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Number 3 Bill introduced

In May the Government introduced the *Tax Laws Amendment (2007 Measures No 3) Bill 2007*. Like all Bills of this nature, the No 3 Bill contained an eclectic mix of proposed changes to the tax law. Of interest to private and entrepreneurial clients are changes to the deemed dividend rules in relation to private company loans, capital gains of testamentary trusts, investments in forestry managed investment schemes, and the new superannuation simplification rules.

The deemed dividend rules in relation to private company loans are contained in Divisions 7 and 7A of Part III of the 1936 Tax Act. As many readers are aware, these rules deem that many loans made to shareholders or their associates are dividends. The rules are actually broader than just loans, and apply to other payments or to a forgiveness of a debt. There are exemptions—for instance, for loans paying commercial interest rates and which satisfy a minimum repayment rule—but they are very strict. This Bill makes several amendments to these rules. The most significant is the removal of the automatic debiting of the private company's franking account. Currently, not only is the loan deemed to be an unfranked dividend, but the company's franking account is debited by the amount of the loan. This "double penalty" will be removed.

The second most significant change is allowing the Commissioner to disregard or alter the application of these rules. Currently, the rules are automatic and there is no such discretion. This Bill gives the Commissioner the discretion to disregard the operation of the rule

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where there has been an honest mistake, inadvertent omission, or where the borrower is not in a position to make the minimum yearly payment. The discretion allows the Commissioner to either disregard the application of the law or to allow the company to frank the deemed dividend.

Other changes in relation to private company loans include:

- allowing the company to convert a "payment" into a loan, enabling it to fall within the commercial loans exemption (if the terms satisfy that exemption);
- where there is an underpayment of the minimum repayment, make the deemed dividend be the amount of the underpayment (currently, any underpayment causes the entire amount to be a dividend);
- allowing some refinancing of loans;
- allowing the franking of a deemed dividend resulting from a marriage breakdown;

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- extending the exemption for commercial loans to loans made to interposed entities;
- repealing section 108 (which contains older rules that still technically apply);
- ensuring that fringe benefits tax does not apply to these loans (technically it currently might still apply, even if an exemption is obtained); and
- various other amendments relating to loan guarantees, calculation of distributable surplus, technical corrections, limiting the time for making assessments.

The Bill also provides for deductions for investments in forestry managed investment schemes. These provisions were previously announced, both last year and in the Budget. Broadly, a participant in a foreign managed investment scheme can claim 100% deduction for its contribution in the scheme, provided that a number of conditions are met. One of these conditions is that 70% of the expenditure made by the managed investment scheme must be in "direct forestry expenditure". As announced in the Budget, the Bill also provides for interests in such schemes to be traded.

Regarding testamentary trusts, the Bill allows a trustee of a testamentary trust to choose to be assessed on a capital gain on the trust, rather than allowing the beneficiary to be so assessed. The change to the simplified superannuation rules ensures that contributions made on behalf of someone else (for instance, a friend) are included in the \$1 million undeducted contributions cap (which expires on 30 June 2006), closing a potential loophole to these rules.

Comment: Many of the proposed changes were previously announced and, therefore, should not come as a huge surprise to readers.

The most significant changes were those announced to the deemed dividend rules. Such rules are draconian and, prior to the introduction of this Bill, could result in costly tax liabilities where even minimal mistakes are made. The changes contained in the Bill are welcome news for private companies and their owners.

CGT applies to share split by brothers

A recent case before the Administrative Appeals Tribunal demonstrates the potential tax liabilities that can arise when attempting to deal with joint interests in property. In the case, *Johnson and Commissioner of Taxation* [2007] AATA 1322, a father had gifted 4,000 shares in a public company to his two sons. The share register indicated that the sons held the shares jointly. In 2006, the brothers decided to take half each and go their separate ways, and therefore executed documents so that each would retain 2,000 shares.

A half interest in property is different from an interest in half of the property...

A private ruling was sought and the Commissioner ruled that the split was a disposal for capital gains tax purposes—each brother had disposed of his half interest in 2,000 of the shares to which the other brother took, in exchange for the remaining half interest in the 2,000 shares that the brother was left with. The brothers appealed to the Tribunal, who found for the Commissioner.

Comment: A half interest in property is different from an interest in half of the property. For instance, joint owners of a one-acre block of land cannot subdivide the land and take half-an-acre each without tax or stamp duty consequences. While it would be logical for the brothers to think that, as they had a half-interest in 4,000 shares this meant that they each owned 2,000 shares, this was not the case. It did not matter that the shares were listed and therefore quite fungible. Readers should obtain professional tax advice if they are considering dividing joint interests in property.



Tribunal strikes down franchise fees

A recent case before the Administrative Appeals Tribunal that demonstrates some common business expenses might not actually be deductible. In the case, *"The Taxpayer" and Commissioner of Taxation* [2007] AATA 1228, the taxpayer was a franchisee of a firewood business and paid significant franchise fees. There were some technical difficulties to this case. For instance, there was not actually a franchise agreement, just a memorandum of agreement that the franchisor would grant a franchise once its business was established. Additionally, there was no actual evidence that the franchise ever operated. The Tribunal was of the view that the franchise arrangement operated like a cooperative.

In finding for the Commissioner, the Tribunal held that the fees were not linked in any way to the taxpayer's income earning activities. At best, they were capital in nature. In the alternative, the general anti-avoidance rules contained in Part IVA of the 1936 Tax Act could apply.

Comment: This is a very sad case for the taxpayer who had serious out-of-pocket expenses but was unable to claim deductions for them. The case highlights the importance of ensuring that every arrangement is commercial in nature and that there are sound business reasons for incurring any expenses. Readers who are asked to enter into strange or out-of-the-ordinary kinds of arrangements should treat such arrangements with caution. It is likely that expenditure incurred on such arrangements will be disallowed.

No evidence of main residence

A recent decision, *Erdelyi and Commissioner of Taxation* [2007] AATA 1388, indicates the need to ensure that a house is actually a main residence, before claiming the main residence exemption. In this case, the taxpayers purchased a block of land with their daughter, on which they constructed a house. They sold the house soon after it was constructed and claimed that it was their primary residence. Both the Tax Office and the Administrative Appeals Tribunal disagreed.

While the couple claimed that they had lived in the house, they had only moved bare essentials into the dwelling and did not notify any authorities of their change of address. Additionally, their level of household consumption was exceptionally lower than that of ordinary households. Therefore, capital gains tax and penalty tax were both applied.

Comment: Readers should always remember that it is the taxpayer's onus in proving that any tax assessment is excessive or incorrect. While the evidence against the house being the couple's main residence was circumstantial at best, it was not up to the Tax Office to prove the house was not the main residence. Rather, the taxpayers had to prove that the house was their main residence and the evidence did not support such a claim.



National tax seminars

BDO Kendalls conducts a series of bi-monthly seminars around the country, focusing on issues topical within the tax world. July's seminar is titled "Taxation of financial arrangements – How the rules affect you". The seminars will be held in the third and fourth weeks of July. If you would like to attend or would like more information about upcoming seminars in the series, please contact your local BDO Kendalls office.



Another tea tree oil case

Previous editions of this Business Tax News have outlined cases where the general anti-avoidance rules contained in Part IVA have applied to strike down tax minimisation schemes. A large number of these schemes involved investing in tea tree oil projects. Recently, there was another case of this sort, *Basten and Commissioner of Taxation* [2007] AATA 1128. With the year-end coming around, readers may find themselves inundated with offers to enter into tax minimisation schemes. In light of all the recent cases, readers should be very wary of tax minimisation schemes, particularly those that involve tea tree oil.

Small business Bill update

The March edition of this Business Tax News discussed the *Exposure Draft Tax Laws Amendment (Small Business) Bill 2007*. This Exposure Draft contained the draft law that would introduce a standardised definition of the term “small business”, which would apply for simplified tax accounting systems for income tax and for GST, for capital gains tax (CGT) and fringe benefits tax concessions, for the different instalment systems for GST and for instalments of income tax, and for certain entrepreneurs’ tax offsets. The new rules have now been introduced into Parliament as the *Tax Laws Amendment (Small Business) Bill 2007*. The Bill has been passed by the House of Representatives already and has moved to the Senate.

As readers will recall, the one criterion that needs to be satisfied is that the turnover of the business is less than \$2 million. The new Bill does not revoke the older criteria, and a taxpayer that does not satisfy this test but satisfies another test, can still use that other test.

Comment: Similarly with the Exposure Draft, the Bill contains few surprises. It is simply written with few difficulties. One matter that was a surprise concerns the CGT small business concessions. One of the older tests that needed to be satisfied to have access to the CGT gains tax concessions was that the net asset value of the taxpayer could not exceed \$5 million. There had been talk in 2005 of increasing this to \$6 million, but this was first delayed for one year and then apparently dropped when these simplified rules were announced. However, in addition to creating the standardised test, the Bill also lifts the net asset value threshold to \$6 million. This assists taxpayers who cannot satisfy the \$2 million turnover threshold—they still have the (now increased) older threshold that they can fall back upon.



A recent case in front of the Administrative Appeals Tribunal has once again highlighted the large penalties that can arise from underpaying GST or overclaiming input tax credits. In the case, *JG and JA Williamson Holdings Pty Ltd as trustee for John William Family Trust and Commissioner of Taxation* [2007] AATA 1344, the taxpayer had purchased farming property and claimed input tax credits on the purchase. However, the property had been purchased under the margin scheme and, therefore, no input tax

credits were available. Additionally, the tax invoice showed GST that was lower than the input tax credits claimed—the taxpayer had calculated the credit based as one-eleventh of the purchase price without looking at the tax invoice. As the margin scheme had been used, the GST was much lower than this figure.

The taxpayer's business activity statements were selected by the Tax Office for review. It was around this time that the taxpayer's tax agent advised it of the mistake made. A voluntary disclosure was made and penalties of 20% (25% reduced for the voluntary disclosure) were levied. The tax agent asked that the penalties should be remitted in full, as the taxpayer had no relevant GST, tax or accounting knowledge. The Tribunal disagreed as, given the nature of the transaction, the taxpayer should at the very least have made some enquiries.

Comment: This may seem a harsh judgment for a taxpayer with little expertise in the area. However, given the potential loss of revenue and the large figures involved, the authorities enforce the GST rules very strongly. For instance, in cases of deliberate underpayment, jail sentences are not uncommon, even though the taxpayer would be thinking that it were just making a few imaginative entries. Even in a case such as the present one, where the taxpayer made a mistake, penalties will be levied and it is very difficult to have such penalties remitted

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