client alert | explanatory memorandum

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Valuing Trading Stock in Retail and Wholesale Industries

The Tax Office recently released Taxation Ruling TR 2006/8 which applies to taxpayers who elect to value their trading stock on hand at the end of an income year at 'cost' for the purposes of section 70–45(1) of the *Income Tax Assessment Act 1997* (ITAA 1997).

The ruling provides that when this election is made, the cost of each item of trading stock will include all direct and indirect expenditure incurred in relation to making the item available for sale.

Taxpayers in retail and wholesale industries who value their stock at cost in accordance with section 70–45(1), should use absorption costing for income tax purposes. Under absorption costing, costs absorbed for tax purposes include the purchase amount and any direct and indirect costs incurred in bringing the trading stock to its current saleable condition. These costs include:

- the purchase price;
- import duties and taxes;
- transport and handling charges;
- adjustment and assembly costs to prepare the stock for sale;
- the relevant costs in operating a purchasing department;
- administrative costs associated with receiving and inspecting the stock; and
- off site storage and distribution centre costs, apportioned over the trading stock.

When the trading stock is sold directly from a warehouse or storage facility to customers, this is characterised as the stock's final selling location, and no further costs are absorbed. In situations where the warehouse or storage facility is used only partly as a selling location and partly as a storage location, then the cost associated with the storage would need to be apportioned on a fair and reasonable basis.

The ruling also gives examples of costs not to be taken into account, including:

- general administrative costs unrelated to the operation of the warehouse or storage facility;
- selling costs;
- costs of carrying obsolete stock;
- interest; and
- advertising.

This ruling was previously released in draft form as TR 2005/D11, and there are some significant changes from that draft, including:

- more detail on the costs to be absorbed;
- comments on Australian Accounting Standard AASB 102; and
- an alternative method for calculating cost for taxpayers with turnover of less than $10 million.

AAT Hears GST Anti-avoidance Provisions Case — [2006] AATA 821

In a recent decision, the Administrative Appeals Tribunal (AAT) handed down its first case in relation to the anti-avoidance provisions in Division 165 of the *A New Tax System (Good and Services Tax) Act 1999* (the GST Act).

The issues that the AAT considered were:

- whether the anti-avoidance provisions in Division 165 of the GST Act disallowed the input tax credit of $70,000 claimed by the taxpayer (VCE); and
- if so, whether the penalty on the shortfall amount of $70,000 was properly imposed at the rate of 50%.

The AAT affirmed the Commissioner's decision to prohibit input tax credits totaling $70,000 claimed by the taxpayer and to impose a penalty of $35,000.

Application of Division 165

In general terms, Division 165 operates if:

- an entity obtains or receives a GST benefit from a scheme; and
- the GST benefit is not attributable to the making of a choice, election, application or agreement that is expressly provided for by the GST law; and
- it is reasonable to conclude that either:
  - — an entity that entered into or carried out the scheme, or part of the scheme, did so with the sole or dominant purpose of that entity or another entity getting a GST benefit from the scheme; or
  - — the principle effect of the scheme, or part of the scheme, is that the avoider gets the GST benefit from the scheme directly or indirectly; and
- the scheme:
  - — is a scheme that has been, or is, entered into on or after 2 December 1998; or
  - — is a scheme that has been or is carried out or commenced on or after that day.

The main objective of Division 165 of the GST Act is to deter schemes that give entities benefits by reducing GST, increasing refunds, or altering the timing of payment of GST or refunds. If the dominant purpose of a scheme is to give an entity such a benefit, the Commissioner has the power to negate the benefit that an entity gets from the scheme by declaring how much GST or refund would have been payable, and when it would have been payable, apart from the scheme.

Background

In April 2003, the taxpayer, VCE, was incorporated and entered into an agreement to acquire a commercial property (rented as a medical centre) from its sole director for $770,000 (GST inclusive). Payment for the purchase of the property was to be paid in instalments in which a deposit of $550 would be paid upon signing of the agreement of the sale, $11,000 would be paid on 30 June 2008, another $11,000 would be paid on 30 June 2013, and the balance of $727,450 would be paid on 30 June 2018. The ownership of the property would transfer to the taxpayer upon payment of the final instalment on 30 June 2018.

The taxpayer registered to account for GST on a non-cash basis, effective from April 2003. In May 2003, the taxpayer lodged its first Business Activity Statement (BAS) for the April 2003 tax period, showing capital purchases of $770,000 and claiming input tax credits of $70,000. At the same time, the vendor declared GST of only $50 on its BAS (and not $70,000) as it was registered to account for GST on a cash basis. Effectively, the vendor had a deferred commitment of the payment for most of the GST by 15 years, while the purchaser had effected an immediate input tax credit.

Upon review of this arrangement, the Commissioner made a declaration under section 165–40 of the GST Act that the taxpayer's net amount for the April 2003 tax period would be reduced to nil, cancelling the input tax credits claimed. The Commissioner also imposed a penalty of $35,000.

The taxpayer argued that Division 165 of the GST Act did not apply and that the transactions represented an ordinary commercial or family dealing.

AAT Decision

The matters that the AAT considered included:

- whether VCE obtained a GST benefit from a scheme;
- whether the GST benefit was attributable to VCE's making an election that is expressly provided for by the GST Act;
- whether the sole director or VCE, either alone or together, entered into or carried out the scheme with the sole or dominant purpose of getting a GST benefit from the scheme;
- the manner in which the scheme was entered into or carried out;
- the form and substance of the scheme;
- the purpose of the GST Act and any relevant provisions in this Act;
- the timing of the scheme;
- the period over which the scheme was entered into and carried out;
- the effect that the GST Act would have in relation to the scheme apart from Division 165;
- any changes in the avoider's financial position that have resulted, or may reasonably be expected to result, from the scheme;
- any change that has resulted, or may reasonably be expected to result, from the scheme in the financial position of an entity that has or had a connection or dealing with the avoider, whether the connection or dealing is or was of a family, business or other nature;
- any other consequence for the avoider or connected entity of the scheme having been entered into or carried out;
- the nature of the connection between the avoider and a connected entity, including the question whether the dealing is or was at arm's length;
- the circumstances surrounding the scheme; and
- other relevant circumstances.

Having considered the above, the AAT found that the taxpayer clearly obtained a benefit from the scheme and the dominant purpose of the taxpayer or the vendor in entering into the scheme was to enable the taxpayer to obtain a GST benefit. The AAT went on to conclude that the taxpayer did not have a convincingly arguable position and the fact that VCE had taken reasonable care in preparing the BAS was irrelevant.

For further information, please view *VCE and Commissioner of Taxation* [2006] AATA 821 (26 September 2006), at: <www.austlii.edu.au/au/cases/cth/aat/2006/821.html>.

Also refer to *Taxpayer Alert TA 2004/1: Non-arm's length arrangements using Goods and Services Tax (GST) cash/non-cash accounting methods to obtain a GST benefit*, at: <http://law.ato.gov.au/pdf/tpa0401.pdf>.

Compensation Payment Assessable as Ordinary Income — [2006] AATA 614

In a recent decision the Administrative Appeals Tribunal (AAT) held that payments made in compensation for a taxpayer's injury at work were assessable as income.

The taxpayer sustained various injuries at work and ceased physical work on 14 July 2000. Subsequently, his employment contract was terminated on 4 August 2000, when it was deemed he was no longer fit to return to work.

The taxpayer commenced litigation regarding the injuries he sustained at work and was awarded, by the Compensation Court, various amounts of compensation including two aggregated amounts to compensate for lost weekly earnings amounting to $27,080 and $4,587 respectively.

The Commissioner held that these amounts were assessable as ordinary income. The taxpayer appealed this decision on the grounds that lump sum compensation was not assessable as ordinary income.

The Commissioner argued that the amounts were in fact income in accordance with ordinary concepts and the AAT considered some of the following tests detailed by the courts in determining when an amount is considered to be ordinary income:

- the character of the income in the hands of the recipient;
- whether in considering all the circumstances, one could conclude the payment received was income;
- the application of an objective test; and
- reliance on the ordinary concepts and usages of the term 'income'.

The AAT, in consideration of the above factors, determined that the payments representing lost earnings due to the taxpayer's incapacitation were in substitute for what the taxpayer would have earned had he not been injured. The AAT was satisfied that this alone was sufficient to characterise the payments as income according to ordinary concepts.

Furthermore, the AAT considered what actually constitutes ordinary income, and turned to the court's indicia of ordinary income, including:

- whether the amount of money is the product of any employment, services rendered or business;
- whether the payment is periodic or a lump sum;
- the purpose of the payment;
- whether the amount is paid in substitution for another amount so as to take on the character of the substituted amount; and
- whether the person expects to receive an amount on a regular basis so that he/she can rely on it for their regular requirements.

The AAT was further satisfied that the payments were paid in lump sum because they were in arrears and were directly related to the taxpayer's employment with his former employer. The amounts that were awarded by the Compensation Court were directly referable to the taxpayer's earnings.

The AAT upheld the Commissioner's decision to assess the amounts awarded in respect of aggregated lost earnings as ordinary income.

Superannuation Contributions Not Deductible — [2006] AATA 733

In a recent decision, the Administrative Appeals Tribunal (AAT) held that contributions made by a taxpayer to a complying superannuation fund were not deductible.

The taxpayer, a solicitor, was a member of her employer's superannuation fund in her capacity as an employee. From 1 June 1993, the taxpayer was also a member of H Pty Ltd superannuation fund, which was a complying superannuation fund for the purposes of section 82AAC of the *Income Tax Assessment Act 1936* (ITAA 1936).

In April 1999, H Pty Ltd was formed to act as trustee of the family trust and the taxpayer was appointed as the sole shareholder, secretary and director of the company.

In the same year, the taxpayer enquired about making contributions to her employer's superannuation fund, by way of salary sacrifice, and was informed she could not do so.

On advice, the taxpayer made contributions to the H Pty Ltd complying superannuation fund for her own benefit in her capacity as owner/controller of H Pty Ltd and lodged tax returns in the relevant years claiming the contributions as deductions.

The Commissioner amended the taxpayer's returns disallowing the deductions on the grounds that superannuation contributions are allowable deductions to the extent that they are made for the benefit of an eligible employee.

The word employee is defined in section 82AAA(1) as a person who is employed by the taxpayer, and:

- is engaged in producing assessable income of the taxpayer; and
- is a resident of Australia and is engaged in the business of the taxpayer.

Although the taxpayer was considered to be an employee of H Pty Ltd in her capacity as director pursuant to section 82AAA(2), the AAT affirmed the Commissioners decision on the basis that established case law provides that an eligible employee must be a different person to the contributor. The taxpayer's argument that the case law did not apply because it related to non-complying funds was rejected by the tribunal.

The taxpayer also argued that the contribution was effectively an employer contribution and had been treated as such by H Pty Ltd. However, the AAT and Commissioner both held that the contributions were clearly a contribution by the taxpayer from her own funds and for her own benefit. The AAT therefore upheld the Commissioner's decision to exclude the contribution amounts from the assessable income of the fund.

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