

## Tax Effective Investment Schemes and Part IVA

In a recent decision in *Macpherson and Commissioner of Taxation* [2007] AATA 1022, the Administrative Appeals Tribunal (AAT) disallowed deductions in relation to a scheme involving a wine grape project.

The scheme, set out in the prospectus document, provided that each investor was to be a farmer with their own identifiable piece of land containing 300 vines. The scheme involved the business of farming and harvesting grapes for the production of wine. However, despite the prospectus, the investors were merely passive investors, as their agreement did not specify where their farms were located.

In this case, and in similar cases that the Commissioner has recently been looking into further, the taxpayer took part in a commercial scheme that required large upfront fees. The AAT noted that these served no purpose other than to generate deductions. In the first year, the taxpayer had outlays of \$6,600 but the scheme operation enabled her to claim deductions totaling \$46,000. Furthermore, the AAT held that the contrived nature of the round robin financing arrangements and the fact that no payments were required until just prior to year-end suggested that the sole or dominant purpose of the scheme was to obtain a tax benefit.

The taxpayer argued that she entered into the agreement with the intention that the scheme would produce commercial returns. However, the AAT supported the Commissioner's decision to disallow part of the deduction (in excess of the amount actually outlaid by the taxpayer) and re-iterated that, even if the taxpayer did expect to profit through the investment, the pursuit of a commercial objective is not inconsistent with the existence of a dominant purpose of seeking to obtain a tax benefit in certain cases.

## Non-commercial Losses and the Commissioner's Discretion

The Tax Office recently released Draft Taxation Ruling TR 2007/D1, which provides guidelines on how the Commissioner's discretion contained in the non-commercial loss provisions may be exercised.

To read the full draft taxation ruling, visit the ATO website at <<http://law.ato.gov.au/pdf/tr2007-d001.pdf>>.

### Background

The non-commercial loss rules as set out in Division 35 of the *Income Tax Assessment Act 1997* (ITAA 1997), seek to defer the losses of an individual who is engaged in a non-commercial business activity from being offset against other assessable income of the individual, in the year that the loss is incurred.

The Division sets out four tests, one of which needs to be satisfied for the loss to become deductible in the hands of the taxpayer. These tests include:

- assessable income test — income and capital gains must be at least \$20,000;
- real property test — the total reduced cost bases of real property or interests, used on a continuing basis to carry on the business, are valued at \$500,000 or more;
- other assets test — the total value of other assets used on a continuing basis to carry on the business are valued at \$100,000 or more; and
- profits test — the activity must have resulted in taxable income in at least three of the last five years.

There is also a provision in the Division that sets out circumstances in which the Commissioner may exercise his discretion to allow a deduction for losses associated with non-commercial business activities.

## **Ruling**

The draft ruling sets out the Commissioner's position on when he may exercise his discretion to allow a loss to be deducted, even though it is incurred in a non-commercial business activity. The provision outlining the Commissioner's discretion can be found in section 35–55 of ITAA 1997.

### ***Special Circumstances***

Under certain special circumstances the Commissioner may consider exercising his discretion if he considers it unreasonable to apply the rule in Division 35. This will include circumstances where the business activity was affected by flood, drought, bushfire or some other natural disaster.

### ***Nature of the business***

If a business fails to satisfy one of the four tests, the failure must be the result of some inherent characteristic common to other businesses. This would apply where the commercial activity fails to satisfy one of the four tests for reasons outside the control of the taxpayer (e.g. a business activity that has a long lead time between commencement and the production of assessable income).

The Commissioner may exercise his discretion for any income year during the period from the time of the commencement of the business activity to the end of the last income year in which the inherent characteristic affects the business's ability to satisfy one of the tests.

### ***Objective expectation about future performance***

The Commissioner must be satisfied that an objective expectation exists that the business will satisfy a test or produce a tax profit in a commercially viable period for that particular industry.

A commercially viable period for the industry concerned is the amount of time in which a business of the type being conducted by the taxpayer, behaving in a commercial manner, will produce a tax profit and hence satisfy one of the tests.

## **Offshore Employee Superannuation Scheme**

In a recent decision in *Wensemius and Anor and Commissioner of Taxation* [2007] AATA 1006, the AAT denied a taxpayer trust a deduction for contributions it made to a New Zealand superannuation fund.

Ordinarily, a deduction for super contributions can be made where those payments are made in respect of an eligible employee. An employee is defined under section 82AAA of the *Income Tax Assessment Act 1936* (ITAA 1936) as:

- an Australian resident who is engaged in the business of the taxpayer; or
- is producing assessable income of the taxpayer.

Employer superannuation contributions are deductible for employees up to certain aged based limits. Certain conditions for deductibility also apply, and are as follows:

- the contribution is made to a fund for the purpose of providing superannuation benefits to another person;
- the fund is a complying superannuation fund in the year of income in which the contribution is made; and

- one or more of the following apply:
  - the person is an eligible employee;
  - the contribution reduces the superannuation guarantee contribution percentage in respect of the other person; and
  - the other person is an employee for the purposes of the *Superannuation Guarantee (Administration) Act 1992*.

In this case, the taxpayer trust claimed \$60,000 as a deduction for an amount contributed to a New Zealand superannuation fund on behalf of an employee of the trust.

The AAT found that there was only evidence to demonstrate that a contribution of \$6,000 had been made to the superannuation fund and the balance of the payments were subject to a round robin system between related parties.

The AAT also found that because the provision of benefits to the employee were at the discretion of the trustee of the superannuation fund, this prevented the superannuation fund from qualifying for the purposes of deductibility under section 82AAE of ITAA 1936. The Commissioner argued that the mere ‘expectation of benefit’ does not equate to the ‘provision of a benefit’ and further submitted that the fund in question did not exhibit the characteristics required to be considered a superannuation fund in accordance with section 10 of the *Superannuation Industry (Supervision) Act 1993*.

The AAT also addressed the deductibility of the contribution under section 8–1 of the *Income Tax Assessment Act 1997* (ITAA 1997). It found that the evidence did not support a finding that the contribution in question was relevant to the company’s derivation of assessable income.

Furthermore, the AAT held that Part IVA would apply in the event that the findings in relation to the deductibility were incorrect.

In arguing that Part IVA should apply, the Commissioner noted that (if the contributions were deductible) the taxpayer would be able to:

- obtain a deduction under section 82AAE of ITAA 1936 and avoid fringe benefits tax because of the discretionary nature of the fund; and
- avoid taxation within the fund on the contributions as they would be subject to the operation of the Australia/New Zealand double tax agreement.

## **Division 7A — Audit Selection Criteria**

The Tax Office recently released guidelines indicating draft selection criteria for Division 7A audit cases. To read the meeting minutes, visit the ATO website at <[www.ato.gov.au/print.asp?doc=/content/82370.htm](http://www.ato.gov.au/print.asp?doc=/content/82370.htm)>.

## **GST: Property Settlement Adjustments**

In GST Determination GSTD 2006/3, the Tax Office considers the treatment of settlement adjustments on the sale of real property. On settlement of property transactions, certain adjustments are often made between the vendor and the purchaser in relation to such matters as rates and land tax, which are usually made in accordance with the provisions of the contract. The Tax Office considers that these relate to the supply of the property. Accordingly, they are taken into account when determining the consideration for that supply.

This determination is of great significance to vendors and purchasers of real property as the legislation does not refer to ‘settlement adjustments’. There is also no readily available information in relation to the GST implications of these adjustments. In addition, the ATO has also pointed out on its website that ‘not including settlement adjustments on the sale of a property’ is a very common GST error in the ‘general industry market segment’, resulting in under/over claims of GST, consequently resulting in penalties.

To read the full GST determination, visit the ATO website at <<http://law.ato.gov.au/pdf/gstd2006-003.pdf>>.

## **What is ‘consideration’ for GST purposes?**

According to the GST legislation, consideration is defined in terms of positive ‘payments’ and includes forbearance by a person. However, ‘payment’ is not defined. The ordinary meaning of the term ‘to pay’ includes provision of value either in cash or in kind. This broad interpretation of ‘payment’ is supported by the formula in section 9–75 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act), which calculates the value of a supply on which GST is levied by reference to the ‘price’ of the supply.

The determination explains that the consideration may be either monetary or non-monetary or both. However, the consideration will not always be the price shown on the contract as, on settlement, adjustments are commonly made for rates, land tax and other outgoings.

## **What the consideration paid under the contract includes**

According to the Tax Office, the consideration paid under the contract includes:

the price shown on the contract

*plus*

any payments by the purchaser to the vendor in respect of an adjustment for rates, land taxes or other expenditure incurred by the vendor prior to settlement

*less*

any payments by the vendor to the purchaser in respect of an adjustment for rates, land taxes or other expenditure paid by the purchaser subsequent to settlement.

## **Practical examples on how to calculate the consideration**

The determination includes various practical examples of the treatment of settlement adjustments including the following scenarios:

- In a case where rates or land tax are assessed to and paid by the supplier before settlement, the contract will usually require the recipient to pay an extra amount to the supplier for the balance of the rates or land tax period that reflects the recipient’s period of ownership. The amount payable by the purchaser is not in consideration for a second supply and is merely extra consideration being paid for the sale and purchase of the land.
- In a situation where rates or land tax assessed to the supplier remain unpaid at the time of settlement, there will be a settlement adjustment in favour of the purchaser.
- In an event where rates or land tax are assessed to the recipient after settlement has taken place, the rates partially relate to usage by the vendor in the period before settlement and partially relate to the purchaser’s usage. Because the terms of the contract usually require an adjustment based on the supplier’s and recipient’s respective ownership periods, the recipient will consequently pay less consideration to the supplier than the purchase price reflected in the contract.

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