



PROPOSED THIN CAPITALISATION AMENDMENTS FOR AUTHORISED DEPOSIT-TAKING INSTITUTIONS (ADIs)



THE GOVERNMENT HAS RELEASED AN EXPOSURE DRAFT OF PROPOSED AMENDMENTS TO THE THIN CAPITALISATION PROVISIONS FOR ADIs.

Background

Australia's thin capitalisation provisions require ADIs operating in Australia which are either foreign owned or which have foreign operations to maintain a minimum level of equity. Failure to maintain this minimum level of equity results in the ADI being denied income tax deductions for a proportion of its interest expenses unless some other exemption from the thin capitalisation provisions is available.

The minimum level of equity to be maintained is calculated by reference to the balance sheet for the ADI's Australian operations.

The change from Australian Generally Accepted Accounting Principles (AGAAP) to Australian Equivalent International Financial Reporting Standards (AIFRS) resulted in the balance sheets of Australian ADIs (and thus their equity calculations) changing, even if the ADIs' operations did not change. For this reason, transitional legislation was enacted allowing affected ADIs to continue to calculate their thin capitalisation position by reference to a notional AGAAP balance sheet, based on the AGAAP accounting and prudential standards in force immediately before 1 January 2005, even after the introduction of AIFRS.

As this transitional legislation expires for income years commencing after 1 January 2009, Treasury has released an exposure draft of proposed legislation which will adjust the thin capitalisation calculations of ADIs using AIFRS accounts.

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Adjustments to the thin capitalisation calculations

Treasury shares

Treasury shares are those shares held by an ADI (or one of its subsidiaries) in itself for the purposes either of:

- holding as an investment for policy holders in relation to a life insurance business; or
- holding as an offset against the accrued expense of a share-based compensation scheme.

The legislation proposes that the value of such shares is not to be deducted in calculating the actual equity capital maintained by the ADI for thin capitalisation purposes.

Excess Market Value Over Net Assets (EMVONA)

EMVONA was a separate asset recognised under AGAAP by entities undertaking life insurance business. It was effectively goodwill on the consolidation of an acquired life insurance subsidiary.

EMVONA is treated as a prudential capital deduction and would normally increase the minimum ("safe harbour") equity amount that an ADI is required to maintain to avoid having interest deductions denied under the thin capitalisation provisions. The legislation reverses this treatment and does not increase the minimum capital amount by the EMVONA value.

Capitalised software

Capitalised software expenditure is also usually treated as a prudential deduction and would normally increase the safe harbour equity amount that an ADI is required to maintain for thin capitalisation purposes. Similarly to EMVONA, the legislation reverses this treatment and does not increase the minimum capital amount by the capitalised software value.

Impact

ADIs which are affected by the thin capitalisation provisions should review their calculations using the proposed rules to determine whether the rules will have an impact on their thin capitalisation position.

BDO COMMENT

As the transitional legislation is about to expire, it would be wise for all ADIs affected by the thin capitalisation rules to notionally recalculate their thin capitalisation position based upon AIFRS accounting standards and current prudential standards, having regard to the legislation proposed.

Importantly, the explanatory material released with the draft legislation notes that the proposed legislation does not intend to replicate the effect of the transitional legislation and that changes to ADIs' thin capitalisation positions are to be expected once the transitional legislation can no longer be applied. As such, immediate thought should be given to the likely impact of the "new" thin capitalisation provisions.

POST IMPLEMENTATION REVIEW INTO ASPECTS OF THE CONSOLIDATION REGIME

ON 9 DECEMBER 2009, THE BOARD OF TAXATION RELEASED A DISCUSSION PAPER ON THE POST IMPLEMENTATION REVIEW INTO CERTAIN ASPECTS OF THE CONSOLIDATION REGIME.



The release of the discussion paper follows from the Assistant Treasurer's announcement on 3 June 2009 that the Board would undertake a post-implementation review of the following aspects of the consolidation regime:

- the operation of the single entity rule;
- the operation of the entry history rule in acquisition cases; and
- the interaction between the consolidation provisions and other parts of the income tax law.

The discussion paper also notes that there has been a relatively poor take-up of the consolidation regime by eligible small business groups, and accordingly, the Board of Taxation will consider the effectiveness of the consolidation regime for these small business groups.

The discussion paper raises a number of questions on which the Board of Taxation seeks comment from stakeholders. The more noteworthy areas on which they seek stakeholder comment include:

- whether the single entity rule and the inherited history rules have improved the business efficiency and integrity of the Australian tax system, and whether the introduction of the consolidation regime has reduced the ongoing tax compliance costs for those groups that have elected into the consolidation regime;
- how the operation of the single entity rule could be improved to ensure it achieves its intended outcomes;
- whether the single entity rule operates appropriately in respect of intra-group assets, and whether the single entity rule should be extended to third parties who have dealings with a consolidated group;
- whether any integrity risks arise from a consolidated group being able to reset the cost base of its assets to market value where there has not been a change in ultimate beneficial ownership of the assets before and after the transaction;
- whether the inherited history rules should be modified to address any difficulties that currently arise, or alternatively whether the consolidation regime should instead adopt a deemed acquisition model, using a "clean slate" rule; and
- what aspects of the consolidation regime cause difficulties for small businesses and whether the consolidation regime should be simplified for small businesses.

BDO COMMENT

It is interesting to note that the consultation paper observes that the take up of the consolidation regime by eligible small business groups has been low, and seeks feedback from stakeholders as to why this is the case. Presumably, the Treasury is unaware that the complexity associated with the consolidation regime, especially in relation to the rules surrounding the tax cost setting and treatment of losses on formation of a consolidated group, presents a significant barrier to entry for small business groups. It is unlikely that the post-implementation review will provide a catalyst for any meaningful change in this area. BDO comment

NEW R&D TAX INCENTIVE – EXPOSURE DRAFT RELEASED

ON 18 DECEMBER 2009, TREASURY RELEASED EXPOSURE DRAFT LEGISLATION OUTLINING THE PROPOSED NEW RESEARCH AND DEVELOPMENT (R&D) TAX INCENTIVE. THE NEW R&D TAX INCENTIVE IS PROPOSED TO REPLACE THE EXISTING R&D TAX CONCESSION FOR INCOME YEARS COMMENCING ON OR AFTER 1 JULY 2010.



The operative rules for the proposed R&D tax incentive will primarily be contained in a new Division 355 of the Income Tax Assessment Act 1997 (ITAA 1997). The existing provisions in the *Income Tax Assessment Act 1936* (ITAA 1936) that govern the current R&D tax concession will be repealed.

How will the new law work?

The new R&D tax incentive proposes to provide eligible entities with a tax offset for expenditure on eligible R&D activities and for depreciation of certain assets used for eligible R&D activities.

Under the proposed new law, only the following entities (which will be known as R&D entities) will be eligible to claim the R&D tax incentive:

- corporations that are Australian residents for tax purposes;
- foreign corporations that carry on R&D activities through a permanent establishment in Australia; and
- public trading trusts with a corporate trustee.

The R&D tax incentive is proposed to be structured as:

- a 45% refundable tax offset for R&D entities with an aggregated turnover of less than \$20 million (unless they are a tax exempt entity or majority owned or controlled by tax exempt entities); and
- a 40% non-refundable tax offset for all other R&D entities.

R&D entities accessing the non-refundable tax offset will be able to carry forward any unused tax offsets under the tax offset carry forward rules.

R&D activities

Under the proposed legislation, R&D activities will be defined as either "core" or "supporting" R&D activities.

Core R&D activities will be defined as experimental activities that are systematic and investigative and:

- involve considerable novelty and high levels of technical risk; and
- are conducted for the purpose of acquiring new knowledge or information, including knowledge or information concerning the creation of new or improved materials, products, devices, processes or services.

Supporting R&D activities will be defined as activities undertaken for the dominant purpose of supporting core R&D activities.

Certain activities will be excluded from being either core or supporting R&D activities.

Generally, only R&D activities conducted in Australia will qualify for the R&D tax incentive. However, it is proposed that the Innovation Australia Board may give approval for an R&D activity to be conducted overseas where:

- there are physical limitations on an R&D activity being conducted in Australia;

- the activity to be conducted overseas makes a significant scientific contribution to related R&D activities conducted in Australia; and
- the related R&D activities to be conducted in Australia will be significant relative to the activity to be conducted overseas.

R&D expenditure

As noted above, the proposed R&D tax incentive will provide R&D entities with a tax offset for expenditure on eligible R&D activities and for depreciation of certain assets used for eligible R&D activities.

Neither tax offset will be subject to an expenditure cap. However, the minimum expenditure threshold of \$20,000 will continue to apply under the new R&D tax incentive, except in relation to expenditure on R&D activities performed for an R&D entity by an entity registered as a research service provider.

Interestingly, R&D entities will be able to claim the R&D tax incentive for their expenditure on eligible R&D activities regardless of where the resulting intellectual property is held.

The Exposure Draft also proposes the following integrity measures:

- R&D entities will be able to obtain the tax incentive for expenditure incurred to an associated entity only when they actually pay the amounts incurred; and
- modified feedstock rules will be introduced to ensure that the value of any direct outputs of R&D activities is offset against the cost of producing those outputs before the tax incentive is claimed.

Administration

The proposed new R&D tax incentive will operate largely on a self assessment basis, with Innovation Australia continuing to have a significant role in:

- registering and assessing whether an activity is eligible R&D;
- providing advance findings to increase certainty to companies; and
- registering research service providers.

The ATO will continue to determine whether an amount of expenditure is validly incurred on that R&D activity.

BDO COMMENT

An earlier consultation paper circulated by Treasury indicated that the Government wished to limit claims for the R&D tax incentive to projects that were "additional" to those that would have been undertaken in the absence of the R&D tax incentive, and which produced "spillover" benefits for the broader Australian economy. In BDO's submission on the consultation paper, we raised concerns about the use of the concepts of "additionality" and "spillovers" as the guiding principles for designing the eligibility rules. However, the draft explanatory memorandum continues to use these concepts.

The proposed new rules are very narrow and will substantially limit future R&D claims for many companies. A number of companies undertaking R&D in Australia have suggested that there will be no benefit in undertaking R&D activities in Australia, and a greater benefit in moving the activities offshore.

R&D plans will not be required under the proposed legislation, however more stringent substantiation requirements will increase the already complex tax compliance process. Overall, the proposed legislation is more complex and will reduce the ability of companies to claim any R&D incentives.

ATO RELEASES "PRIVATE EQUITY" DRAFT TAX DETERMINATIONS

ON 16 DECEMBER 2009, THE AUSTRALIAN TAXATION OFFICE (ATO) RELEASED TWO DRAFT TAXATION DETERMINATIONS, INTENDED TO TARGET TRANSACTIONS UNDERTAKEN BY "PRIVATE EQUITY" GROUPS WHICH INVOLVE THE ACQUISITION OF SHARES IN AN AUSTRALIAN COMPANY, AND THE SUBSEQUENT DISPOSAL OF THOSE SHARES (TYPICALLY UNDER A NEW STOCK EXCHANGE FLOAT OR IPO) AT A SIGNIFICANT PROFIT.



TD 2009/D18 outlines the ATO's view on whether a private equity entity can make an income gain from the disposal of the target assets it has acquired. TD 2009/D17 addresses the ATO's view on whether the general anti-avoidance rule in Part IVA of the *Income Tax Assessment Act 1936* (ITAA 1936) may apply to arrangements designed to alter the intended effect of Australia's International Tax Agreements network.

Background – the Myer/TPG transaction

Although neither Draft Taxation Determinations make mention of the Myer/TPG transaction, both TD 2009/D17 and TD 2009/D18 arose as a result of the widely publicised transaction in which the private equity group, Texas Pacific Group (TPG), bought the Myer Group in 2006 and subsequently sold its stake (realising a substantial profit) in the public float of Myer in October 2009.

It was reported in the media that the shares sold in Myer were held by a Netherlands resident private company, which in turn was owned by a Luxembourg resident company, which was ultimately owned by a Cayman Islands resident company. The Cayman Islands company was used as the vehicle to pool funds from investors resident in various jurisdictions (predominantly the United States) to fund the acquisition of the Myer Group.

The media reports suggested that TPG is of the view that the disposal of the Myer shares by the Dutch intermediate holding company is not subject to Australian tax, on the basis that the disposal is a capital gain derived by a non-resident from the disposal of shares in a company that are not taxable Australian property for the purposes of Division 855 of the *ITAA 1997*. Alternatively, if the profit is on revenue account (as the ATO argues), TPG believes that the Australia-Netherlands tax treaty protects the profit from Australian income tax on the basis that the profit is derived by the Dutch resident company from a transaction that is not attributable to a permanent establishment situated in Australia.

However, the ATO is of the view that the profit from the disposal of the Myer shares is on revenue account, and that the decision by TPG to structure the acquisition and disposal of the Myer Group via interposed Luxembourg and Netherlands resident companies is an example of "treaty shopping" designed to serve no other commercial purpose than to secure a tax benefit.

TD 2009/D18 – private equity disposal may be on revenue account

In TD 2009/D18, the ATO states that the profit from the disposal of Australian assets by a private equity entity may be included in the assessable income of the private equity entity, where the profit is income according to ordinary concepts (ordinary income). If the profit is not ordinary income, a capital gain or capital loss from the disposal of most CGT assets is disregarded for Australian income tax purposes if it is made by a non-resident of Australia.

Whether a profit will be ordinary income will depend on all the circumstances of the particular case. The Explanations part of TD 2009/D18 gives little by way of new guidance on the income/capital question in relation to transactions undertaken by private equity entities, other than by reciting key paragraphs from *Californian Copper Syndicate v Harris* (1904) 5 TC 159 and *FCT v Myer Emporium* (1987) 163 CLR 199. The ATO also reiterates its views contained in Taxation Ruling TR 92/3. However, TD 2009/D18 gives the following example of a profit derived by a private equity entity on a transaction that would be taken to be on revenue account, which clearly indicates the ATO's view on the Myer/TPG transaction:

Example

Offshore Co, acquires an Australian public company with the intention of restructuring its activities and re-floating the company on an Australian Stock Exchange. Offshore Co does not have the intention of becoming a long term investor to derive dividend income from its shares. If it is carrying on a business of restructuring and floating companies, due to the regularity and repetition and size and scale of its activities, the profit from the disposal of shares in the Australian public company will constitute ordinary income. Even if Offshore Co's profit from this arrangement is regarded as a profit from an isolated transaction (for example because Offshore Co is a special purpose vehicle that carries out only this one operation) that transaction was still entered into in the course of carrying on a business or in carrying out a business operation or commercial transaction. Consequently, the profit constitutes income according to ordinary concepts for the purposes of section 6-5 (See Taxation Ruling TR 92/3 Income tax: whether profits on isolated transactions are income).

Treaty shopping and Part IVA

TD 2009/D18 also notes that where a private equity entity that has acquired Australian target assets is a resident of a country with whom Australia has a tax treaty, the business profits article will generally determine that the country of residence of the entity disposing of the assets will be entitled to tax those profits. In the absence of an Australian permanent establishment, non-resident private equity entities in treaty countries will not usually be subject to tax on their Australian sourced business profits.

However, the ATO warns in TD 2009/D17 that in relation to treaty shopping arrangements, income gains may nevertheless be taxed in Australia. Broadly, TD 2009/D17 states that the application and scope of Australia's tax treaties is subject to the operation of the general anti-avoidance provision in Part IVA of the *ITAA 1936*. The ATO further states that where an arrangement is put in place merely to attract the operation of a particular tax treaty in the context of a broader structuring arrangement, this may be a scheme or a part of a scheme which otherwise satisfies the terms of Part IVA, and any tax benefit obtained in relation to such a scheme may be cancelled.

TD 2009/D17 gives a further example that states clearly the ATO's view on the operation of Part IVA in the Myer/TPG transaction:

Example

NV Offshore BV (Offshore) is the Dutch holding company of a newly incorporated Australian company that acquires all of the shares in Target Co, an Australian manufacturing company. An Australian consolidated tax group is then formed. Offshore is in turn owned by a Luxembourg entity that is itself owned by an entity resident in the Cayman Islands. Various United States resident investors and a private equity group control the Cayman Islands entity. Their primary purpose for acquiring Target Co is to improve its business operations in the short term and then sell the consolidated group via an initial public offering for an amount greater than the purchase price. There are no commercial reasons for using a Dutch company and a Luxembourg company as intermediate entities in the ownership chain, although there is a tax benefit in having the profit derived from the sale of the group by a Dutch company rather than the Cayman Islands entity because of the Australia-Netherlands tax treaty in relation to business profits sourced in Australia. In the absence of commercial reasons for the interposition of the Dutch and Luxembourg entities between the Cayman Islands entity and the Australian company and having regard to the factors set out in paragraph 177D(b), it would be concluded that obtaining this tax benefit was the dominant purpose of one or more persons who carried out the scheme of acquiring Target Co in the manner undertaken.

BDO COMMENT

Both TD 2009/D17 and TD 2009/D18 fail to address two key issues that are fundamental to whether private equity deals similar to the Myer/TPG transaction give rise to an Australian tax liability: the source of the profit arising from the sale of the shares, and whether any of the activities associated with the acquisition or disposal of the shares could give rise to an Australian permanent establishment. Both of the Draft Taxation Determinations seem to assume that the profit from the Myer/TPG transaction was Australian sourced, without providing meaningful analysis to support this conclusion.

The reaction to the Draft Taxation Determinations from participants in the private equity industry has been predictably hostile, however from a policy perspective the question needs to be raised – in what circumstances should profits from the sale of shares in non-land rich Australian companies by non-residents be subject to Australian tax? Clearly, the introduction of Division 855 of the *ITAA 1997* shows that the current policy is that profits from the disposal of such shares held on capital account should not be subject to Australian tax (provided that the profits are not attributable to an Australian permanent establishment). However, the Government needs to consider whether improved clarity around this position is required for transactions that, based on common law principles, might be considered to be on revenue account.

TREASURY RELEASES EXPOSURE DRAFT LEGISLATION TO REPEAL FIF PROVISIONS

ON 18 DECEMBER 2009, TREASURY RELEASED FOR CONSULTATION EXPOSURE DRAFT LEGISLATION REGARDING THE DECISION TO REPEAL THE FOREIGN INVESTMENT FUND (FIF) AND DEEMED PRESENT ENTITLEMENT RULES THAT APPLY TO FOREIGN TRUSTS ANNOUNCED IN THE 2009-10 FEDERAL BUDGET.

The FIF provisions are generally that an Australian resident must include an amount of deemed income (FIF income) in their assessable income in respect of their investments in any FIFs (ie: foreign companies or trusts), unless a specific exemption is applicable. The calculation of FIF income is most commonly based on the change in the market value of a FIF interest or, where a market value is not readily ascertainable, based on a deemed rate of return.

The main amendments proposed in the Exposure Draft include:

- the repeal of the FIF provisions in Part XI of the *ITAA 1936*;
- the repeal of the deemed present entitlement rules in sections 96A, 96B and 96C of the *ITAA 1936*; and

- various consequential amendments.

The Exposure Draft also proposes certain amendments to section 23AK of the *ITAA 1936* which are intended to ensure that distributions out of FIF income previously attributed to the relevant taxpayer under the FIF regime continue to be non-assessable non-exempt income after the repeal of the FIF provisions. A new section 23B of the *ITAA 1936* is also proposed to be introduced to effectively maintain the rule that provides that proceeds from the disposal of a FIF interest taking place after the repeal of the FIF provisions will be reduced by the relevant FIF attribution account surplus. However, it is interesting to note that sections 23AK and 23B will be subject to a "sunset" provision which will result in those provisions being repealed at a future date. The income year in which the sunset provision will take place is not specified in the Exposure Draft.

The Exposure Draft also does not indicate the income year in which the repeal of the FIF provisions will take effect.

BDO COMMENT

The impending repeal of the FIF regime is a positive development for overseas fund managers seeking Australian investors, as well as for Australian fund managers seeking to offer a range of overseas investments in their portfolios for Australian investors. However, it is interesting that no particular commencement date has been given in the Exposure Draft for the repeal of the FIF and deemed present entitlement rules.

The original media releases announcing the proposal to repeal the FIF measures and the deemed present entitlement rules indicated that the rules would be replaced with a narrowly targeted anti-avoidance rule to address investments in offshore "roll-up" funds. Unfortunately, the Exposure Draft does not include measures to address investments in "roll-up" funds. It remains to be seen whether the anti roll-up measures will be narrowly targeted enough to ensure that ordinary investments in overseas companies or trusts will not be subject to an accruals taxation regime.

ATO RELEASES DRAFT RULING ON THIN CAPITALISATION AND TRANSFER PRICING

THE AUSTRALIAN TAXATION OFFICE (ATO) HAS RELEASED DRAFT TAXATION RULING TR 2009/D6 WHICH ADDRESSES THE INTERACTION BETWEEN THE TRANSFER PRICING PROVISIONS AND THE THIN CAPITALISATION PROVISIONS.

The ATO has also withdrawn Draft Taxation Determination TD 2007/D20 which addressed the same issue. In a separate development, the ATO has released a draft Practice Statement (PSLA 3187) setting out a practical "rule of thumb" for pricing the interest rate on cross border related party loans.

Background

The transfer pricing provisions contained in Division 13 of the *Income Tax Assessment Act 1936* (ITAA 1936) allow the Commissioner of Taxation (the Commissioner) to make a determination that has the effect of deeming arm's length consideration to have been given for the purposes of the ITAA 1936, in respect of property supplied or acquired under certain international agreements.

In the context of cross border loans to Australian members of multinational groups, this means that the Commissioner may reduce the borrower's deductions for interest and other costs in respect of the loan if the Commissioner determines that those costs exceed their arm's length amount.

The thin capitalisation provisions in Division 820 of the *Income Tax Assessment Act 1997* (ITAA 1997) can also operate to deny debt deductions (including interest) to the extent that the entity is thinly capitalised (ie: has "excess debt"). In determining whether an entity has excess debt, most entities apply the "safe harbour debt amount", which for most entities permits a maximum debt to asset ratio of 75% (subject to certain adjustments).

The interaction between the transfer pricing provisions and the thin capitalisation provisions has been an area that has caused some degree of uncertainty over recent years. Broadly, the issue of concern is whether the transfer pricing provisions may be applied to reduce (or deny) interest deductions where an entity has debt funding from an overseas parent that exceeds the maximum amount that independent lenders dealing at arm's length with the borrower would lend, notwithstanding that the entity's total debt is less than its safe harbour debt amount.

For example, an entity that is wholly funded by its foreign parent as to 75% debt and 25% equity would not ordinarily have any of its debt deductions denied under the thin capitalisation provisions, as its total debt does not exceed its safe harbour debt amount. However, if independent lenders dealing at arm's length with that entity would only be prepared to advance debt funding of no more than 50% of its assets, an issue arises as to whether the transfer pricing rules may apply to reduce, or deny, interest deductions on the part of the loan from the parent that exceeds this arm's length gearing level. TR 2009/D6 now provides guidance on the ATO's approach to this issue and other related matters.

TR 2009/D6

In TR 2009/D6, the ATO rejects the view that if the thin capitalisation provisions do not result in any adjustment to the debt deductions of an entity, the transfer pricing provisions should not apply to adjust the pricing of the associated costs. Instead, the ATO states that where an entity does not have excess debt (within the meaning of the thin capitalisation provisions), the transfer pricing provisions may still apply to adjust the interest and other costs directly incurred in obtaining or maintaining the debt funding. The existence of a safe harbour debt amount does not prevent the Commissioner from determining an appropriate arm's length cost for *all* of the debt funding.

However, the transfer pricing provisions cannot be applied to *completely* deny deductions for funding costs on debt that is not excess debt for the purposes of the thin capitalisation provisions, merely because those deductions relate to a portion of the total debt funding that exceeds the amount that would have arisen under an arm's length capital structure.

Any arm's length interest rate worked out under the transfer pricing provisions will be applied to the actual amount of debt.

The ruling also explains that, in determining the arm's length pricing of an entity's debt, regard is to be given not only to the entity's own financial characteristics as a stand-alone entity, but also to the effect of affiliation with the entity's ultimate parent. The practical effect of recognising the effect of "parental affiliation" is that the entity's cost of borrowing may be lower than it would otherwise be if it were an independent, stand-alone entity.

Effect of tax treaties

Although not discussed in the formal part of the Draft Ruling, Appendix 1 to TR 2009/D6 includes an analysis of whether the Associated Enterprises Article in Australia's tax treaties represents a separate assessing power to that provided under Division 13 of the *ITAA 1936*. TR 2009/D6 states that, in the ATO's view, the Associated Enterprises Article represents an additional assessing power, but notes that there should usually be no fundamental inconsistency between the results under Division 13 and the Associated Enterprises Article, since both are based on the arm's length principle.

Implications for members of multinational groups

Broadly, the position the ATO takes in TR 2009/D6 is that an entity must ensure that the pricing of all of its international related party debt must be on arm's length terms, even if the entity's total debt does not exceed its safe harbour amount.

This means that entities will need to perform an analysis of various factors including the term of

the loan, the borrower's creditworthiness and the effect of parental affiliation, in order to determine an appropriate arm's length rate to apply to their related party debt.

In situations where there are no readily apparent comparable arm's length prices - for example, because the debt funding arrangements in question would not exist between independent parties dealing at arm's length - the ATO will consider an approach which "would lead to a fair result that is as consistent as practicable with the arm's length principle."

Pending finalisation of its view, the ATO has released in Draft Practice Statement PSLA 3187 a "rule of thumb" to assist taxpayers in pricing their cross border related party loans. In Draft Practice Statement PSLA 3187, the ATO states that it will not reduce interest deductions under the transfer pricing provisions where the interest rate paid by the taxpayer reflects the usual rate of interest paid by the ultimate parent company, to the extent that the amount of the debt does not exceed the statutory safe harbours in the thin capitalisation provisions. However, the rule of thumb approach cannot be used in respect of a cross-border related party loan that is subject to an explicit guarantee.

BDO COMMENT

The origin of TR 2009/D6 (and its predecessor, TD 2007/D20) is from concerns that many Australian subsidiaries of multinational groups were debt funded by their foreign parents up to the safe harbour threshold at junk bond rates, resulting in substantial interest deductions, and reducing the Australian entities' taxable profits. TD 2007/D20 attempted to address the question of whether all of the interest should be deductible if the debt funding from the parent exceeded the debt that would arise under an arm's length capital structure.

The approach the ATO takes in TR 2009/D6 appears sensible, in that it suggests that an arm's length interest rate should be applied to the whole of the entity's debt, rather than restricting the debt deduction to the maximum amount of interest that would have been incurred had the entity adopted an arm's length capital structure, or applying a differential rate to the "excessive" debt.

However, the "rule of thumb" is a very conservative approach, as it reflects the parent's cost of borrowing, rather than the subsidiary's. In many situations, the subsidiary will have a higher "arm's length" cost of funding than its parent. Thus, taxpayers should be aware that although the ATO will accept the rule of thumb, use of that rule of thumb may lead to transfer pricing issues in the parent company's jurisdiction.

GST APPEAL: FEDERAL COURT HOLDS VACANT RESIDENTIAL ZONED LAND IS NOT "RESIDENTIAL PREMISES"

ON 3 DECEMBER 2009, THE FEDERAL COURT IN *VIDLER V FCT* [2009] FCA 1426 DISMISSED THE TAXPAYER'S APPEAL FROM THE AAT, HOLDING THAT SALES OF TWO VACANT BLOCKS OF LAND WERE NOT SUPPLIES OF INPUT-TAXED "RESIDENTIAL PREMISES" FOR THE PURPOSES OF THE GST ACT.



In 2004, the taxpayer sold two blocks of land in Ipswich, Queensland which were vacant and undeveloped at the time of the sale. The taxpayer did not remit GST on the consideration for the sale of the land, arguing that the sale of those blocks constituted an input taxed supply of "residential premises" on the basis that the land was zoned for residential use.

Section 40-65(1) of the GST Act provides that a sale of real property is input taxed, but only to the extent that the property is residential premises to be used predominantly for residential accommodation (regardless of the term of occupation).

Section 195-1 of the GST Act defines "residential premises" to mean land or a building that:

- (a) is occupied as a residence or for residential accommodation; or
- (b) is intended to be occupied, and is capable of being occupied, as a residence or for residential accommodation;

(regardless of the term of the occupation or intended occupation) and includes a floating home.

As neither blocks of land were occupied at the time of their respective sales, the relevant issue was whether, pursuant to subparagraph (b) the definition of "residential premises", the land was "intended to be occupied, and [was] capable of being occupied, as a residence or for residential accommodation".

The Commissioner argued that vacant land, even if zoned residential, can never be "residential premises" because it lacks the form of permanent structure with living facilities

which would allow it to be used as a residence or for residential accommodation.

However, the taxpayer argued that as the definition of "residential premises" separately lists "land" and "building" in the opening words of the definition, the definition does not warrant the word "land" to mean land with a building on it.

The Federal Court agreed with the Commissioner, holding that as the respective blocks of land were not occupied at the time of their sale, the land would need to be otherwise capable of providing some shelter and basic living facilities in order to meet the definition of "residential premises". The Court held that the vacant land clearly did not meet these requirements and therefore the vacant land was not residential premises for the purposes of the GST Act.

BDO COMMENT

The issues considered in *Vidler* are relatively straightforward. However, it is useful to have confirmation that vacant land does not ordinarily satisfy the definition of residential premises. It is also interesting to note that in oral submissions before the Court, the Commissioner requested that in the event of the appeal being dismissed, the Federal Court should rule that vacant land can never be considered "residential premises" for the purposes of the GST Act. However, the Court declined to make such an expansive ruling, notwithstanding its view that it is "difficult to envisage a scenario in which vacant land could plausibly constitute residential premises."

AUSTRALIA'S FUTURE TAX SYSTEM – HENRY REVIEW 2010

ON 23 DECEMBER 2009, THE AUSTRALIA'S FUTURE TAX SYSTEM REVIEW PANEL ("THE PANEL") DELIVERED ITS FINAL REPORT ("THE HENRY REPORT") TO THE GOVERNMENT.

When it received the Henry Report, the Government said it would consider its contents and release it in early 2010, along with an initial response. Throughout January and into February 2010, the Government has come under increasing political pressure to release the Henry Report, which to date it has resisted.

The Panel's review, chaired by Treasury Secretary Ken Henry, was initially commissioned in May 2008 as a result of the Government's 2020 Summit, which proposed a comprehensive review of State and Federal taxes to consider measures to harmonise and simplify taxes, reduce inefficient taxes, ensure a progressive system and address negative interaction with the welfare system.

Although Government press releases boasted that this review would take a "root and branch" approach and would be the most comprehensive review of the Australian taxation system for "at least 50 years", commentators quite rightly criticised the Government for placing key aspects of the GST and tax-free superannuation payments for the over 60s outside the scope of the review. The exclusion of these cornerstone issues from the review has been, and will surely remain, a source of mirth and derision by tax, economic and political commentators for decades to come.

Not surprisingly, parts of the Henry Report have leaked to the media, with the media suggesting that the Henry Report's recommendations include doing away with compulsory tax returns for many individuals, the implementation of various changes to the taxation of capital gains, and the introduction of a range of new imposts including a Medicare-style disability levy, a national profit-based resource rent tax and road congestion levies.

Like many taxpayers, BDO eagerly awaits the release of the Henry Report. BDO's formal response to the Henry Report will be available from the BDO website shortly after the Henry Report is released.

If you would like to be added to the mailing list to receive a copy of our formal response to the Henry Report, please contact your local BDO office.

ATO RELEASES DRAFT RULING ON TRUST TAXATION AND CORPORATE BENEFICIARIES

THE AUSTRALIAN TAXATION OFFICE (ATO) HAS RELEASED DRAFT TAXATION RULING TR 2009/D8, WHICH SETS OUT THE ATO'S OPINION ON THE CIRCUMSTANCES IN WHICH A PRIVATE COMPANY WITH A PRESENT ENTITLEMENT TO AN AMOUNT INCOME FROM A TRUST MAY BE TAKEN TO HAVE MADE A LOAN BACK TO THE TRUST FOR DIVISION 7A PURPOSES.



Background

Division 7A of Part III of the *Income Tax Assessment Act 1936* (ITAA 1936) generally provides that a loan made by a private company to a shareholder or associate is treated as an unfranked dividend (and hence taxable to the recipient of the loan) unless the loan is placed under a written loan agreement which imposes certain minimum interest rate and repayment requirements. Division 7A is intended to address a tax mischief under which shareholders of private companies could extract the company's profits as a tax-free "loan" instead of as a taxable dividend.

In order to access the corporate tax rate whilst retaining the use of accumulated earnings to fund an ongoing business, many discretionary trusts use distribution strategies that proceed along the following lines:

- the trust has a company as a beneficiary;
- the trust makes distributions to the company; and
- the distributions to the company remain unpaid.

The distributions to companies that remain unpaid are often referred to as "unpaid present entitlements" (UPEs), and are typically described as a receivable (not a loan) on the company's balance sheet. To date, it has been commonly understood by both taxpayers and tax practitioners that a UPE does not represent a loan from the company to the trust for Division 7A purposes (provided that the UPE is not classified as a loan back to the trust in either the company's or the trust's accounts).

However, a senior officer of the ATO commented at a seminar last year that he was of the view that there are situations

where a UPE could be regarded as a loan for the purposes of Division 7A. In particular, subsection 109D(3) of the *ITAA 1936* defines "loan" for the purposes of Division 7A as follows:

109D(3) What is a loan?

In this Division, "loan" includes:

- an advance of money; and*
- a provision of credit or any other form of financial accommodation; and*
- a payment of an amount for, on account of, on behalf of or at the request of, an entity, if there is an express or implied obligation to repay the amount; and*
- a transaction (whatever its terms or form) which in substance effects a loan of money.*

The ATO officer questioned whether a UPE could constitute the provision of "financial accommodation" by reason of the company not demanding payment of the UPE and allowing the trustee to invest the underlying funds for the trust's own purposes.

To address these issues, the ATO has released TR 2009/D8 to outline the ATO's preliminary views.

In what circumstances will TR 2009/D8 apply?

TR 2009/D8 applies where:

- a private company has a present entitlement to amounts from an associated trust estate that is part of the same family group of entities as the private company; and
- funds representing the present entitlement remain intermingled with other funds of the trust estate, or are otherwise able to be used

for the purposes of the trust estate (whether or not they remain so intermingled or available by being paid back to, reinvested in, or lent back to the trust by a relevant sub-trust).

When will a UPE be treated as a loan?

According to TR 2009/D8, a private company beneficiary's UPE can be extinguished and converted into a loan back to the trust where any of the following occur:

- there is in effect **an agreement** for the company to lend the money to the trust;
- the trustee **credits amounts to a loan account** held in the name of the private company beneficiary, **with the authorisation, acquiescence or knowledge of the private company**;
- the trustee, acting pursuant to a term of the trust deed, pays or applies money to or for the benefit of the beneficiary; or
- the trustee **credits a loan account** in the name of the corporate beneficiary, and under the trust deed the trustee has the power to credit such amounts for the benefit of the corporate beneficiary as a payment or application of trust funds.

In each of the above situations, the ATO considers that the unpaid amount ceases to be a UPE and becomes a loan for Division 7A purposes. As a consequence, the UPE will represent a taxable dividend to the trust (to the extent of retained profits of the corporate beneficiary), unless the "loan" is subject to a written loan agreement specifying the appropriate minimum interest rate and repayment terms.

Ordinary treatment of UPEs

Where the arrangement comprising the

UPE only gives rise to an **equitable right** to payment of the distributed amount (and does not in substance comprise anything further), the ATO considers that this will not amount to a loan.

However, a private company beneficiary will be taken to have **provided financial accommodation to a trust** (and hence deemed to have provided a loan to the trust for Division 7A purposes) if the private company authorises (including by acquiescing with knowledge) the trust's continued use of the funds representing the UPE by not calling for:

- payment of that UPE; or
- investment of the funds representing the UPE for the private company's absolute benefit (and no benefit accruing to the main trust from the use of those funds).

This requirement for a UPE to be invested for the private company's absolute benefit is a new development. However, TR 2009/D8 states that this "new" treatment will not apply to UPEs arising before the date of issue of TR 2009/D8 (ie: before 16 December 2009). Accordingly, the new treatment will be relevant for trust distributions made out of trust income for the 2009/2010 year.

The proposed treatment of UPEs set out in TR 2009/D8 is a serious issue and will generally apply to the majority of company beneficiaries. Practically, TR 2009/D8 will impact the use of "bucket" companies, and will generally require UPEs arising in respect of the 2009/10 and later income years to be put under written loan agreements, which will generally require the UPE to be paid over to the company within 7 years. Many private groups may find these conditions difficult to comply with.

Where the new treatment to UPEs will apply, TR 2009/D8 indicates that where the UPE is still an equitable interest, it will be necessary to tag the UPE with some income entitlement from the use of the UPE by the trust in order to show that the UPE has been invested for the sole benefit of the corporate beneficiary. Complying with this requirement will be difficult in practice.

All taxpayers whose structures use trusts and corporate beneficiaries should seek advice from their BDO contact to assess the likely impact of TR 2009/D8 and to discuss the appropriate strategy going forward.

AXA ASIA PACIFIC – TAXPAYER ENTITLED TO SCRIP FOR SCRIP ROLLOVER

ON 4 DECEMBER 2009, THE FEDERAL COURT HELD IN AXA ASIA PACIFIC HOLDINGS LTD V FCT [2009] FCA 1401 THAT THE TAXPAYER WAS ENTITLED TO PARTIAL SCRIP FOR SCRIP ROLL-OVER RELIEF IN RESPECT OF THE DISPOSAL SHARES IN A SUBSIDIARY.

Background

In the 2002 income year, the taxpayer disposed of its shareholding in AXA Australia Health Insurance Pty Ltd ("AXA Health"), a wholly owned subsidiary of the taxpayer. In a relatively complex arrangement for which the taxpayer sought assistance from Macquarie Bank Limited ("Macquarie"), the taxpayer transferred its shares in AXA Health to Macquarie Health Funding Pty Ltd (MHF), a special purpose vehicle established by Macquarie, for cash consideration of \$57 million and 513 million \$1 convertible preference shares in Macquarie Health Acquisitions Pty Ltd (MHA), MHF's immediate parent company. Relevantly, the shareholding of MHA was structured such that a minority interest was indirectly held by a company not associated with Macquarie. The shareholding in MHA was structured in this way to ensure that MHA was not wholly owned by the Macquarie Group.

The taxpayer claimed scrip for scrip rollover relief in relation to the proceeds that consisted of the convertible preference shares in MHA.

The Commissioner argued that scrip for scrip rollover was not available on the basis that the taxpayer and MHF did not deal with each other at arm's length within the meaning of section 124-780(4) of the *ITAA 1997*.

A critical part of the transaction (as far as eligibility for the scrip for scrip rollover was concerned) was the issue of the convertible preference shares by MHA in exchange for the taxpayer's ordinary shares in AXA Health. As the convertible preference shares had different voting rights compared to those carried by the ordinary shares in AXA Health, the issue of whether the parties dealt at arm's length was relevant because, if the parties to a relevant arrangement do not deal at arm's length, certain additional conditions must be satisfied in order for scrip for scrip rollover to be available, one of which being that the shares exchanged under the arrangement must carry the same kinds of rights and obligations. In this case, the convertible preference shares did not have similar voting rights to the ordinary shares in AXA Health, thus this requirement would not have been satisfied. The Commissioner also separately argued that the arrangement was subject to Part IVA of *ITAA 1936*.

Decision

The Court held that the taxpayer and MHF dealt with each other at arm's length, within the meaning of section 124-780(4) of *ITAA 1997*. In an interesting judgement, the Court held that the fact that a transaction is devised in a certain way to obtain a revenue advantage does not mean that the transaction is a non-arm's length one.

The Court also affirmed previous cases addressing the issue of dealing at arm's length, noting that:

- there is a difference between an arm's length **relationship** and an arm's length **dealing**;
- the fact that parties are not in an arm's length relationship does not necessarily mean that dealings between them might not be at arm's length if other facts and circumstances favour such a result; and
- it does not follow that where parties are in an arm's length relationship, a dealing between them must be characterised as an arm's length one if the facts and circumstances generally suggest otherwise.

The Court also reviewed cases which suggested that arm's length parties may be considered not to have dealt at arm's length where those parties colluded to achieve a particular result. However, the Court held that in this particular case, the parties had not colluded to devise a means to avoid the incidence of capital gains tax. The Court considered that while the architecture of the Macquarie bid was integral to the offer, and made the offer more attractive for the taxpayer, this did not mean that the dealing between the parties was not at arm's length.

In addressing the Commissioner's argument that Part IVA applied to cancel the "tax benefit" associated with the structure of the transaction, the Court rejected the Commissioner's alternative postulate that had MHA been wholly owned by Macquarie, the same transactions would have taken place.

Accordingly, for the purposes of section 177C(1) (a) of *ITAA 1936*, it was held that there was no amount that would have been included, or might reasonably be expected to have been included, in the assessable income of the taxpayer if the scheme identified by the Commissioner had not been entered into or carried out, and accordingly there was no "tax benefit" to which Part IVA could apply.

BDO COMMENT

The decision in *AXA Asia Pacific* is interesting as it considers whether parties to a complex corporate transaction that are otherwise unrelated are dealing at arm's length with each other where a party structures a deal in a way that ensures a tax effective outcome for the counterparty. However, readers should note that the Commissioner has appealed this decision to the Full Federal Court.

FEDERAL COURT UPHOLDS DECISION TO APPLY PART IVA TO SALE OF ASSETS

ON 21 DECEMBER 2009, THE FEDERAL COURT HELD IN *BRITISH AMERICAN TOBACCO AUSTRALIA SERVICES LIMITED V FCT* [2009] FCA 1550 THAT THE STRUCTURE OF THE SALE OF CERTAIN ASSETS AS PART OF THE WORLDWIDE MERGER OF THE BRITISH AMERICAN TOBACCO GROUP ("THE BAT GROUP") AND THE ROTHMANS INTERNATIONAL GROUP ("THE ROTHMANS GROUP") WAS A SCHEME TO WHICH THE GENERAL ANTI-AVOIDANCE PROVISIONS IN PART IVA OF THE *INCOME TAX ASSESSMENT ACT 1936* APPLIED.



Background

In January 1999 the worldwide merger of the BAT Group and the Rothmans Group was announced. In each jurisdiction, the larger of the BAT Group or the Rothmans Group took the lead role in the merger.

In Australia, the merger involved WD & HO Wills Holdings Limited (Wills Holdings) (which was part of the BAT Group) and Rothmans Holdings Limited (Rothmans Holdings), together with their respective subsidiaries. As Rothmans Holdings was the larger of the Australian groups in terms of market share and market capitalisation, the merger of the Australian groups was structured such that Rothmans Holdings took over Wills Holdings. This was ultimately achieved on 2 September 1999 when Rothmans Holdings acquired all of the shares in Wills Holdings.

However, BAT Indonesia had a larger market share than Rothmans Indonesia. Accordingly, BAT Indonesia acquired Rothmans Indonesia from its Australian resident shareholders, Rothmans Asia and Rothmans Holdings. The disposal of BAT Indonesia resulted in a capital loss to Rothmans Asia of more than \$100 million. Furthermore, at the time of the announcement of the worldwide merger, Rothmans Asia had accumulated capital losses of \$63.3 million.

The ACCC undertakings and the disposal of the Wills brands

At an early stage in the merger process, the Australian Competition and Consumer Commission (ACCC) was concerned that the merger would substantially lessen competition in the Australian cigarette market, and indicated that unless there was divestment of some of the brands of the proposed Australian merged group, the ACCC would seek an injunction to restrain the merger.

In order to satisfy the ACCC's requirements, Wills Holdings and Rothmans Holdings ultimately entered into negotiations with various members of the group controlled by Imperial Tobacco Group plc (Imperial) to sell a number of Australian and New Zealand tobacco brands, including nine brands owned by Wills Holdings (the Wills Brands), subject to the condition precedent that the Australian merger be successfully implemented. The consideration for the sale of the brands was approximately \$325 million, with \$181.7 million being attributable to the Wills Brands.

Had the transaction been structured such that the Wills Brands were sold directly to Imperial by members of the Wills Group, a capital gain of approximately \$118 million would have arisen. However, in structuring the sale of the brands to Imperial, it was noted that Rothmans Holdings had capital losses of at least \$163 million, which could be applied against subsequent capital gains arising in Rothmans Holdings. Thus, rather than having the Wills Group dispose of the brands directly to Imperial, the disposal of the Wills Brands was structured along the following lines:

1. The merger was completed prior to entering into any contractually binding agreements for the sale of any brands to Imperial.
2. On the day following the successful implementation of the merger, the Wills Brands were transferred by the taxpayer to Rothmans for \$181.7 million. No taxable capital gain was generated under this transaction, as rollover relief was chosen under Subdivision 126-B of the ITAA 1997 (which at the time was available in respect of CGT events arising from the transfer of assets between members of the same wholly owned group).
3. Following the transfer of the Wills Brands to Rothmans Holdings, contracts for the sale of various brands (including the Wills Brands) by Rothmans to Imperial were completed, giving rise to a capital gain to Rothmans. The consideration received by Rothmans Holdings for the Wills Brands was \$181.7 million (the same as the consideration paid by Rothmans Holdings to the Wills Group for those brands).
4. The capital losses were transferred from Rothmans Asia to Rothmans Holdings, and applied against the capital gains derived by Rothmans Holdings on the disposal of the various brands.

Commissioner determined that Part IVA applied

Following a review undertaken by the ATO of the relevant transactions, the Commissioner applied Part IVA of the ITAA 1936 to increase the taxpayer's taxable income by approximately \$118 million (the amount of the taxable capital gain that would have arisen had the Wills Brands been sold by the taxpayer directly to Imperial).

Broadly, Part IVA provides that the Commissioner may cancel a "tax benefit" a taxpayer obtains in connection with a "scheme" where, having regard to the various matters referred to in section 177D(b), it would be concluded the dominant purpose of entering into the scheme was to enable the taxpayer to obtain the tax benefit.

The Commissioner argued that a tax benefit was derived by the taxpayer because, had the Wills Brands been sold by the taxpayer directly to the Imperial Group, a taxable capital gain of \$118 million would have arisen. The Commissioner argued that this tax benefit was obtained in connection with the scheme constituted by the disposal of the Wills Brands to Rothmans and their subsequent disposal by Rothmans to the Imperial Group, coupled with the election to apply rollover relief under Subdivision 126-B and the utilisation of the capital losses in Rothmans Holdings. The Commissioner also argued that the scheme was entered into for the dominant purpose of obtaining the tax benefit.

However, the taxpayer argued that the reasons for the transfer of the Wills Brands by the taxpayer to Rothmans were commercial, and not for the dominant purpose of obtaining a tax benefit. The taxpayer argued that the initial disposal of the Wills Brands to Rothmans prior to their sale to Imperial was consistent with a clearly defined and consistent strategy of having all the brands packaged into a single vendor entity, which presented certain logistical advantages in terms of reducing the number of different vendor entities involved in the transaction. The taxpayer also asserted that the overall arrangement had been implemented in order to comply with the ACCC's requirements.

The taxpayer also argued that no tax benefit for the purposes of Part IVA should be taken to arise by virtue of section 177C(2A)(a) of the ITAA 1936, which broadly provides that for the purposes of Part IVA, a "tax benefit" does not include an amount not being included in the assessable income of a taxpayer where the non-inclusion of the amount is because of a scheme that consists solely of the making of a choice or election

under Subdivision 126-B of the *ITAA 1997* or an agreement under Subdivision 170-B of the *ITAA 1997*.

Broadly, the taxpayer argued that the non-inclusion of the \$118 million in its assessable income was attributable to a scheme consisting solely of the making of the Subdivision 126-B election after the taxpayer and Rothmans had become part of the same wholly-owned company group. The taxpayer contended that restricting the scheme to this element would mean that there would be no tax benefit to which Part IVA could apply.

Decision of the Federal Court

In considering the relevant scheme for the purposes of the application of Part IVA, the Federal Court noted that the definition of a "scheme" under section 177A is wide, and encompasses not only a series of steps that together can be said to constitute a scheme, but may also consist of the taking of one step. However, in agreeing with the Commissioner, the Federal Court also noted that the "scheme" must be related to the tax benefit obtained, and held that the relevant scheme consisted of much more than the mere making of the Subdivision 126-B rollover election. Instead, the Court held that the relevant scheme consisted of the overall arrangement involving the disposal of the Wills Brands to Rothmans and then by Rothmans to Imperial, together with the Subdivision 126-B rollover election and the utilisation of the capital losses.

The Federal Court suggested that this sequence of events had the effect of avoiding the adverse capital gains tax consequences that may otherwise have arisen if the taxpayer had sold the Wills Brands directly to Imperial. This being the case, the Federal Court held that a tax benefit had been derived by the taxpayer in connection with the broader scheme, in the form of the non-inclusion of \$118 million in the taxpayer's assessable income.

In considering whether the scheme was entered into for the dominant purpose of obtaining the tax benefit, the Federal Court noted that there was no legal or commercial reason why the Wills Brands could not have been disposed of by the taxpayer directly to Imperial, rather than being transferred to Rothmans and then disposed of by Rothmans to Imperial. Taking this into account, and after considering the various factors under section 177D(b) of the *ITAA 1936*, the Federal Court concluded that the scheme was entered into for the purpose of enabling the taxpayer to obtain the relevant tax benefit.

BDO COMMENT

This case illustrates the potentially wide reach of Part IVA, illustrating that taking an additional step that may be unnecessary to achieve the desired commercial outcome of a transaction (in this case, the disposal of certain tobacco brands) may be sufficient to attract Part IVA.

GST TREATMENT OF REBATES REIMBURSED BY THE COMMONWEALTH

ON 18 DECEMBER 2009, THE FULL BENCH OF THE FEDERAL COURT HELD IN *TT LINE COMPANY PTY LTD V FCT* [2009] FCAFC 178 THAT GST WAS PAYABLE IN RESPECT OF CERTAIN REBATES REIMBURSED BY THE COMMONWEALTH GOVERNMENT UNDER THE BASS STRAIT VEHICLE EQUALISATION SCHEME.



Background

The taxpayer, TT Line Company Pty Ltd (TT Line) is a company that is wholly owned by the state of Tasmania and operates the *Spirit of Tasmania* ferry service between Tasmania and the Australian mainland.

Under the Bass Strait Vehicle Equalisation Scheme (the Scheme), TT Line provided rebates to eligible passengers and received cash reimbursements of these rebates from the Commonwealth Government.

The Scheme was initially introduced by the Commonwealth Government to reduce passengers' costs associated with sea transport of passenger vehicles across the Bass Strait, with the amount of the rebate to be calculated to ensure that the net fare for a vehicle plus a driver travelling on a standard fare on a Bass Strait crossing would be comparable to the notional cost of driving an equivalent distance on a highway.

Under the Scheme, on taking a booking, the operator deducts the applicable rebate from the eligible passenger's vehicle fare. Each month, the operator claims a reimbursement from the Commonwealth Government for the rebates given to eligible passengers.

In the relevant years, funding for the Scheme was conferred by the *Appropriation Act (No. 1) 2007–2008* (the Appropriation Act), with the Scheme being listed as an "administered program" of the Department of Transport and Regional Services in accordance with the Portfolio Budget Statements for 2007–2008.

TT Line initially sought a declaration from the Federal Court that the reimbursements TT Line

received from the Commonwealth Government did not constitute part of the "consideration" for the supply of transport services to eligible passengers, and hence TT Line was not liable to GST in respect of those reimbursements. The Federal Court at first instance dismissed TT Line's application, holding that the reimbursements TT Line received from the Commonwealth Government formed part of the consideration for the supply of transport services to passengers. TT Line appealed this decision to the Full Bench of the Federal Court.

Submissions on appeal to the Full Bench of the Federal Court

This issue in this case is whether the reimbursements TT Line received from the Commonwealth Government were consideration for the supply of transport services provided by TT Line to eligible passengers.

Section 9-15(1) of the GST Act defines "consideration" to include any payment, act or forbearance, in connection with, or in response to or for the inducement of a supply of anything. However, section 9-15(3)(c) provides that a payment made by a government related entity to another government related entity is not the provision of consideration if the payment is specifically covered by an appropriation under an Australian law.

TT Line argued that the reimbursements it received from the Commonwealth were not "consideration" in connection with the supply of transport services to a passenger within the meaning of section 9-15 of the GST Act, on the basis that the reimbursements lacked the sufficient nexus with the supply of the

transport services. TT Line argued that the supply of transport services to a passenger did not give rise to an entitlement to receipt of the payment from the Commonwealth, submitting instead that the reimbursements were given by the Commonwealth Government as a subsidy or gratuity, under a scheme designed to give effect to Government policy. TT Line also submitted that the reimbursements were not "in connection with" the supply of transport services, but were instead a subsidy "in connection with" the operation of the Scheme.

TT line also argued that as it is a government related entity (being wholly owned by the state of Tasmania) and funding for the Scheme is conferred by the Appropriation Act, the payments were covered by an appropriation and thus fell within the exception in section 9-15(3)(c) of the GST Act.

However, the Commissioner submitted that the reimbursements were consideration for the provision of the transport services, as TT Line's right to retain the payments it received under the Scheme in relation to a particular passenger's travel was contingent upon TT Line making the supply of the transport services to the passenger.

The Commissioner also argued that the exception in section 9-15(3)(c) is applicable only where the purpose of the appropriation is to appropriate money for payments specifically to government related entities. The Commissioner argued that it is not sufficient that the recipient of the payment is a government related entity if the appropriation would permit payment to a non-government related entity for the same purpose.

Decision of the Full Federal Court

The Full Federal Court agreed with the decision of the Federal Court at first instance. In dismissing the appeal, the Court noted that the Scheme provides a rebate to passengers, not to operators. The Court held that the fare for the transport services (and hence the consideration) was the aggregate of the fare paid by the passenger (net of the rebate), plus the reimbursement of the rebate given by the Commonwealth.

The Court also considered that TT Line's argument that it had no enforceable entitlement to receive any payment under the Scheme despite providing transport services was irrelevant and, in any event, there was no act which severed the nexus between the payment of the rebate and the supply of transport services.

The Full Federal Court also dismissed the taxpayer's argument that the reimbursements under the Scheme were covered by an appropriation, noting that while the Budget Statements referred to the Scheme, they did not refer to TT Line and held that in order to satisfy the section 9-15(3)(c) exception, it must be clear that an appropriation is for the benefit of a government related entity. In the context of the Scheme, the Court considered that it is the passenger who receives the benefit of the rebate and not TT Line. Accordingly, the Federal Court held that the payment was not a payment by a government related entity to another in the relevant sense, as the beneficiary of the payment was the passenger, with TT Line acting as a mere conduit for providing the rebate to eligible passengers. The Court also considered that if TT Line's claim that it is not liable to pay GST were accepted, there would be an anomalous result as between TT Line (as a government related entity) and another operator who is not a government related entity.

BDO COMMENT

The decision in this case provides guidance on many third party arrangements and also the circumstances under which a payment between government related entities is specifically covered by an appropriation. Taxpayers that receive government rebates or reimbursements in relation to the supply of goods or services to third parties should review the implications of this case.

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