

client alert | explanatory memorandum

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Service Trusts

The Tax Office recently announced that where small to medium enterprises use service trust arrangements, there will be little risk of an audit provided taxpayers adhere to Taxation Ruling 2006/2.

A service trust arrangement involves a taxpayer incurring a deduction for fees and charges in the conduct of business for the acquisition of staff, clerical and administrative services and plant or equipment from an associated trust entity. These arrangements are often called Phillips arrangements.

TR 2006/2 advises that a service arrangement may not provide an objective commercial explanation under the following circumstances:

- the service fees and charges are disproportionate or grossly excessive in relation to the benefits conferred by the service arrangement;
- the service fees and charges guarantee the service entity a certain profit outcome without reasonable commercial explanation; or
- the service fees and charges generate profits in the service entity without any clear evidence that the service entity has added any value or performed any substantive functions.

The ruling indicates that it is not for the Commissioner to decide how much the taxpayer should spend in obtaining their income, but rather to determine how much the taxpayer has spent, as a question of fact.

If the Commissioner believes on independent inquiry that the amount expended was in part for the pursuit of an independent advantage (i.e. other than wholly in pursuit of the taxpayer's income earning activities or business) then based on a fair and reasonable apportionment, that part of the expenditure will not be deductible.

In some cases, where a fair and reasonable assessment is undertaken of the service arrangement, Part IVA of the *Income Tax Assessment Act 1936* may also apply to deem the taxpayer was trying to obtain a tax benefit in connection with the arrangement.

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

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

or alternatively download the Tax Office guide Your service entity arrangements at:

<<http://www.ato.gov.au/content/downloads/N13086-04-2006.pdf>>

Payment to Senior Public Servant not a Bona Fide Redundancy

In a recent decision, the Administrative Appeals Tribunal (AAT) concluded that a payment of \$353,000 made to a senior public servant as a result of the termination of his employment was not a bona fide redundancy.

The taxpayer's position was terminated as a result of internal restructuring of the NSW Rail Access Corporation. As the restructure was due to take some months to complete, his position was immediately filled, albeit temporarily, until the restructure was finalised. The taxpayer argued that his termination payment was a bona fide redundancy as his role was only filled temporarily and his position had already become redundant.

Bona fide redundancy is defined in section 27F of the *Income Tax Assessment Act 1936* (ITAA 1936) and the Commissioner supports this definition in Taxation Ruling 94/12. An employee's position is considered to be redundant **not** when the employee becomes redundant, but when the job itself becomes redundant.

In accordance with TR 94/12 and section 27F of the ITAA 1936, an employee would be in receipt of a bona fide redundancy payment under the following circumstances:

- where the employer has made a definite decision that the job the employee has been performing is not to be performed by anyone;
- the decision is not due to the ordinary and customary turnover of labour;
- the decision leads to the termination of the employee's employment; and
- the termination of employment is not on account of personal act or default of the employee.

Given the facts of the case, the AAT concluded that the determinative factor was that the taxpayer's position was filled almost immediately, even though it was only a temporary assignment.

The AAT further indicated that despite the replacement employee only being appointed in an acting capacity, this did not detract from the view that the acting employee did in fact replace the taxpayer. In TR 94/12 and in section 27F of ITAA 1936, it clearly provides that one of the conditions of a bona fide redundancy is that the position must be made redundant.

The AAT held that the payment of \$353,500 in respect of the taxpayer's termination was considered an ordinary eligible termination payment and was not in the form of a bona fide redundancy payment, and therefore was not eligible for concessional treatment.

In addition, a lump sum annual leave payment of \$56,606 was considered to be assessable income and also not entitled to concessional treatment.

Case reference: *John Cowling v. Commissioner of Taxation* [2006] AATA 646 (21 July 2006)

Distribution of Shares Assessable as Dividend

The Federal Court has held that shares distributed to a taxpayer were assessable as a dividend.

As a result of a corporate reorganisation by Hewlett Packard (HP), a newly incorporated subsidiary company (Agilent) was formed to separate two businesses within HP. Subsequent to the formation of Agilent and a resulting IPO of 15.9% of its shares, HP resolved to distribute its 84.1% shareholding in Agilent to shareholders of HP by way of a stock dividend. The dividend resulted in a reduction of HP's retained profits of \$4.2 billion which was disclosed in its consolidated accounts.

HP had advised shareholders that the receipt of the Agilent shares was regarded by the Tax Office as an assessable dividend as the distribution was against HP's retained profits. The taxpayer applied for a private ruling in respect of the taxation treatment of the Agilent shares, in which the Tax Office confirmed that the shares received in Agilent were assessable as a dividend. Consequently, the Tax Office issued an amended assessment to the taxpayer, including in his assessable income an amount of \$168,961. The taxpayer objected to the amended assessment and proceeded with his case to the Administrative Appeals Tribunal (AAT).

Under section 6 of ITAA 1936, a dividend includes any distribution made by a company to any of its shareholders, whether in money or other property. The shares distributed by HP were considered to be property, and therefore, under the definition in section 6 it follows that a dividend was paid by HP to its shareholders.

Once it's been established that a dividend has been paid, section 44(1) of ITAA 1936 broadly provides that the assessable income of a shareholder in a company includes dividends that are paid to the shareholder by the company **out of profits** derived by it from any source.

The taxpayer contended that the dividend was not paid out of profits derived by the company and the distribution was from capital from the corporate restructure. In return, the Tax Office submitted that the profit was paid out of retained earnings and therefore out of profits, referring to the reduction in retained earnings disclosed in HP's consolidated accounts.

In the first instance, the AAT concluded that the shares received were not assessable as a dividend as a significant component of the distribution of Agilent shares was in the nature of a capital receipt rather than wholly out of profits. The AAT based this view on the difference between the value of the shares issued (\$US29 billion) and the retained earnings at the time the shares were issued (\$US4.2billion).

The Federal Court overturned the AAT's decision and ruled that there was no doubt that profits by way of retained earnings were utilised to fund the distribution. Further, there was no evidence to suggest that the distribution was funded from any other source.

Case reference: *FCT v. Condell* [2006] FCA 1047 (15 August 2006)

Deduction to Employee Benefit Trust Disallowed

In a recent decision, the Federal Court held that a payment of \$500,000 to an employee benefit trust was not deductible. However, the Court overturned the FBT assessment, which was raised in the following year.

The Directors of Cameron Brae made a resolution to contribute \$500,000 to a trust fund to which there were two beneficiaries. Following this contribution, the amount, less a trustee's fee, was credited to a bank account in the name of Cameron Brae Pty Ltd. This account was used as a trading account for shares and money market securities.

In its tax return for the 1998 income year, Cameron Brae sought to take a deduction for the contribution made to the trust fund on the basis that it was a superannuation fund. This deduction was denied by the Commissioner to the full extent of the contribution and an additional levy was charged for an understatement of assessable income.

Furthermore, in the following income year, the Commissioner assessed the amount of the contribution as a taxable fringe benefit increasing Cameron Brae's aggregate fringe benefits for the tax year.

The issues raised in the case were as follows:

- Whether section 82AAE of ITAA 1936 authorises a deduction from Cameron Brae's income for the amount contributed to the employee benefit trust.
- Alternatively, whether this amount was an allowable deduction under section 8-1 of ITAA 1997.
- Whether the additional penalty tax was validly imposed by the Commissioner.
- Whether the contribution amount represented a fringe benefit to Cameron Brae, and if the additional penalty amount imposed by the Commissioner was validly imposed.

Superannuation Contribution

The Court held that the amount was not deductible under section 82AAE as the fund in question failed to satisfy the conditions governing the section. In consideration of the facts, the Court found that the trust fund was not in fact a superannuation fund as its governing deed did not provide that its employees would benefit from the funds set aside. Rather, the terms of the deed provided that the trustee had absolute discretion as to the amount, time and value of any benefit to be paid.

For the contribution to represent a deductible amount under the section, it must be for the sole purpose of making provision for superannuation benefits for its eligible employees. The governing deed indicated that the beneficiaries were discretionary class members, and therefore did not have a vested entitlement to any payment from the fund. Rather any payment from the fund was completely at the discretion of the trustee.

Section 8-1

The Court also found that the alternative motive for making a contribution to the employee benefit trust — to attract and retain suitable employees — did not warrant a deduction under section 8-1 of the *Income Tax Assessment Act 1997* either, as there was no requisite connection with the business ends of the taxpayer. Rather it was apparent that the advantage being sought was to benefit the directors of Cameron Brae.

Fringe Benefits Tax

As defined in section 136(1) of the Fringe Benefits Tax Assessment Act (FBTAA), a fringe benefit is one which is provided to an employee or an associate of the employee by the employer in respect of their employment.

The Commissioner argued that the amount contributed to the employee benefit trust on behalf of the two beneficiaries was a fringe benefit as it provided a property benefit or residual benefit to the employees.

In consideration of the analysis undertaken in determining the deductibility of the contribution amount, it was found that the contribution amount was not made for the benefit of the two beneficiaries of the fund, nor was it made by Cameron Brae in its capacity as employer of the two beneficiaries.

The Court held that no fringe benefit was conferred on the two beneficiaries, because the contribution provided no entitlement in the nature of a superannuation benefit to the two beneficiaries; rather there was only an expectation of favourable exercise of discretion by the trustee.

Penalty Tax

The penalty amount remained as the taxpayer failed to provide enough reasoning that would allow the deduction under the law, nor was the position reasonably arguable.

Appeal

Both the taxpayer and the Commissioner have appealed to the Full Federal Court against aspects of this decision.

Case reference: *Cameron Brae Pty Ltd v. FCT* [2006] FCA 918 (21 July 2006)

Claiming Input Tax Credit on Corporate Credit Card Statements

In GST Ruling GSTR 2000/26, the Tax Office sets out the circumstances in which a GST registered entity, that holds a corporate credit card statement issued by an organisation that is covered in the determination appended to this ruling, can claim an input tax credit for a creditable acquisition, without holding a tax invoice for that acquisition.

The ruling also explains:

- the information that a corporate credit card statement must contain for the determination to apply;
- the requirements that must be met in order for the determination to apply; and
- the requirements that the corporate credit card provider must meet when issuing a corporate credit card statement for the determination to apply.

By way of background, section 11–20 of the GST Act provides that an entity is entitled to an input tax credit for any creditable acquisition that it makes. According to section 11–5, an entity makes a creditable acquisition if:

- it acquires anything solely or partly for a creditable purpose; and
- the supply of the thing to the entity is a taxable supply; and
- it provides or is liable to provide, consideration for the supply; and
- the entity is registered or required to be registered for GST.

Under section 11–15, an entity acquires a thing for a creditable purpose to the extent that it is acquired in carrying on its enterprise. However, a thing is not acquired for a creditable purpose to the extent that it relates to making input taxed supplies or is of a private or domestic nature.

Section 11–25 provides that the input tax credit that the entity is entitled to is the amount of GST payable by the supplier, subject to any apportionment for non-creditable use. However, before an input tax credit can be claimed, section 29–10(3) provides that a tax invoice must be held (unless the GST exclusive value of the supply is \$50 or less, as provided for in section 29–80(1)).

Corporate Cards to Which the Ruling Applies

This ruling only applies to corporate cards issued by the following entities:

- financial institutions that issue VISA International corporate cards;
- American Express International;
- Diners Club International;
- financial institutions that issue MasterCard International corporate cards;
- Australian Card Services Pty Ltd;
- Motorcharge Ltd; and
- Fleet Systems Pty Limited.

This ruling also applies to other corporate cards, as specified in waiver of tax invoice determinations, as issued from time to time, including:

- GE Capital Fleet Services Australia Pty Ltd;
- Flag Choice Hotels Limited;
- Retail Decisions Pty Ltd; and
- Cabcharge Australia Limited.

Requirements that Must Be Satisfied by the Corporate Card Statement

A GST registered entity that is a member of a corporate card provider will not be required to hold a tax invoice for a creditable acquisition purchased with the corporate card in order to claim an input tax credit on the acquisition if the following criteria are satisfied:

- The member has been provided with a corporate card statement (in paper or electronic format) produced by the corporate card provider which includes:
 - the member's name;
 - the name(s) of the person(s) who use(s) the corporate card or, in the case of fuel cards, the vehicle identifier; and
 - the member's Australian Business Number (ABN) or address.
- For each acquisition that the member may claim an input tax credit the statement has:
 - the date the member purchased the acquisition;
 - supplier's name;
 - supplier's ABN;
 - supplier's Branch Registration Number (only if applicable);
 - a brief description of the acquisition or a description of the supplier's industry;
 - the amount of GST paid; and
 - the total amount paid; and
 - other requirements

In order for a member of a corporate credit card provider to be entitled to an input tax credit without a tax invoice, it must have a strictly enforced policy in relation to making adjustments for expenditure on the corporate card that is of a private or domestic nature, i.e. for acquisitions that were not made in connection with carrying on its enterprise.

Further, the entity must obtain supplementary documentation to support each acquisition on the corporate card statement that has a private or domestic component. This documentary evidence must clearly identify the creditable and non-creditable components of the acquisition.

For further information, please view GST ruling GSTR 2000/26 – Goods and Services Tax – corporate card statements – entitlement to an input tax credit without a tax invoice at: <<http://law.at0.gov.au/pdf/gst00-26.pdf>>.

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