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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 corporate and international clients are changes to dividend tainting rules, to thin capitalisation, to interest withholding tax rules, and in relation to trust distributions to non-residents.

Under the current "tainting" rules, a share capital account is tainted if certain amounts are transferred into the share capital account that do not reflect share capital (such as profits or unrealised gains). If this occurs, the account is not treated as share capital for the purposes of the tax law. It is very costly to untaint a share capital account, as "untainting" tax must be paid. Under Australian Equivalents of International Financial Report Standards (AIFRS), it is actually quite easy to inadvertently taint a share capital account. On the other hand, it may be possible to exploit a tainted share capital account by franking payments that represent returns of share capital. The Bill, therefore, repeals the tainting rules, ensuring that any amount paid out of a share capital account will be unfrankable. On the flipside, the anti-avoidance rules relating to dividend stripping arrangements have been broadened to ensure that the Commissioner will look at the source of profits to see whether a dividend stripping arrangement has been entered into.

The thin capitalisation changes are simple. They extend the transitional rules relating to a thin capitalisation calculation from three years to four years. The

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transitional rules allow companies to use Australian Generally Accepted Accounting Principles, rather than AIFRS, when calculating their thin capitalisation position.

The changes to the interest withholding tax rules were originally contained in *Tax Laws Amendment (2006 Measures No 7) Bill 2006* but, as mentioned in previous editions of this Corporate Tax News, were repealed in March. The changes amend an exemption to the withholding tax rules that relates to widely issued debentures and some other securities, ensuring that non-debentures would only qualify for the exemption if they are not equity interests and if they are part of syndicated loan arrangements.

There are two changes in relation to trust distributions made to non-residents. The first closes a loophole in relation to non-resident beneficiaries
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that are themselves trusts; it enables the Australian trustee to be taxed on such income (like other beneficiaries). The second expands the PAYG withholding system so that trustees of managed investment schemes must withhold 30% of distributions to non-residents.

This is actually good news for trustees of managed investment schemes as, without this collection mechanism, the trustee itself would be personally liable for the tax.

Comment: Many of the proposed changes were previously announced and, therefore, should not come as a huge surprise to readers. Of particular interest is the extension of the thin capitalisation transitional provisions from three to four years. This is helpful to entities that have not yet been able to restructure their finances to ensure that they comply with the thin capitalisation limits under AIFRS. However, such entities should not become complacent, as they only have one extra year to bring their financing structures into line with the thin capitalisation rules.



Director uses corporate law to avoid tax penalty

Previous editions of this Corporate Tax News have focussed on the directors that have been held liable for the tax obligations of their companies. There was another such case in May, *Paola v Deputy Commissioner of Taxation* [2007] NSWCA 108, where directors' penalty tax liability was confirmed.

However, there was another case that has only recently been reported, *Deputy Commissioner of Taxation v Dick* [2006] NSWDC 17, where the director utilised an unusual defence to avoid the liability. In that case, the defendant was the director of a football club that had failed to remit its PAYG that it had withheld from salaries and wages. Amongst other things, the director sought to apply a defence in subsection 1318(1) of the *Corporations Act* 1936, which states that "in any civil proceeding against

a person" in their capacity as director, where the person both acted honestly and, the court considers that "the person ought fairly to be excused", then the court may relieve the person from the liability. The NSW District Court applied this defence to remove the tax penalty imposed on the director.

Comment: The case of *Dick* is one of the few cases where a penalty imposed on a director in relation to unpaid tax of the company has been set aside. It is not a recent case, but has recently come to light and been discussed by various commentators. Before all directors can break out the champagne, it should be kept in mind that this case was before the District Court and could easily be overturned or ignored by the Supreme Courts or the Federal Court.

Redundancy to director was bona fide

In a case handed down recently, *Long and Commissioner of Taxation* [2007] AATA 1269, the Administrative Appeals Tribunal held that a redundancy payment made to a director of a business was bona fide. As most readers would be aware, bona fide redundancy payments are tax-free. The taxpayer in this instance was a director of a corporate trustee that operated a pay-TV installation business. Her husband and son were co-directors. Following the loss of a key contract, the corporate trustee terminated her employment and paid her redundancy. As she was involved in the decision to make herself redundant, it was not surprising that the Tax Office objected. However, the Tribunal found that the decision to make her

redundant was made in good faith, as it resulted from the loss of the customer contract.

Comment: This case is good news for directors facing termination of their employment. If the Tax Office had been successful, where any director that is involved in the decision-making process that leads to that director's redundancy, the payment would not be tax-free. This is very harsh, particularly as most such redundancies are made for reasons that are outside the control of either the director or the company, such as in this case where there was the loss of a key contract. However, it is likely that the Tax Office will appeal this case to the courts.

Appeals update

The July 2006 edition of this Corporate Tax News mentioned the case of *Experienced Tours and Commissioner of Taxation* [2006] AATA 517. In that case, the taxpayer company had issued shares to its employees and, as a consequence, had credited a share premium account. The Administrative Appeals Tribunal had held that the amount credited was both a fringe benefit and was deductible. Both the taxpayer and the Commissioner have dropped their appeals to the Federal Court, and the Commissioner has issued a Decision Impact Statement, saying that he may seek to clarify this area of the law in future in another case.

The February edition of this Corporate Tax News discussed the case of *Deputy Commissioner of Taxation v Bluebottle UK Ltd* [2006] NSWCA 360, where the Court of Appeal overturned the decision of Justice Gzell of the Supreme Court of NSW. As readers would recall, the court action related to two shareholders of Virgin Blue, both of which were Swiss companies, and which have unpaid taxes. They had assigned the rights to receive their dividends to Bluebottle. The Commissioner sought to recover the unpaid taxes by forcing Virgin Blue to pay the dividends to the Tax Office and the Court of Appeal allowed this decision. The taxpayer has been granted special leave to appeal to the High Court.

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.

Commissioner wins transfer pricing privilege case

The July 2006 edition of this Corporate Tax News discussed the Administrative Appeals Tribunal case of *The Mining Holding Company and Commissioner of Taxation* [2006] AATA 491. While this was a transfer pricing case involving a potential adjustment resulting in an approximate \$173 million tax bill, the case actually concerned the application of the freedom of information legislation. The appeal from this case, *Commissioner of Taxation v Devereaux Holdings Pty Limited* [2007] FCA 821, was handed down recently.

As with all transfer pricing cases, much depended on the information available to the Tax Office and the taxpayer. The taxpayer therefore sought access to a large number of Tax Office documents. When the Tax Office sought to withhold access to some documents, the taxpayer appealed to the Administrative Appeals Tribunal. The Tribunal held that access could not be denied. In particular, where the Tax Office claimed legal professional privilege, the Tribunal held that, as some versions of the documents had already been (inadvertently) released to the taxpayer, the Tax Office had waived any privilege.

The Federal Court has overturned this decision, holding that the documents were subject to legal professional privilege and denying the taxpayer access to the documents.

Comment: As mentioned when discussing the original decision, even though the transfer pricing rules have been around for two decades, there has been little judicial consideration of them. The cases that have come to light deal with such issues as “bad faith” by the Commissioner, or comments such as legal professional privilege, without looking at such meaty issues as what is ‘arm’s length’ and what are the appropriate methodologies.

Notwithstanding this general comment, it is very important for taxpayers to understand how the Tax Office arrives at a set arm’s length price. In particular, as the burden of proof is on the taxpayer, it is imperative that the taxpayer knows the information at the Tax Office’s disposal and understands all the calculations. One would hope, therefore, that the taxpayer appeals against this decision and is allowed access to these Tax Office documents.

Consolidation released

In May there were a handful of Tax Determinations issued in May dealing with consolidations. They were all finalisations of previously issued draft Determinations.

The Determinations are:

- Tax Determination TD 2007/12, which deals with a subsidiary in liquidation and unsatisfied liabilities owed by such subsidiaries to members of the consolidated group (previously issued as TD 2006/D41);
- Tax Determination TD 2007/13, which deals with deemed capital gains in relation to deregistered subsidiaries (previously issued as TD 2006/D42);
- Tax Determination TD 2007/15, which deals with subsidiaries that are deregistered and reinstated, and whether they remain in the

consolidated group (previously issued as Draft TD 2006/D39); and

- Tax Determination TD 2007/18, which deals with what is a “revenue asset” for the purpose of resetting the cost bases of such assets (previously issued as Draft TD 2006/D46).

As mentioned in previous editions of this Corporate Tax News, it is unnecessary for most readers to be abreast of all the technical nuances of these Determinations. What is useful for readers is that there are still a number of releases being issued (although the number has decreased dramatically over the last twelve months) indicating the complexity of the consolidation regime, which still creates difficulties for taxpayers, tax practitioners and the Tax Office



Deductions denied for mining and exploration expenses

In five recent cases, all called “*The Taxpayer*” v *Commissioner of Taxation*, and reported at [2007] AATA 1277-1281, the Administrative Appeals Tribunal held that the taxpayers were not entitled to deductions

for prepaid interest and management fees of over \$250,000 in connection with an exploration and mining project. The project involved the exploitation of mining tenements. The project fell down at the first hurdle, as the Tribunal considered that the expenditure was capital in nature and did not fall under the special provisions relating to “exploration and mining” expenditure. Rather, it was aimed at deriving a profit from the sale of the tenements.

The expenditure would have fallen down at later hurdles as well, as the Tribunal also found that the expenditure was incurred prior to acquiring the tenements (breaking the nexus to the income producing activities), that it involved foreign tenements and would have been quarantined under the foreign loss rules, and that it was likely to be an anti-avoidance scheme which would have been struck down by the general anti-avoidance rules.

Comment: The Tax Office has been leading a charge against tax avoidance schemes and it is therefore unsurprising that this project was attacked, as it had the usual trappings of a tax avoidance scheme such as prepaid interest and management fees. What is unusual in this instance is that the Tax Office did not need to rely on the general anti-avoidance rules, as the expenditure was not deductible under general principles. Any readers in the mining exploration and development industry should ensure that all of their expenditure items are reviewed by a tax expert, to ensure that a deduction can be claimed.

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