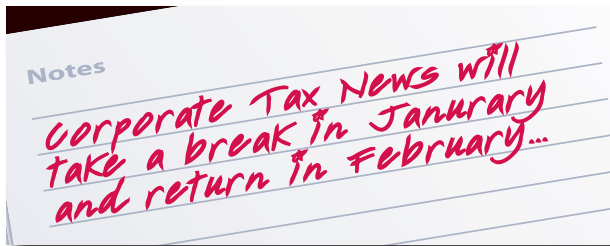




**A National Tax Publication**

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## Thin capitalisation and AIFRS

Recent editions of this Corporate Tax News have discussed the various tax issues that have arisen or could potentially arise for companies or other entities that adopt the Australian equivalent of the International Financial Reporting Standards (AIFRS). One of the more pressing issues has been the impact of AIFRS on an entity's thin capitalisation position. The adoption of AIFRS can result in the erosion of the value of a company's assets, particularly intangible assets, in its balance sheet. Alternatively, new liabilities would need to be recognised.

The thin capitalisation rules limit the interest deductions for entities that are part of an international group (whether Australian or foreign owned). The limit is achieved by restricting the debt to a factor of the gross value of the entity's assets, although the calculations are relatively complicated. Concepts of "asset" and "liability" are derived from an entity's accounts and, therefore, if the adoption of AIFRS results in the erosion of an entity's assets or the increase in its liabilities, the thin capitalisation position is made worse. *Continued over page...*

## Season's greetings

Whatever this season means to you, we trust you will enjoy the festivities. We thank you for your support and look forward to working with you again in 2007. Best wishes from your team at BDO.



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*Continued from previous page...* The Government recognises this and has therefore allowed a three-year transitional period for companies, so that they can use AGAAP. The introduction of this transitional period, and the Tax Office's guidance on how to actually apply this considering that companies do not keep AGAAP books, have been the subject of discussion in previous editions of this Corporate Tax News. One of the more important points to reiterate is that some entities are already one-third of the way through the transitional period and have not yet reviewed their thin capitalisation position.

The Government knows that the transitional period was just a stopgap measure and, therefore, in November the Treasury released a Discussion Paper on the impact of AIFRS on thin capitalisation. The Paper provides no answers. However, it did raise a number of options that might be undertaken to overcome the issue, including:

- continue the choice of AGAAP and AIFRS, for thin capitalisation purposes;
- allow a departure from accounting standards in recognition of certain liabilities and valuation of assets;
- abandon use of accounting standards for the recognition of liabilities and valuation of assets, for thin capitalisation purposes; and
- amend the thin capitalisation "arm's length test", to make it easier to apply.

The Treasury also asks for any other suggestions that might apply, and for other input as to the impact of

AIFRS on thin capitalisation. It should be noted that each of the options has its related problems and would dramatically increase the complexity of this already complex area of the law.

The Paper does not analyse any of the options in full, nor does it answer any of the questions. It is intended only to start the discussion as to what needs to be done at the end of the three-year transitional period. We can only hope that more will follow.

**BDO comment:** Even though the Discussion Paper raises more questions than answers, it does have one piece of good news for members of foreign groups – the end of the three-year transitional period does not necessarily spell thin capitalisation disaster.

The transitional period was originally announced to allow entities time to get their thin capitalisation house in order. The Discussion Paper appears to indicate that it was more a period to enable the Government to amend the thin capitalisation rules in line with the adoption of AIFRS.

However, the Paper is nothing more than a discussion of the issues. While it indicates that amendments might be made, it neither promises as such nor indicates which option would be undertaken. Therefore, entities with thin capitalisation issues should review their current position in line with AIFRS and should make contingency plans in the event that no changes are made.

## Treaties updated

The Treasurer announced that Australia has signed a revised double tax agreement with Finland. As readers would be aware, this is the latest in a list of new treaties, which began with the amendments to the US treaty. The Finnish treaty is in line with changes to that treaty and we can expect other treaties to follow.

The Treasurer has also announced that the Australia/Japan double tax agreement will be revised. Given the position of Japan as a major trading partner to Australia, such a revision is likely to have wide-reaching consequences. While it is likely that Australia will attempt to bring this treaty in line with the recently revised US and UK treaties, no details of possible revisions have been released.

## Another two directors liable

As with previous months, another two directors have been issued with a penalty notice in respect of unpaid PAYG amounts. In the case of *Deputy Commissioner of Taxation v Craddock* [2006] VSC 408, the penalty notice (made to husband and wife directors) was challenged because it was, in the opinion of the directors, "incorrect"—after the notice was issued, the Commissioner reduced his estimate of the liability. The Supreme Court gave short shrift to this argument and upheld the notice. As mentioned in previous editions of this Corporate Tax News, directors of companies should ensure that the companies pay their correct amount of tax, or they may find themselves personally liable.

## Open exchange traded options not deductible

A recent Interpretive Decision demonstrates the differences that can arise between accounting and tax treatments for financial instruments. The Decision, ATO ID 2006/313, dealt with exchange traded options, with the taxpayer asking whether it could deduct the market value of such options that were still open at year end. In the Commissioner's opinion, the taxpayer cannot deduct this market value while the option position remains open (that is, the option has not expired, exercised or otherwise closed out), as the trader does not have a presently existing obligation. This is notwithstanding that the trader had received a premium on issuing/selling the option and had already been assessed on that premium.

**BDO comment:** This appears to be a very unfair Decision, as it taxes the trader on the opening of the option but does not allow a deduction until the option is closed. Also, the Decision leads to a mismatch between tax and accounting expenses, although this is not uncommon under Australian income tax law.



Readers should be aware the Interpretive Decisions bind the Commissioner in respect of that taxpayer only. While they are useful guides as to the interpretation of the law in certain situations, they cannot be relied upon by other taxpayers.



## Director cannot claim deductions for expenses incurred for company

A recent case demonstrates that directors should ensure that any expenses incurred for their company must be reimbursed. The case was *Little and Commissioner of Taxation* [2006] AATA 949. The director (who was also the principle owner) had incurred a number of expenses, being insurance, leasing and parts for a truck, which was owned by the director but used for activities as part of the purpose of establishing and acquiring a franchise business for his company. The Tribunal held that the director could not claim the expenses in his own name as they were incurred "too soon" before his own income earning activities (the earning of dividends or a salary from the company). If the company had incurred the expenses, it could have claimed the expenses as part of its business.

**BDO comment:** Even though this case concerns a small business operator and family company, the underlying principle is relevant for all company directors. Expenditure is only deductible if it can be linked with income earning activities. Therefore, as a general rule, directors should not incur expenses that are rightfully those of the company. If they do, they should be reimbursed.

## Expatriate's receipt of ETP not exempt

The Administrative Appeals Tribunal recently held that an eligible termination payment (ETP) to an expatriate (ex-)employee was not an exempt foreign ETP. In the case of *A Tax Payer v Commissioner of Taxation* [2006] AATA 980, the expatriate had been employed by an Australian company for one year (2001-2002). However, prior to that time, the expatriate had been employed by that company's UK holding company, both in Australia (since 1997) and in the UK (for the seven years prior). In substance, therefore, her substantial ETP was not for her service to the Australian company, but rather for her service to the UK holding company. She argued that this should be exempt under special provisions relating to foreign ETPs. The Tribunal did not agree and the ETP was taxed in Australia.

**BDO comment:** This case demonstrates the issues that can arise in respect of expatriate employees, and the issues that can apply when payments are



not correctly identified nor made correctly. The taxpayer argued that she received two discrete payments for two separate service periods. However, the paying company treated the payments as a single composite amount. There are a number of concessions available to expatriate employees but they are technical in nature and correct procedures and formats need to be followed.

As an aside, readers should note that it would likely not have been taxed at marginal rates, but would have been taxed under more concessionary ETP rules.

## Appeal update



The July edition of this Corporate Tax News discussed the case of *Guss v DCT* [2006] FCAFC 88, which concerned whether the decision to issue a director's penalty notice was "reviewable" by the Federal Court under Australia's administrative law provisions.

The Court held that it was not and the director lodged an application for special leave to appeal to the High Court. Unfortunately, special leave was refused and the penalty notice now stands.

## Demerger Determination finalised

In November the Commissioner issued Taxation Determination TD 2006/73, which was a finalisation of draft Determination TD 2006/D19, and deals with the method for apportioning cost bases between original and replacement interests after a demerger.

The draft Determination was discussed in the July edition of this Corporate Tax News. Thankfully, the Commissioner accepts that there is more than one method of apportionment in this regard, mentioning both a "relative market value" approach and a "parcel by parcel" approach. This allows some small degree of flexibility for taxpayers.



## Consolidation releases

In November, the Commissioner issued draft Taxation Ruling TR 2006/D12, which deals with consolidation and errors in “cost setting amounts” of “reset cost base assets” (broadly, any asset except for monetary or financial assets). Under the consolidation rules, errors are accepted but a resulting deemed capital gain or loss is applied to the head entity of the consolidated group. The Ruling discusses when this will occur or when, as an alternative, the Commissioner considers that recalculations need to be made. A number of examples are provided in the Ruling.

The Commissioner also issued in November (but with effect from 1 July 2002, when the consolidation regime first became effective), Practice Statement Law Administration PS LA 2006/15, which deals with the consolidation regime and the administration of various administrative penalties. Like all Practice Statements, this one is a guide for Tax Office staff as to how to apply various penalty regimes. It discusses the application of the penalties when a member of consolidated group has an income tax assessment amended because of an action of the head entity, such as the head entity lodging the approved form showing a choice to consolidate, after the date that the member must lodge its income tax return.

In addition, the Commissioner issued a number of Tax Determinations in relation to consolidations, being:

- Taxation Determination TD 2006/74: membership: where a consolidatable group comes into existence at some time during a day can the head company make a choice under section 703-50 of the *Income Tax Assessment Act 1997* specifying that day as the day on and after which the consolidatable group is taken to be consolidated? (previously issued as TD 2006/D37)
- Taxation Determination TD 2006/75: can the transfer of a tax loss under section 707-120 of

the *Income Tax Assessment Act 1997*, to the extent that it could have been utilised by the transferor in the trial year under section 165-20 of that Act, constitute a COT transfer? (previously issued as TD 2006/D37)

- Taxation Determination TD 2006/76: can a tax loss, transferred under section 707-120 of the *Income Tax Assessment Act 1997* to the extent that it could have been utilised by the transferor in the trial year under section 165-20 of that Act, satisfy the condition described in paragraph 707-350(1)(c) of the *Income Tax (Transitional Provisions) Act 1997*? (previously issued as TD 2006/D38)
- Draft Taxation Determination TD 2006/D39: if a member of a consolidated group is reinstated under section 601AH of the *Corporations Act 2001* after having been deregistered, will it be taken to have continued to satisfy the membership requirements in section 703-15 of the *Income Tax Assessment Act 1997* during the period between deregistration and reinstatement?
- Draft Taxation Determination TD 2006/D45: is the ‘applicable functional currency’ for the head company of a consolidated group determined by looking at the ‘accounts’ of all the members of the consolidated group, for the purposes of item 1 of subsection 960-60(1) of the *Income Tax Assessment Act 1997*?

As mentioned in previous issues of this Corporate Tax News, the exact details of the Rulings, Statements and Determinations are only relevant for tax managers and tax advisers who are responsible for a corporate group’s consolidation position. For other readers, the message is that the consolidation regime is very technical and there are still a large number of changes, clarifications and interpretations that will be issued in relation to it.

## Interpretive Decisions on withholding tax and PEs

In November, the Commissioner issued a number of Interpretive Decisions relating to royalty withholding tax and to "substantial equipment" and other permanent establishments (PE's).

The royalty withholding tax Decisions were:

- ATO ID 2006/305, which states that a resident agent receiving a royalty on behalf of a non-resident licensor is required to deduct withholding taxes from remittances of the royalty.
- ATO ID 2006/307, which agrees that payments for the exclusive right to use a broadcasting licence and an apparatus licence are not "royalties" under Australia's domestic tax law.
- ATO ID 2006/308, which agrees that payments for the exclusive right to use a broadcasting licence and an apparatus licence are not "royalties" under the UK/Australia double tax agreement.

The PE Decisions were:

- ATO ID 2006/306, which confirms that use of substantial equipment by a Swiss resident in Australia is a deemed PE under the Swiss/Australia double tax agreement.
- ATO ID 2006/309, which follows on from 307 and 308, above, and agrees that a UK licensor of a broadcasting licence and an apparatus licence,



does not have a PE in Australia for the purposes of the UK/Australia double tax agreement.

- ATO ID 2006/314, which considers that a helicopter leased by a Norwegian resident and used in Australia will give rise to a deemed PE under the Norway/Australia double tax agreement.

**BDO comment:** The two "substantial equipment PE" Decisions are worrying, as they demonstrate that the Tax Office is focussing on non-residents that have equipment in Australia in attempting to widen and Australian tax net. This follows from the decision of *McDermott Industries (Aust) Pty Limited v Commissioner of Taxation* [2005] FCAFC 67, which had held that a ship charterer had a PE in Australia by virtue of the ship being in Australia. However, ATO ID 2006/314, which goes so far as to say that a helicopter is substantial equipment, may be broadening the tax net a little too far.

Readers should be aware the Interpretive Decisions bind the Commissioner in respect of that taxpayer only. While they are useful guides as to the interpretation of the law in certain situations, they cannot be relied upon by other taxpayers.

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