Transfer of Property by Body Corporate Back to Developer

The Tax Office has recently released ATO ID 2006–94 on the capital gains tax (CGT) implications arising from the transfer of property by a body corporate back to the developer.

In this case, a developer built a block of three units with adjoining common property. The developer entered into a contract to sell the units to individual purchasers. Just after the sale contract was entered into, the strata plan for the units was registered and the body corporate was formed.

The contracts for the sale of the three lots contained a special sale-back condition where the purchasers, as members of the body corporate, were bound to vote in favour of sub-dividing the common property to create a new lot and to transfer the new lot back to the developer.

CGT event A1 occurs where there has been a transfer of ownership in an asset. Subsection 104–10(3) provides that the time of the event is when the contract is entered into or, if there is no contract, when the change in ownership occurs.

The question under review was whether the new lot was disposed of by the body corporate when the original sale contract was entered into or at a later time when the new lot was actually transferred to the developer.

The Tax Office stated that the inclusion of the sale-back condition was the only means by which the intention of the parties to transfer the property could be given contractual form. The sale proceeds of the original three units reflected the intention to create the new lot to be transferred back to the developer.

As the body corporate was obliged under the sale contract to resolve to create and transfer the new lot back to the developer, the time of the disposal of the new lot was when the sale contract was entered into.

For further information, please review 'Capital Gains Tax: time of CGT event A1 where body corporate transfers property to developer' at:

http://law.ato.gov.au/atolaw/print.htm?DocID=AID%2FAID200694%2F00001

Separate Business Premises and the PSI Test

The Administrative Appeals Tribunal has recently ruled in favour of a taxpayer in relation to the application of the personal services income (PSI) rules. It held that while the business premises were used for dual purposes, the test only requires that the building be used 'mainly' for business purposes under the business premises tests set out in section 87–30(1).

The taxpayer entity hired its controller to provide business consulting services to its clients. The controller operated this business from the office space above his garage, which was separate from his primary residence. However, some of the other parts of the controller's home, such as the driveway and front gate, were also used in the course of operating the business.

The Commissioner contended that the business was not separate from the applicant's private home and considered that the business premises test in section 87–30 of ITAA 1997 could not be satisfied. This was on the basis that various parts of the residence were not physically separate from the business premises.

The AAT found that despite the fact that some of the common residence was shared by the business, the explanatory memorandum that accompanies the introduction of section 87–30 provides that the business premises may be used 'mainly' by the business and not exclusively. The AAT also held that there was appropriate signage in place to distinguish the business from the residence and the business was not within 'the curtilage of private premises'.

The AAT ruled that the business premises in this instance was sufficiently separated from the private residence to satisfy the criteria set out in section 87–30(1).

Main Residence Exemption — Testamentary Trusts

The Tax Office has recently released ATO Interpretative Decision ID 2006/34, which considers whether the main residence exemption will apply where a testamentary trust transfers its interest in a dwelling to an individual beneficiary.

The facts of the case under review were as follows:

- The dwelling of a deceased taxpayer was to be held on trust in accordance with the taxpayer's will for five individual beneficiaries.
- The dwelling was the main residence of the deceased throughout the period of ownership.
- None of the beneficiaries were the taxpayer's spouse and none were granted a right to occupy the dwelling under the will.
- One of the beneficiaries started to occupy the dwelling as their main residence.

In the 2006 income year the trustee transferred one-fifth of the interest in the dwelling directly to the beneficiary and sold the remaining four-fifths interest to the same beneficiary under a power of sale.

Broadly, an exemption is available under Division 118 of ITAA 1997 (main residence exemption) where an interest in the deceased taxpayer's main residence passes to a beneficiary under the deceased taxpayer's will and one or more of the following is satisfied:

- the deceased acquired the main residence on or after 20 September 1985; and
- any sale by the beneficiary occurs within two years of the deceased's death; or
- the deceased acquired the main residence before 20 September 1985; and
- the dwelling was, from the deceased's death until the sale by the beneficiary, the main residence of one or more of:
  - — the spouse of the deceased; or
  - — an individual who has the right to occupy the dwelling under the deceased's will; or
  - — if the CGT event was brought about by an individual to whom the ownership interest passed as a beneficiary.

Broadly, under section 128–20 of ITAA 1997 a CGT asset (i.e. the dwelling) does not pass to a beneficiary under a will if the beneficiary becomes the owner of the asset because it is transferred under a power of sale.

As mentioned above, the asset was transferred under power of sale and hence the main residence exemption does not apply.

For further information please review ATO ID 2006/34 — Income Tax: Capital Gains Tax: main residence exemption — testamentary trust — CGT event brought about by individual to whom ownership has passed, at:

http://law.ato.gov.au/atolaw/view.htm?rank=find&criteria=AND~2006%2F34~basic~exact&target=JA&style=java&sdocid=AID/AID200634/00001&recStart=1&recnum=1&tot=1&pn=J:::J

GST — Improvements on the Land

In GST Ruling GSTR 2006/6, the Tax Office provides a detailed explanation of the meaning of the term 'improvements on the land' or similar phrases for the purposes of Subdivision 38–N and Division 75 of the *A New Tax System (Goods and Services Tax) Act 1999* (the GST Act).

The ruling considers whether or not there are improvements on the land for the purposes of establishing whether a supply made by the Commonwealth, a state or a territory is GST-free. More importantly (for most GST-registered entities), the ruling considers whether there are improvements on the land where a taxable supply is made under the margin scheme (and specifically, if the margin for that supply is calculated under subsection 75–10(3) of the GST Act).

By way of background, section 75–10(1) of the GST Act provides that if a taxable supply of real property is under the margin scheme, the amount of GST on the supply is one-eleventh of the margin for the supply. The 'margin' for the supply is defined in section 75–10(2) to be the amount by which the consideration for the supply exceeds the consideration for acquisition of the interest, unit or lease in question (subject to section 75–10(3) and section 75–11)) i.e. only the value of the 'improvements on the land' is taxed for GST purposes. However, the term 'improvements on the land' is not defined in the GST Act.

The meaning of 'improvements on the land'

In this ruling, the Tax Office provides that, in order for there to be 'improvements on the land':

- there must have been some human intervention;
- the human intervention must have been physically located on the land; and
- the human intervention must enhance the value of the land at the relevant date for ascertaining whether there are improvements on land.

Human interventions

The Tax Office is of the view that human interventions that enhance the value of the land are:

- houses, townhouses, stratum units, separate garages, sheds and other outbuildings;
- commercial and industrial premises;
- farm houses, farm outbuildings, internal fencing, stockyards, wells and bores, excavated tanks, dams, surface drains, culverts, bridges, sown pasture, formed internal roads and irrigation layouts;
- formed driveways, swimming pools, tennis courts, and walls;
- any other similar buildings or structures;
- fencing — internal or boundary fencing;
- utilities — for example, water, electricity, gas, sewerage connected or available for connection;
- clearing of timber, scrub or other vegetation;
- excavation, grading or levelling of land;
- drainage of land;
- building up of soil fertility;
- removal of animal pests, rabbit burrows, etc;
- removal of rocks, stones or soil; and
- filling of land.

Human interventions that do not enhance the value of the land include:

- fire breaks, solely to allow access to fire equipment and to reduce the spread of a fire;
- clearing, where the clearing may deteriorate over time with the regrowth of the same or different vegetation;
- clearing, where it degrades the land by later causing erosion or salinity problems;
- building(s), where the building has deteriorated to such an extent that it is a detriment as it is unhabitable and has been condemned by order of the local council; and
- fencing, where it has deteriorated such that no valuable fencing exists.

Multiple human interventions on the land

The Tax Office considers that where there are a number of improvements to the land, there is a need to determine whether any of the interventions enhance the value of the land — it is not appropriate to take a holistic approach.

When you ascertain whether there are improvements on the land

Improvements on the land need to be determined at the date specified in the table below (as provided at paragraph 34 of the ruling).

Section	Relevant day for ascertaining whether there are improvements on the land
Subsection 38–445(1)	When the supply is made
Subsection 38–445(1A)	When the land was previously supplied by the Commonwealth, a state or a territory, by way of a lease to the recipient of the supply
Subsection 38–450(1)	When the supply is made
Item 2A of the table in subsection 75–10(3)	When the land was previously supplied by the Commonwealth, a state or a territory, by way of a lease to the recipient of the supply
Item 3 of the table in subsection 75–10(3)	1 July 2000
Item 4 of the table in subsection 75–10(3)	1 July 2000
Subsection 75–10(3A)	The day on which the taxable supply takes place

Who establishes whether there are improvements on the land

The Tax Office is of the view that in order to determine whether there are improvements on the land, reference should not be made to the use or intended use of the land by the supplier or the recipient of the supply (an objective test is to be used).

As whether there is an improvement on the land is a question of fact, the Tax Office suggests that it is prudent to engage a professional valuer.

Meaning of 'on the land'

The Tax Office is of the view that the meaning of 'on the land' includes any human intervention that increases the value of the land, and is not limited to visible structural improvements, i.e. it includes improvements below the surface of the land (e.g. underground drainage or other facilities). However, the Tax Office notes that 'on the land' does not include amenities in the surrounding area (i.e. that are not upon the land), even if they enhance the value of the land.

For further information, please view GST Ruling GSTR 2006/6 — Goods and Services Tax — Improvements on the land for the purposes of Subdivision 38–N and Division 75, at:

http://law.ato.gov.au/pdf/gst06-06.pdf

Commissioner's Discretion under the Non-commercial Loss Provisions

The Administrative Appeals Tribunal has recently affirmed the decision made by the Commissioner not to exercise its discretion under section 35–55 of ITAA 1997.

Broadly, section 35–10 of ITAA 1997 provides that if individuals, either alone or in partnership, cannot satisfy certain tests, the net deduction relating to the business activity will be deferred to a later income year in which the assessable income of the business activity exceeds allowable deductions. The tests are:

- assessable income test;
- profits test;
- real property test; and
- other assets test.

However, under section 35–55 the Commissioner may decide to exempt a taxpayer from section 35–10 if the Commissioner is satisfied that one or more of the following has occurred:

- the business activity would have satisfied one of the four above-mentioned tests but for special circumstances outside the control of the taxpayer such as drought, flood, bushfire or any other natural disaster; or
- the business has commenced and, for a particular period of time because of the nature of the business, will not satisfy any of the above-mentioned tests; or
- there is an objective expectation based on evidence that it is commercially viable that within a period of time the business will satisfy one of the above-mentioned tests or have assessable income exceeding the allowable deductions for that particular business in a particular year.

In the case under review, the taxpayer was a member of a partnership which undertook an olive growing business. The business commenced in 1998 and had made losses in every year of operation. In addition, the taxpayer also failed to satisfy any of the four tests mentioned above.

However, the taxpayer applied for Private Binding Rulings (PBRs) for the income years ended 30 June 2002, 2003 and 2004. The PBRs brought a case forward for the Commissioner not to apply the rule in section 35–10 in accordance with section 35–55, based on the special circumstances that a drought existed during the 2002 to 2004 years. The taxpayer also provided independent advice detailing that an olive growing business will not realise income until five years from the initial plantation of the trees.

The Tax Office did not exercise its discretion under section 35–55 to exempt the taxpayer for the following reasons:

- even in the absence of the drought, the business activities would still not have satisfied any of the above-mentioned tests; and
- the 320 trees planted in 1998 which would yield income in five years time would not produce enough income to satisfy the above-mentioned tests.

The AAT affirmed the decision of the Tax Office.

Disaster Relief Payments

The Tax Office has released Taxation Determination TD 2006/22, which concerns one-off payments by charities to taxpayers who suffer financial hardship as a result of a natural disaster such as a flood, drought or bushfire.

Often when a natural disaster occurs, a charity may run a relief appeal and as part of that appeal, may accept payments from the Government as well as private donors. Where the charity makes a once-off payment to a taxpayer who is in financial need to cover the basic necessities of life, then that payment will not be subject to tax. The payment is not taxable as it is a simple gift to the taxpayer and is therefore not assessable income of the taxpayer.

For further information, please consult <http://law.ato.gov.au/pdf/td06-022.pdf>.

Trading Stock — Foreign Currency Exchange Gain

The Tax Office has released Taxation Determination TD 2006/29, which states that foreign exchange gains are included as ordinary income for the purposes of determining PAYG instalment income.

Where a taxpayer derives a foreign currency exchange gain in relation to the purchase of trading stock that is denominated in a foreign currency, that gain will be ordinary income of the taxpayer. While the foreign currency rules in Division 775 of ITAA 1997 govern the calculation of a foreign currency exchange gain, and section 775–15 operates to include any gains in assessable income, that income is still income according to ordinary concepts.

When calculating PAYG instalment income, the taxpayer is required to include ordinary income by subsection 45–120(1) of Schedule 1 to the *Taxation Administration Act 1953*. Thus any foreign currency exchange gains are required to be included in instalment income.

The Tax Office also notes that this determination does not prevent a taxpayer from recognising a net foreign exchange gain in its instalment income in accordance with Law Administration Practice Statement PS LA 2005/17.

In that statement, the Tax Office accepted that where a taxpayer accounts for any foreign exchange gains or losses on a net basis, they may use the net gain in the calculation of their instalment income. As there is no requirement that taxpayers disclose foreign exchange gains or losses on a gross basis in their financial statements, often their accounting systems do not account for such gains and losses on a gross basis.

In such situations taxpayers may account for foreign exchange gains and losses on a net basis when determining their PAYG instalment income, provided that any known material foreign exchange losses are excluded at the time of determining the instalment income.

For further information, please consult <http://law.ato.gov.au/pdf/td06-029.pdf>.

Service Trusts — Deductibility of Service Fees Paid to Associate Service Entities

Note: This article does not provide supplementary information for a bulletin article, but explains the final ruling on this subject.

The Tax Office recently released TR 2006/2, which considers whether fees paid in relation to service arrangements between associated entities are deductible under section 8–1 of the *Income Tax Assessment Act 1997* (ITAA 1997) and whether Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) may apply to the service arrangement.

TR 2006/2 was previously released in draft form as TR 2005/D5, and the August 2005 edition of this bulletin discussed the guide released by the Tax Office in relation to the interpretation of TR 2005/D5.

Service arrangements covered

Typically, a service arrangement considered in the ruling includes a taxpayer who provides professional or other services to clients. The taxpayer may be a sole practitioner, a partner in a partnership or a company.

The taxpayer enters into an agreement with a service entity. The service entity is generally a trust or a company. Under the agreement, known as the service agreement, the service entity agrees to provide services to the taxpayer in return for a fee. The taxpayer will then claim a tax deduction for the fees paid and the service entity will include the fees received in its assessable income. The fees charged by the service entity are usually based on a mark-up over costs and result in a profit to the service entity.

When will service fees be deductible under section 8–1?

In accordance with the ruling, expenditure arising from service arrangements will broadly be deductible under section 8–1 where it can be demonstrated that the service arrangement provides an objective commercial explanation for the expenditure. That is, the expenditure incurred has resulted in the provision of commercial benefits.

A commercial benefit may be a service that adds value or performs substantive functions for the practice.

When will service fees not be deductible under section 8–1?

The ruling provides examples of where service arrangements may not demonstrate commercial benefits of entering into the arrangement, such as:

- the service fees and charges are disproportionate or unwarranted in relation to the benefits provided by the service arrangement;
- there is no reasonable commercial explanation for the profits derived by the service entity; or
- it cannot be demonstrated that the service entity has added any value or performed substantive functions for the fees charged (e.g. there is no clear separation between the service entity and the taxpayer).

Part IVA

Broadly, Part IVA will apply where schemes have been entered into for the dominant purpose of obtaining a tax benefit.

The ruling details factors to consider when determining whether Part IVA may apply, such as:

- non-commercial aspects of the arrangement (e.g. excessive fees);
- the lack of a clear distinction between the taxpayer and the service entity (i.e. the taxpayer assumes all the risks as if there was no service entity) and the service entity does not perform services which add value or are substantive.

This ruling applies to years of income commencing both before and after its date of issue.

For further information including examples, please review TR 2006/2 Income tax: deductibility of service fee paid to associated service entities: Phillips arrangements at:

http://law.ato.gov.au/atolaw/print.htm?DocID=TXR%2FTR20062%2FNAT%2FATO%2F00001

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