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Part IVA Applies to Vineyard Project

In a recent decision, the Administrative Appeals Tribunal (AAT) has held that Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) applied to a taxpayer's investment in a vineyard. In *Iddles and Commissioner of Taxation* [2005] AATA 787 (17 August 2005), the taxpayer had objected to his assessments for the 1997, 1998 and 1999 income years after he had been denied deductions related to his investment in a viticulture project. The AAT considered the deductibility of the outgoings and the taxpayer's purpose in entering into the investment.

Background

In late June 1997, the taxpayer entered into a management and licence agreement to cultivate, tend, manage and maintain vine plots under the Austvin Vineyards 1997 viticulture project. In line with the agreement, the taxpayer appointed Austvin Vineyards Ltd (the manager) to actually manage and maintain the vine plots.

The Austvin Vineyards prospectus offered passive participation in a vineyard business by offering 0.2-hectare vine plots to investors for 15 years in return for licence and management fees. A related party of Austvin Vineyards Ltd, Australian Vintage Ltd, contracted to purchase all grapes produced for an agreed sale price, and the proceeds would pass to the investor. The prospectus also offered a limited-recourse loan to fund the licence and management fees. The day-to-day management and operation of the vineyard was carried out by the manager, and the taxpayer had no direct role at all.

Claimed Deductions

For the 1997, 1998 and 1999 income years, the taxpayer claimed deductions for outgoings including management fees, licence costs and prepaid interest. In order to fund the investment, the taxpayer utilised the limited-recourse loan that limited his outflow to only $2,204 for the year ended 30 June 1997, but resulted in a tax deduction of $17,204 for that year. This tax deduction was a major selling point, which was presented in an open letter from the Chairman of Austvin Vineyards Ltd, and contained in the prospectus.

For the two subsequent income years, the taxpayer claimed deductions totalling $12,765 and $6,058, respectively. As the vines had not yet matured, no grape sales were made in any of these three years and the taxpayer didn't derive any income from his vine plots.

In response to the taxpayer's initial objection to his assessments, the AAT held that the taxpayer, through the manager, was carrying on a business of growing and selling wine grapes from the vine plots licensed to him. Consequently, the relevant amounts pertaining to the 1997, 1998 and 1999 income years were therefore prima facie deductible.

When questioned why he had invested in the project, the taxpayer acknowledged that he had considered the tax implications of an investment in the viticulture project; however, he was more interested in the long-term commercial success and viability of the project. The taxpayer argued that he was nearing his retirement and wished to diversify his income-producing investments. He was attracted to the viticulture project as it was a growth industry and the project featured a new vineyard with state-of-the-art equipment.

Part IVA Application

Under Part IVA of ITAA 1936, the Commissioner has the ability to cancel a tax benefit obtained by a taxpayer in connection with a scheme if it can be concluded that the scheme was entered into for the sole or dominant purpose of obtaining the tax benefit. The Tax Office argued that the licence and management agreement was a scheme which resulted in a tax benefit in the form of greater deductions. In response, the taxpayer argued that the scheme was entered into as a way of diversifying his investment portfolio and income streams upon nearing retirement and if a tax benefit was present, it was relatively small ($8,000) when compared to taxpayer's total personal tax charge ($99,000).

Tribunal's Conclusion

Upon investigating the structure of the investment arrangement, the Tax Office argued that the only role the licence and management fees played in the arrangement was to generate the tax savings that actually funded the investors' actual payments. As the vines were not producing any grapes, the positive cash flows of the project were solely attributable to the tax savings generated by the scheme.

In regard to the application of Part IVA, the AAT held that while the project was designed to include tax benefits, it could not be shown that the principal purpose of the project was to enable its investors (such as the taxpayer) to obtain tax benefits. However, the AAT held that the taxpayer's dominant purpose for entering into the management and licence agreement was to obtain tax benefits.

Due to the nature and substance of the arrangement, the AAT held that the investment was more akin to a passive investment than carrying on a business and held that Part IVA applied. Consequently, the taxpayer's deductions were denied.

For further information, please review *Iddles and Commissioner of Taxation* [2005] AATA 787, at:

<www.austlii.edu.au/au/cases/cth/aat/2005/787.html>.

Settlement was Taxable ETP

In a recent decision, the Administrative Appeals Tribunal (AAT) has found that a payment of $3.1 million made to a taxpayer by his former employer was an eligible termination payment (ETP), as the payment resulted from the termination of the taxpayer's employment. In addition, the AAT held that the payment was unable to be classified as an exempt capital payment for personal injury under section 27A(1)(n) of the *Income Tax Assessment Act 1936* (ITAA 1936), even though the taxpayer's claim for the payment was based on receiving compensation for hurt, humiliation and distress.

In the case under review, *Applicant v. Commissioner of Taxation*, the taxpayer received a $3.1 million termination payment from his former employer as a result of continual hurt and abuse suffered by him during his time of employment. The taxpayer and the former employer entered into a deed of release in April 2002, which stated that the payment was in respect of all issues relating to the taxpayer's employment and the termination of that employment. This termination amount was referred to as an ETP in the deed and was consequently deemed by the Commissioner to be an assessable ETP in the taxpayer's 2002 assessment. The taxpayer appealed against the assessment and the matter was brought before the AAT.

The taxpayer argued that despite the wording of the deed, the payment was not made due to the termination, but as compensation for the hurt and humiliation caused by the former employer. As such, the taxpayer argued that the amount was a capital payment that was excluded from the ETP rules.

In relation to the argument that the payment was an exempt capital payment in respect of personal injury under section 27A(1)(n) of ITAA 1936 for the hurt and humiliation suffered by the taxpayer, the AAT found that the terms of the deed did not reflect this in any way.

In order to be an exempt capital payment, the payment must be:

> *'consideration of a capital nature for, or in respect of, personal injury to the taxpayer….*
>
> *And its likely effect on the capacity of the taxpayer to derive income from personal exertion…'*

Based upon previous interpretations, the AAT stated that the inclusion of the words ‘personal injury’ intended to include both physical injury and mental illness. However this did not extend to the taxpayer and his emotional hurt. Consequently, the payment was not exempt as a capital payment.

As a result, the AAT was satisfied that the purpose of the payment was to secure the taxpayer’s resignation and, therefore, the payment was a taxable ETP. The AAT confirmed the 2002 assessment.

For further information, please review *The Applicant v. Commissioner of Taxation* [2005] AATA 583, at:

<www.austlii.edu.au/au/cases/cth/aat/2005/583.html>.

Tax Office Audits

For further information on the Tax Office’s compliance program, please refer to:

<www.ato.gov.au/corporate/content.asp?doc=/content/61826.htm>.

Derivation of Management Fees

In a recent decision, the Administrative Appeals Tribunal (AAT) has ruled in favour of a taxpayer, and held that it should not have been assessed on the management fees charged to its parent company for services performed until the fees were actually ‘quantified, accepted and charged’.

In the case under review, *Lee and McKeand and Son Pty Ltd v. Commissioner of Taxation* [2005] AATA 650, the taxpayer was a wholly owned subsidiary of Lee McKeand Holdings Pty Ltd (LK Holdings). In 2001, acting on advice from its accountant, the taxpayer charged a management fee of $468,000 to LK Holdings in relation to services rendered by the taxpayer in 1999 and 2000. The Commissioner subsequently amended the taxpayer’s returns for both the 1999 and 2000 income years, including management fees of $234,000 in each year.

The Commissioner chose to include the management fees in the taxpayer’s 1999 and 2000 returns on the basis that the taxpayer could have sued LK Holdings for recovery of the fees as the services had been provided.

The taxpayer appealed against these amendments on the grounds that the fees had not actually been derived in 1999 and 2000. The taxpayer submitted that the management fees were derived and assessable income only in the year ended 30 June 2001 as this was the year they were quantified, accepted and charged. It was then that the fees became recoverable.

The AAT accepted this argument by the taxpayer and upheld the appeal. The AAT rejected the Commissioner’s argument that the taxpayer could have sued for the fees in 1999 or 2000, as the agreement that the fees related to was only established in 2001.

In an odd twist, the AAT held that the management fees became quantified, accepted and charged in 2002, not 2001 as argued by the taxpayer. This was due to the fact that the management fees only became recoverable once they were entered in the taxpayer’s accounts. However, this discrepancy did not prevent the taxpayer from being successful in its appeal, and the 1999 and 2000 amended assessments were set aside.

For further information, please review *Lee and McKeand and Son Pty Ltd v. Commissioner of Taxation* [2005] AATA 650, at:

<www.austlii.edu.au/au/cases/cth/aat/2005/650.html>.

Input Tax Credits

In two recent Interpretative Decisions (ID 2005/204 and ID 2005/205), the Tax Office has confirmed that a taxpayer registered for GST is required to reduce their deduction for telephone and car expenses by the amount of any input tax credit entitlements.

Where a taxpayer is registered for GST, any deductions allowed under section 8–1 of the *Income Tax Assessment Act 1997* (ITAA 1997) must be net of the associated input tax credits as required by section 27–5.

In the example contained in ID 2004/204, the taxpayer carries on a business and has a yearly telephone bill of $1,100, which includes GST of $100. As the use of the telephone is 50% business and 50% private, the taxpayer is limited to a deduction of only the 50% related to business use. Under section 27–5, a loss or outgoing may not be deducted if the loss or outgoing includes an amount relating to an input tax credit that the taxpayer is entitled to claim.

Consequently, the maximum allowable deduction under section 27–5 is $500 (50% of $1,100 less the $50 input tax credit).

In regard to car expenses, a taxpayer is allowed to claim a deduction using one of the four methods contained in section 28–12 of ITAA 1997. ID 2004/205 sets out an example where a registered GST taxpayer uses a car in part of carrying on their business and chooses to claim car expenses under the 'one-third of actual expenses' method. The taxpayer's total car expenses for the year are shown to be $3,300, including GST of $300.

Under the 'one-third' method explained in subsection 28–70(2), a taxpayer is only entitled to one-third of the car expenses that would otherwise be an allowable deduction under section 8–1. Accordingly, the allowable deduction under the 'one-third' method would be limited to $1,000.

For further information, please review ATO ID 2005/204 — Deductions: Telephone expenses and input tax credit, at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005204/00001>; and

ATO ID 2005/205 — Deductions: Car expenses and input tax credit, at:

<http://law.ato.gov.au/atolaw/print.htm?find&docid=AID/AID2005205/00001>.

GST: Going Concern Clauses

A recent Western Australian Administrative Appeals Tribunal (AAT) case, *Midford and Deputy Commissioner of Taxation*, highlights a very crucial aspect of GST legislation concerning the GST-free going concern provisions.

The GST Act provides that supplies of going concerns are GST-free provided that certain conditions are met, one of those being that the parties formally agree in writing that the supply (sale) is a GST-free going concern. The actual contract of sale does not have to contain the agreement (most usually do), as it may otherwise be on a separate document. However, the agreement must be in writing.

In the *Midford* case, the seller was selling commercial premises, which were subject to a lease. The Tax Office was satisfied that the supply of tenanted commercial premises was a going concern. The Tax Office's issue was that there was no agreement in writing that the parties to the contract (who were both registered for GST) had agreed that a supply of a going concern was being made.

The parties had used the standard Real Estate Institute of Western Australia contract which provided that the purchaser of the commercial property had agreed to continue with the current lease in place, but a going concern clause was not embodied in the contract of sale nor any other contemporaneous document.

The AAT was required to determine whether the parties had agreed in writing that a going concern was supplied under the terms of the contract.

The AAT confirmed that the exemption requires the parties to agree in writing that the supply is of a going concern. The AAT gave the word 'writing' its ordinary meaning and stated that the agreement must be expressed in or reproduced in words.

The seller of the property argued that the combination of the sale of land contract and the lease agreement created an agreement in writing as required by the GST Act. The AAT did not agree and noted that the GST legislation requires an express agreement in writing that a supply of a going concern was being made.

As a consequence, the seller had to account for 1/11th of the sale price and was not in a position to recover such costs from the buyer as the contract did not contain a GST recovery clause. In this case, the seller had to forfeit 1/11th of the proceeds to the Tax Office and the buyer was able to claim an input tax credit for 1/11th of the consideration it provided.

The case highlights the importance of GST clauses and agreements concerning GST. The following points need to be kept in mind during negotiations in the buying and selling of businesses:

- Supplies of going concerns need to be evidenced in writing.
- In the absence of GST recovery clauses and in the event that a GST supply is made, the seller (supplier) will be required to account for 1/11th of the consideration received.
- GST recovery clauses should be inserted into contracts to facilitate the recovery of GST in the event that a party is required to account for GST.

For further information, please review *Midford and Deputy Commissioner of Taxation* [2005] AATA 623, at:

<www.austlii.edu.au/au/cases/cth/aat/2005/623.html>.

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