payment, loan or debt forgiveness concerned, even if it is not the only reason or not the main reason for the transaction. The existence of multiple reasons for a transaction does not prevent a reasonable person from concluding that the payment, loan or debt forgiveness occurred because the entity has been a shareholder or associate at some time, the Tax Office says.

The Tax Office states that this definition requires attention to the question of fact of whether the entity was in the past a shareholder or an associate. The Commissioner notes that the test for determining whether an event falls within the relevant provisions of Division 7A is a reasonable person's conclusion, which is an objective test requiring the weighing up of all the circumstances to determine whether the reason is real and substantial.

Date of effect

The Determination applies to all income years, both before and after its date of issue.

SMSFs and business real property

The Tax Office has released Draft Self Managed Superannuation Funds Ruling SMSFR 2008/D3 in which it explains how the term ‘business real property’ in section 66(5) of SIS Act applies for SMSFs in respect of certain exceptions to the investment restrictions in the SIS Act.

Business real property

The term ‘business real property’ is defined in section 66(5) as:

- any freehold or leasehold interest of the entity in real property; or
- any interest of the entity in Crown land, other than a leasehold interest, being an interest that is capable of assignment or transfer; or
- if another class of interest in relation to real property is prescribed by the regulations for the purposes of this paragraph — any interest belonging to that class that is held by the entity;

where the real property is used wholly and exclusively in one or more businesses (whether carried on by the entity or not), but does not include any interest held in the capacity of beneficiary of a trust estate.

Basic conditions

The Draft SMSF Ruling states that two basic conditions must be satisfied before an SMSF, or any other entity related to or dealing with an SMSF, can be said to hold business real property under section 66(5) of SIS Act:

- the SMSF or the other entity must hold an eligible interest in real property; and
- the underlying land must satisfy the business use test.

The Draft SMSF Ruling states it is first necessary to identify the relevant entity in order to determine whether the two basic conditions are satisfied.

The relevant entity will vary according to the dealing that takes place and the applicable provision of the SIS Act or Regs. The Commissioner notes that it is important to ensure that the definition applies to the correct entity, set out as follows:

- the related party from which the interest is acquired if the SMSF or a related party is acquiring an interest in real property from another related party; or
- the entity that is granting the rights under the lease or the lease arrangement (i.e. the lessor or the landlord) if the SMSF or a related party is leasing real property to another related party, or the real property is the subject of an enforceable lease arrangement between such parties.

Condition 1: Eligible interest in real property

The Draft SMSF Ruling states that only those interests in real property (specifically covered by the definition) held by a relevant entity are eligible to be treated as business real property. Those interests are interpreted by the Commissioner as follows.

Freehold and leasehold interests in real property

The term ‘real property’ refers to land and includes strata titled property. Further, any building or other thing that is a fixture attached to the land forms part of that real property.

The term ‘freehold interest in real property’ is interpreted according to its ordinary meaning, which entitles the interest holder to hold exclusive possession of a real property for an indefinite period of time. The interest holder can hold the property as either a joint tenant or as a tenant in common.

The expression ‘leasehold interest in real property’ conveys a right on the part of an entity holding the interest to exclusively possess the property for a period of time that is either pre-determined or capable of being determined.

Interests in Crown land

An interest in Crown land must be capable of being assigned or transferred. To determine whether a right or interest in Crown land is capable of being assigned or transferred, the Tax Office says it is necessary to examine the Crown land statute that specifies the nature and extent of the interest.

Interest held as trust beneficiary

The Tax Office says an interest held in the capacity of a beneficiary of a trust estate cannot be business real property if it is subject to a trust administered for the benefit of the entity.

Condition 2: Business use test

The business use test requires the real property to be used wholly and exclusively in one or more businesses, whether or not that business or those businesses are carried on by the relevant entity.

The Draft SMSF Ruling states that the ‘wholly and exclusively’ threshold requires an assessment of whether the property in its entirety is used in one or more businesses to the exclusion of any other types of use of the property. However, the Commissioner says a common sense approach accommodates some departure from a literal application of the test, due to the onerous requirements of the threshold.

According to the Draft SMSF Ruling, a minor, insignificant or trifling non-business use of the property can also be accommodated under the ‘wholly and exclusively’ threshold. An exception also applies if a part of the property on which the business is carried on contains a residential dwelling subject to three provisos: the business real property is used in a primary production business; the area containing the dwelling does not exceed two hectares; and the predominant use of the property is not for domestic or private purposes.

An interest in real property will not lose its status as business real property of an entity if the entity is not carrying on any business that establishes the connection required between the use of the property and a business, the Draft SMSF Ruling says.

Carrying on of a business

The Commissioner says the indicators of what constitutes the carrying on of a business for the purpose of the business real property test are similar to those under income tax law. (Taxation Ruling TR 97/11 provides the Commissioner’s view of when a business is being carried out.)

However, the Commissioner considers that it would be rare for an SMSF to meet the conditions necessary to establish a property investment business when it is engaging in property investment activity.

Examples

The Draft SMSF Ruling contains numerous examples to illustrate how the business real property principles apply to the following scenarios:

Scenario	Business real property	
	Yes	No
Primary production with a private residence — vineyard	✓	✓
Primary production with a private residence — cattle farm		✓
Poultry farm and unused paddock	✓	
Incidental use of poultry farm by SMSF member voluntary organisations	✓	
Temporary agistment on otherwise vacant land		✓
Water licence		✓
Fishing licence		✓
Afforestation arrangement		✓
Letting holiday flat — no business		✓
Residential property held in a property investment business	✓	✓
Motel with manager's residence	✓	✓
Bed and breakfast — no business		✓
Bed and breakfast — business scale	✓	
Doctor's surgery in residential premises	✓	
Shop co-located with an uninhabitable residence	✓	
Mechanic's home garage		✓
Inner city design studio with some use as primary residence		✓
Storage of personal items on commercial premises	✓	
Storage of personal items at leased warehouse		✓
Shares in a company that owns business real property		✓
Instalment warrant over real property		✓
Lease of commercial retail premises	✓	
Indoor market owned by SMSF	✓	
Substance over form in determining the nature of an interest in real property	✓	
Sublease of property	✓	
Sublease of property for private use	✓	
Assigned lease	✓	

The examples in the Draft SMSF Ruling only provides the Commissioner's view on how sections 66(2)(b) and 71(1)(g) of SIS Act and Div 13.3A of SIS Regs apply. Other SIS provisions that may be relevant to the example scenarios are not covered in the Draft SMSF Ruling, for example, the sole purpose test, arm's length dealings, trustee duties and investment strategy requirements.

Date of effect

When finalised, the SMSF Ruling will apply to SMSFs and former SMSFs for all income years.

Legal status of SMSF Ruling

An SMSF Ruling, whether in draft or final form, represents the Commissioner's views about the way in which the provisions of the SIS Act, or regulations under that Act, apply to SMSFs.

An SMSF Ruling is not legally binding on the Commissioner. However, if the Commissioner later takes the view that the law applies less favourably to you than the Determination, the fact that a taxpayer acted in accordance with the SMSF Ruling would be a relevant factor in the Commissioner exercising his discretion as to what action to take in response to the breach of that law.

Taxpayer Alerts

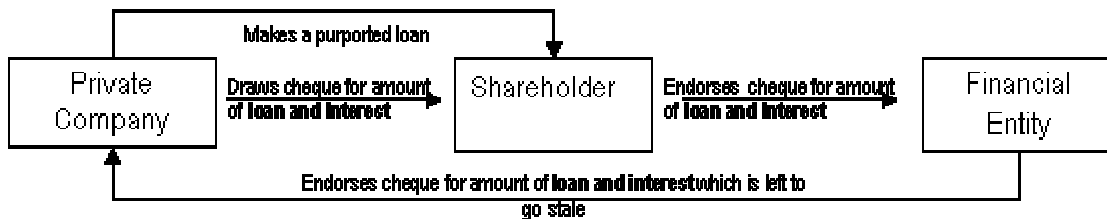
The Tax Office has released two Taxpayer Alerts warning taxpayers of certain arrangements that are currently being examined.

Private company loans

In Taxpayer Alert TA 2008/9, the Commissioner describes an arrangement whereby a shareholder purports to make a repayment of a shareholder loan from a private company via a round robin of endorsed cheques to avoid the operation of Division 7A of ITAA 1936.

The Tax Office says that the aim of such an arrangement is to distribute private company profits to shareholders tax-free, which is in breach of the rules to prevent disguised distributions to shareholders or their associates.

The structure of the arrangement is summarised diagrammatically below:



The features of concern for the Tax Office in relation to the arrangement include whether:

1. such an arrangement or certain steps in it may be a sham;
2. the delivery of the endorsed cheque to the private company amounts to, or gives rise to, a repayment of the shareholder's debt to the private company;
3. section 109R(2) of ITAA 1936 operates to disregard the repayment which, pursuant to the terms of the arrangement, precedes a further loan of a similar or larger amount;
4. Part IVA applies to include the amount of the distributions from the private company in the assessable income of the shareholder; and
5. any entity involved in the arrangement is a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to TAA 1953.

Prepayment of service fees

In Taxpayer Alert TA 2008/10, the Commissioner describes an arrangement for the prepayment of service fees from a trading entity to an associated service entity in which the dominate purpose of the arrangement was to secure a deduction in the year of alleged payment rather than in the year any services were provided.

The structure of the arrangement is summarised diagrammatically below:



The features of concern for the Tax Office in relation to the arrangement (as described in the Alert) include whether:

1. such an arrangement or certain steps in it may be a sham;
2. the trading entity is entitled to a deduction under section 8–1 of ITAA 1997 and, in particular, whether the amount purportedly paid to the service entity:
 - (i) constituted a loss or outgoing;
 - (ii) was to any extent incurred in gaining or producing the trading entity's assessable income; and
 - (iii) was to any extent necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income;
3. section 82KK of ITAA 1936 applies so that the deduction is not allowable until the services for which it was purportedly incurred are provided by the service entity;
4. Part IVA operates to disallow the deduction until the services for which it was purportedly incurred are provided by the service entity; and
5. any entity involved in the marketing of such an arrangement is a promoter of a tax exploitation scheme for the purposes of Division 290 of Schedule 1 to TAA 1953.

Legal status of Alerts

Taxpayer Alerts are only intended to be an 'early warning' of tax planning arrangements that the Tax Office have under risk assessment. However, it is expected that the Tax Office will follow up on the release of any Alert with a public ruling or determination.

Taxpayers who have entered into or are contemplating entering into an arrangement similar to that described in an Alert can seek a formal determination of the Tax Office's position through a Private Ruling.

Director penalty notice

The Tax Office has issued a Decision Impact Statement (DIS) outlining its response to the decision in *DCT v. Meredith* [2007] NSWCA 354, which concerned whether the giving of a director penalty notice (DPN) by post under section 222AOF of ITAA 1936 could be rebutted by evidence of non-receipt or non-delivery.

Tax Office view of decision

Following the decision of the NSW Court of Appeal, the Commissioner accepts the decision that a DPN under section 222AOE or section 222APE of ITAA 1936 sent to a director by ordinary pre-paid post will be 'given' to the intended recipient at the time the notice is posted.

The Tax Office says the decision is limited to the giving of a section 222AOE or section 222APE DPN pursuant to section 222AOF. (Section 222AOF prescribes a method for giving such a notice to a director who is registered with ASIC as a current director.)

The Tax Office states that, in the case of DPNs given pursuant to section 222AOF, the Commissioner will calculate the time for compliance with the notice from the date on which the notice was posted, irrespective of whether or when the DPN was received or delivered. Accordingly, where compliance with the DPN does not occur within 14 days after the DPN is posted to the current director, the Commissioner will regard the relevant section 222AOC or section 222APC penalties as being recoverable from that director.

Tax Office's prior treatment

Before the Court of Appeal's decision, the Commissioner accepted that a DPN under section 222AOE or section 222APE sent to a director by ordinary pre-paid post was 'given' to the intended recipient at the time the notice would have been delivered in the ordinary course of post and that the director had 14 days after the day of delivery in the ordinary course of post to cause the company to comply with section 222AOB and achieve remission of the penalties.

Overview of case

The taxpayer was the director of a private company. Between 1 March 2002 and 21 June 2004, the company withheld amounts of tax from the salary of its employees but failed to remit those amounts to the Tax Office.

In July 2004, the Commissioner gave the taxpayer a DPN pursuant to section 222AOC of ITAA 1936, which imposed a penalty equivalent to the withheld amounts, and the available options to discharge that liability. The taxpayer said that she had not received the notice, and that if it had been delivered she would have received it. She claimed that it had not been delivered and therefore she was not liable.

At first instance, the District Court found on the balance of probabilities that the penalty notice had not been delivered and dismissed the Commissioner's claim for an amount of \$67,576. The Court of Appeal granted the Deputy Commissioner leave to appeal and then allowed that appeal. The Court of Appeal disagreed with the District Court and said the delivery was not the issue, but rather whether the notice had been sent in accordance with the statutory provisions.

In a majority decision, the Court of Appeal upheld the Deputy Commissioner's appeal that the statutory precondition to recovery of unpaid tax from a company director under section 222AOE of ITAA 1936 was satisfied by sending the notice by post to the address which appeared in the records of ASIC. The fact that the director claimed she never received the notice was not relevant.

Legislative framework

Division 9 of Part VI of ITAA 1936 confers upon the Commissioner the power to recover from a director of a company any withholding amounts that the company has failed to remit. Simply, the director becomes personally liable to pay a penalty equal to the unremitted amount. However, any late payment and/or general interest charges (GIC) imposed on the company for non-remittance of the withholding amounts remain the debt of the company.

The Commissioner cannot recover from the director that penalty unless a DPN is served on the director in accordance with section 222AOE. The Commissioner is not entitled to recover from a director the penalty until the end of 14 days after the notice is given. There exists no provision which permits the Commissioner to extend the 14-day period for compliance with a DPN. If a director is unable to pay the tax detailed in the notice, action to recover the penalty from the director will be taken without further notice unless within the 14 days a voluntary administrator or a liquidator is appointed, the liability is discharged, or an agreement to pay the liability is entered into under section 222ALA.

A DPN may be served on anyone who was a director at any time during the period beginning when the company withheld the relevant amount and ending when it was due to be remitted to the Tax Office.

Legal status of DIS

A DIS is not a public ruling but provides a statement of the Commissioner's position in relation to the decision of a court judgment, and how the law will be administered as a consequence of the decision.

Main residence exemption

In *Chapman and FCT* [2008] AATA 241, the AAT affirmed that a taxpayer was not entitled to the full CGT main residence exemption on the sale of his home as he had not occupied it as his main residence throughout the ownership period. Therefore, the taxpayer was only entitled to a partial exemption for the one year out of the three year period of ownership that he occupied it as his home (with the property being rented out for the other two years), the Tribunal found.

In doing so, the Tribunal dismissed the taxpayer's argument that he had occupied it 'as soon as it was practical to do so' in terms of the requirements of section 118–135 (as his employment obligations in another part of the state prevented him from moving in when he purchased it). However, the Tribunal found that the phrase 'the time it was first practicable' should not be read down to mean 'the time it was first convenient'. It also noted that the intention of section 118–135 was to take account of delays moving into a home that arose only because of 'illness or other reasonable cause'.

The Tribunal also dismissed the taxpayer's argument that he had 'intended' to make the dwelling his main residence in terms of the Commissioner's views in CGT Determination 51 about factors to be taken into account when determining if a dwelling qualifies as a main residence. Instead, the Tribunal pointed out that paragraph 3 of the Determination states that 'mere intention' to occupy a dwelling as a sole or principal residence, but without actually doing so, is insufficient to obtain the exemption.

Finally, the Tribunal upheld the 25% shortfall penalties imposed for failure to take reasonable care, despite the taxpayer's claim that he had used a tax agent. The Tribunal pointed out that it still remained the taxpayer's obligation to retain records and bring relevant facts to the tax agent's attention. The Tribunal also found that a higher standard of care was required from tax agents due to their knowledge and skill, and that it was reasonable to expect the agent to have made enquiries about the prior rental use of the property in this case.

Legislative framework

First practicable to do so

The phrase 'the time it was first practicable' is not defined in either ITAA 1997 or ITAA 1936.

A taxpayer is required to move into the dwelling when first practicable to do so. This requires consideration of situations if, for example, there is a delay in moving in because of illness or other unforeseen circumstances. However, a taxpayer must move into the dwelling as soon as the cause of the delay has ended.

In ATO ID 2001/744, it was considered that a taxpayer whose dwelling had a 'protected tenant' and who only commenced court proceedings to evict the tenant two years after acquiring the dwelling did not move in when it was first practicable to do so.

Use of dwelling for income-producing purposes

Section 118–190 of ITAA 1997 states that a taxpayer will get only a partial exemption for a CGT event that happens in relation to a dwelling if:

- the dwelling was the taxpayer's main residence; and
- the dwelling was used for income-producing purposes during all or part of the taxpayer's ownership period.

A residence will only be taken to have been used to produce assessable income if the taxpayer has incurred interest on money borrowed to acquire the dwelling and this interest could be deductible (section 118–190(1)(c)).

The capital gain where the dwelling was rented out in its entirety can be calculated using the formula below:

$$\text{Total capital gain from CGT event} \quad \times \quad \frac{\text{Number of days when dwelling was not main residence}}{\text{Total number of days in ownership period}}$$

If part of the dwelling was used for producing assessable income (for example, 25% of the dwelling was used as a doctor surgery), the capital gain is calculated using the formula below:

$$\text{Total capital gain from CGT event} \quad \times \quad \text{Percentage used for producing assessable income}$$

The interest deductibility test

The interest deductibility test applies irrespective of whether a taxpayer actually borrowed money to acquire his or her dwelling. In applying the test, it is assumed that the taxpayer did borrow money to acquire the dwelling.

In Taxation Ruling IT 2673, the Tax Office states that whether a dwelling or part of it is used for an income producing purpose will depend on the nature of any income producing activities conducted in it and the role played by the dwelling in those activities.

The Ruling provides examples of when a dwelling is used for an income producing purpose: part of a dwelling is dedicated for use in deriving rental income, and where a doctor's dwelling contains a surgery that is used solely as a place of business and is clearly identifiable as a place of business.

While the Ruling acknowledges that many other income producing activities may be conducted from a taxpayer's dwelling, such as music lessons, paid-child-minding and tutoring, the dwelling would only be regarded as being used for gaining assessable income if that part of the dwelling has the character of a place of business, which is a question of fact. This requires a taxpayer to consider whether the particular part of the dwelling:

- is set aside exclusively as a place of business;
- is clearly identifiable as a place of business; and
- is not readily suitable or adaptable for use for private or domestic purposes in association with the dwelling generally.

Therefore, if the taxpayer satisfies the above requirements, he or she would be entitled to deduct part of the interest on money borrowed to acquire the dwelling.

Home first used to produce income

If a taxpayer starts using part or all of his or her main residence to produce income for the first time after 7.30pm (EST) on 20 August 1996, section 118–192 of ITAA 1997 states that the taxpayer is taken to have acquired his or her dwelling at its market value at the time he or she first used it to produce income if all of the following apply:

- the dwelling was acquired on or after 20 September 1985;
- the dwelling was first used to produce income after 20 August 1996;
- the taxpayer would only be entitled to a part exemption when a CGT event happened in relation to the dwelling because the dwelling was used to produce assessable income during the taxpayer's ownership period; and
- the taxpayer would have been entitled to a full exemption if the CGT event happened to the dwelling immediately before he or she first used it to produce income.

This section applies automatically, i.e. the taxpayer does not have a choice. However, an exception exists. If the taxpayer chooses to continue treating the dwelling as his or her main residence after it ceases to be the main residence (under the '6-year rule'), and the dwelling is fully exempt, the section does not apply.

Data matching

Luxury cars

The Tax Office says it will request and collect details of individuals or entities that, between 1 July 2005 and 30 June 2007, have purchased or acquired a motor vehicle valued at \$57,009 or higher from the following sources:

- NSW — Roads and Traffic Authority, NSW;
- Qld — Queensland Transport;
- Victoria — Vic Roads;
- Tasmania — Department of Infrastructure, Energy and Resources;
- SA — Department for Transport, Energy and Infrastructure (Transport SA);
- WA — Department for Planning and Infrastructure;
- NT — Northern Territory Department of planning and infrastructure (Transport Division); and
- ACT — ACT Road Transport Authority, Road User Services, Urban Services.

The Tax Office says these details will be electronically matched with certain sections of its data holdings to identify non-compliance with lodgment and payment obligations under taxation law. Records relating to approximately 600,000 individuals will be matched. The Tax Office expects the data matching to occur from June to July 2008.

Explanation of car cost

\$57,009 was the luxury car tax threshold for the 2005-06 and 2006-07 income years.

Luxury car tax is a tax imposed on 'luxury' cars. The amount is calculated based on the price of the car, including GST and customs duty, less any luxury car tax included in the supply, and any other Australian tax, fee or charge. The price includes GST and any customs duty, dealer delivery charges, and standard and statutory warranties. Generally, it excludes any other Australian tax, fee or charges (for example, stamp duty, transfer fees, registration, compulsory third-party insurance, extended warranties and costs associated with financing the purchase of the car).

Owner-builder licence registration

The Tax Office says it will acquire owner-builder licence registration information from the Building Commission (Victoria) and the NSW Office of Fair Trading. This information will be electronically matched with Tax Office data holdings to identify taxpayers who may not be meeting their taxation obligations. Records relating to approximately 75,000 entities will be matched. This program is called the Owner Builders Data Matching Project.

PAYG withholding payment summary

The Deputy Commissioner has issued a Legislative Instrument that removes the requirement for a paper PAYG payment summary copy to be attached to an individual taxpayer annual income tax return for the 2008 income year and onwards.

This instrument also exempts entities from providing employees and other payees with a duplicate copy of a PAYG withholding payment summary for all types of payments subject to PAYG withholding.

The effect of this instrument is that payers will only be required to provide one original copy of any payment summary that they issue to their payees.

Increase in pension thresholds

The assets test thresholds for pensions will rise in line with increases in the Consumer Price Index (CPI) from 1 July 2008. Taxpayers receiving the following pensions or allowances could benefit from the assets test increase:

- age pension;
- carer payment;
- disability support pension
- Newstart allowance;
- parenting payment;
- youth allowance;
- Austudy;
- mature age allowance;
- widow allowance;
- partner allowance; and
- special benefit.

The new limits are stated below:

	From 1 July 2008	Previous amount
	(\$)	(\$)
Pension Income Free Areas		
Single	138.00	132.00
Single + 1 child	162.60	156.60
Couple (combined)	240.00	232.00
For each additional child add	24.60	24.60
Illness separated couple (combined)	240.00	232.00
Pension Disqualifying Income Limits¹		
Single	1,519.50	1,513.50
Single + 1 child	1,544.10	1,538.10
Couple (combined)	2,538.50	2,530.50
For each additional child add	24.60	24.60
Illness separated couple (combined)	3,003.00	2,995.00
Pension Asset Free Areas		
<u>Homeowners</u>		
Single	171,750	166,750
Partnered (combined)	243,500	236,500
Illness separated couple (combined)	243,500	236,500
<u>Non-Homeowners</u>		
Single	296,250	287,750
Partnered (combined)	368,000	357,500
Illness separated couple (combined)	368,000	357,500

	From 1 July 2008 (\$)	Previous amount (\$)
Retirement Village & Granny Flat Residents		
Extra allowable amount	124,500	121,000
Special Disability Trust		
Concessional asset value limit	532,00	516,500
Exempt Funeral Investment		
Exempt funeral investment threshold	10,250	10,000
Pension Disqualifying Asset Limits²		
Single, homeowner	540,250	535,250
Single, non-homeowner	664,750	656,250
Partnered, homeowner (combined)	856,500	849,500
Partnered, non-homeowner (combined)	981,000	970,500
One partner eligible, homeowner	856,500	849,500
One partner eligible, non-homeowner	981,000	970,500
Illness separated couple, homeowner	980,500	973,500
Illness separated couple, non-homeowner	1,105,000	1,094,500

1. Pension disqualifying income limits include consideration for Pharmaceutical Allowance.
2. Pension disqualifying asset limits include consideration for Pharmaceutical Allowance.

Capital improvement threshold

The Tax Office has released Taxation Determination TD 2008/13 in which it states that the CGT improvement threshold for the 2008-09 income year is \$119,594 (up from \$116,337 that applied in the 2007-08 income year).

Application of threshold

If a CGT asset is acquired before 20 September 1985 and improvement of a capital nature has been made to it after 19 September 1985, the improvement may be treated as a separate asset for CGT purposes upon disposal of the original CGT asset. This will occur if:

- the cost base to the taxpayer of the improvement exceeds the improvement threshold for the year; and
- the amount of the cost base of the improvement exceeds 5% of the capital proceeds in respect of the disposal of the asset to which the improvement was made.

FBT rate

The Tax Office has released Taxation Determination TD 2008/12 in which it states that the car parking threshold for the FBT year that commenced on 1 April 2008 is \$7.07 (up from \$6.78 that applied in the previous FBT year).

HELP and HECS repayment thresholds

The Tax Office has released the HELP and HECS repayment thresholds for the 2008-09 income year:

HELP repayment income (HRI)	Repayment rate
Below \$41,595	Nil
\$41,595 – \$46,333	4% of HRI
\$46,334 – \$51,070	4.5% of HRI
\$51,071 – \$53,754	5% of HRI
\$53,755 – \$57,782	5.5% of HRI
\$57,783 – \$62,579	6% of HRI
\$62,580 – \$65,873	6.5% of HRI
\$65,874 – \$72,492	7% of HRI
\$72,493 – \$77,247	7.5% of HRI
\$77,248 and above	8% of HRI

The HELP repayment income is the taxable income plus any net rental losses, total reportable fringe benefits amounts and exempt foreign employment income of a taxpayer.

SFSS repayment thresholds

The Tax Office has released the student financial supplement scheme (SFSS) repayment thresholds for the 2008-09 income year:

Repayment income (RI)	Repayment rate
Below \$41,595	Nil
\$41,595 – \$51,070	2% of RI
\$51,071 – \$72,492	3% of RI
\$72,493 and above	4% of RI

The SFSS repayment income is the taxable income plus any net rental losses, total reportable fringe benefits amounts and exempt foreign employment income of a taxpayer.

Other tax issues

Changes to the 2008 tax returns

Company tax return 2008

Item No.	Description
6, Label X	Forestry managed investment scheme income
7, Label U	Forestry managed investment scheme deduction
9	Disclosure of product or private ruling information relating to forestry managed investment scheme

The 2008 tax return has segregated R&D concessions disclosure information:

Item No.	Description	2007 equivalent
7, Label L	Australian owned R&D tax concession	Item 7, Label L and Label M
7, Label J	Foreign owned R&D tax concession	
7, Label M	Australian owned R&D – extra incremental 75% deduction	
7, Label K	Foreign owned R&D – extra incremental 75% deduction	

Partnership tax return 2008

Item No.	Description
10	Forestry managed investment scheme income
17	Forestry managed investment scheme deduction, including disclosure of product or private ruling information

Trust tax return 2008

Item No.	Description
10	Forestry managed investment scheme income
13	Superannuation lump sums and employment termination payments paid to beneficiaries
17	Forestry managed investment scheme deduction, including disclosure of product or private ruling information

Simplified tax system election

While the Company, Partnership and Trust tax returns for 2008 still have a tax item titled ‘Simplified tax system (STS) elections’, all labels that were previously located under this item have been removed. In its place, the tax returns contain a statement reminding taxpayers that the STS has been repealed and replaced by the small business entity regime.

(Note that under the small business entity regime, a taxpayer does not need to elect to enter into the regime. Instead, it will be apparent from the entity’s tax return whether it has used the small business entity tax concessions.)

Superannuation funds

For superannuation funds, the two tax returns for 2008 are a significant departure from the single 2007 format. For the 2007-08 income year, the two returns for superannuation funds are:

- Fund income tax return 2008, which is to be used by all superannuation funds other than SMSFs; and
- Self managed superannuation fund annual return 2008, which is to be used by SMSFs only.

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