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Tax Update

Welcome to …

… the March 2007 edition of the Tax Update. Having regard to the developments that have taken place since our last Tax Update, there is every indication that 2007 is shaping up to be another challenging and exciting year.

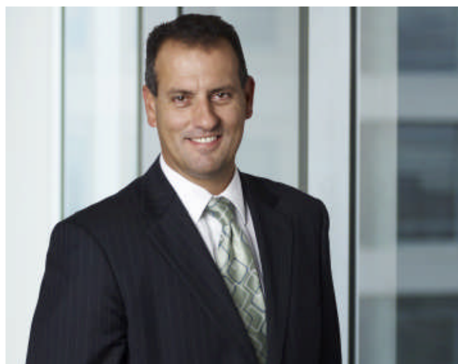
In this Update, we set out some of the more interesting recent developments in the world of tax, including taxation determinations, decisions from the Courts and legislative developments. As always, if you have any queries or concerns about anything to do with tax or superannuation, please do not hesitate to call our Tax team.

Private companies: Division 7A to be amended and section 108 to be abolished

On 6 December 2006, the Assistant Treasurer, Peter Dutton MP, announced that the Government will amend Division 7A of the *Income Tax Assessment Act* 1936 ("**the ITAA 1936**") to remove the automatic debiting of a company's franking account when a deemed dividend arises. However, deemed dividends will continue to be treated as unfranked dividends and assessable income in the hands of shareholders or their associates.

Currently, when a deemed dividend arises under Division 7A, the private company's franking account is debited and the deemed dividend is assessable as an unfranked dividend in the hands of the shareholder or associate, but without access to a franking credit to offset the tax paid by the company. In explaining the rationale for the change, Mr Dutton said "this double penalty is not in proportion to the potential tax mischief involved".

The Commissioner of Taxation will also be provided with a discretion to disregard a deemed dividend where there is evidence that a taxpayer has attempted to comply with Division 7A but they have made an honest mistake and efforts have been made to rectify the mistake. "This new discretion will allow the Commissioner to appropriately handle taxpayers that have unintentionally breached Division 7A, but where there was no tax mischief involved", Mr Dutton said.



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Inside

Private companies: Division 7A to be amended and section 108 to be abolished Pg 1 – 2

Tax Bill (No 7) introduced, includes major CGT small business amendments Pg 2

Recent cases Pg 3
Raftland Pty Ltd v FCT [2007] FCAFC 4
McNally v FCT [2007] FCA 51
Keycorp Limited v FCT [2007] FCA 41

Consolidation: transfer of losses Pg 4

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Division 7A to be amended Continued

The purpose of Division 7A is to prevent private companies from making tax-free distributions of profits to shareholders (or their associates). Unless they come within specified exclusions, advances, loans and other credits to shareholders (or their associates) are treated as assessable dividends to the extent that there are realised or unrealised profits in the company.

There are other changes to be made, including the following:

- changes to the fringe benefits tax (FBT) laws to simplify their interaction with Division 7A. Mr Dutton said that these changes will reduce the extent to which taxpayers can be inadvertently caught by Division 7A in the first place; and
- the Government will also repeal section 108 of the ITAA 1936 (the precursor to Division 7A) "as it is a duplicate provision that is no longer necessary".

The changes generally have effect from 1 July 2006. However, the discretion will apply from 1 July 2002 and the FBT amendments from 1 April 2007.

The Government expects to introduce the changes into Parliament in the Autumn 2007 sittings, following consultation with the accounting profession and other key stakeholders.

Tax Bill (No 7) introduced, includes major CGT small business amendments

The Tax Laws Amendment (2006 Measures No 7) Bill 2006 ("the Bill") was introduced into the House of Representatives on 7 December 2006. The Bill was passed by the House of Representatives without amendment on 7 February 2007. The Bill was introduced into the Senate on 7 February 2007 and awaits debate.

The Bill contains the following amendments:

- Small business CGT provisions – amending the *ITAA* 1997, the *ITAA* 1936 and the *Income Tax (Transitional Provisions) Act* 1997 to make a wide range of changes regarding the small business CGT concessions, including the following:

replaces the controlling individual 50% test with a significant individual 20% test that can be satisfied either directly or indirectly through one or more interposed entities

changes the maximum net asset value test to $6 million and by allowing provisions for annual leave, long service leave, unearned income and tax liabilities, as well as a negative asset value of a connected entity, to be taken into account

allowing the taxpayer to choose whether to roll-over the whole or part of a capital gain

giving deceased estates access to the CGT concessions on assets disposed of within two years of death, to the same extent that the taxpayer could have enjoyed those concessions before death; and

introducing an alternative to direct ownership where the capital gains tax event happens to a share in a company or interest in a trust.

- Interest Withholding Tax exemption changes

The amendments to the interest withholding tax (IWT) provisions of the tax law are being made to restore the original purpose of the 2005 IWT amendments and eliminate a risk to tax system integrity.

Without the amendments, interest on a range of debt interests that are not debentures and not contemplated as eligible for exemption by Government, could possibly be able to claim eligibility for IWT exemption.

- Capital protected borrowings

This measure will ensure that, from 1 July 2007 where the expense on a capital protected borrowing exceeds the Reserve Bank of Australia's personal unsecured loan variable interest rate, part of the expense will be attributed to the cost of the capital protection feature.

The amount of the excess is treated as not being interest but as the cost of the capital protection feature. That amount will not be deductible where this cost is capital in nature.

- Changes for deductible gift recipients

The amendments will give effect to the Government's announcement in the 2006/2007 Budget that it will enhance philanthropy by streamlining the deductible gift recipient ("DGR") integrity arrangements and reduce compliance requirements of DGRs.

The reduction in compliance costs is achieved through removing the gift fund requirement for certain DGRs and allowing the consolidation of multiple gift funds for others.

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Recent cases

Raftland Pty Ltd v FCT [2007] FCAFC 4

This case considers whether the "trust reimbursement provisions" set out in section 100A of the *ITAA* 1936 apply to distributions to trusts appointed as beneficiaries because of their accumulated tax losses, and who is to be assessed on the income.

In this case (which was decided on 31 January 2007), the Full Federal Court (Dowsett, Conti and Edmonds JJ) has dismissed the taxpayer's appeal from the decision of Keifel J. Keifel J held that the appointment of a loss trust controlled by Harts Accountants as a beneficiary of the Raftland trust and the purported distributions of trust income by the trustee of the Raftland trust to the trustee of the loss trust were a sham, such that the trustee of the Raftland trust held the trust income upon trust for the default beneficiaries nominated under the Raftland trust. However, her Honour further held that s 100A applied to deem the default beneficiaries not to be presently entitled for tax purposes, with the consequence that the trustee of the Raftland trust was to be assessed on the trust income pursuant to section 99A.

In dismissing the appeal, the Full Federal Court disagreed with Keifel J's view that the appointment of the loss trust was a sham. On this basis, it was the trustee of the loss trust that was presently entitled to the income purportedly distributed by the trustee of the Raftland trust. Nevertheless, the Full Federal Court took the view that the trust reimbursement provisions set out in section 100A continued to apply and, in particular, that the terms of section 100A(3A) did not prevent this conclusion. Specifically, because of the carry forward trust losses in the loss trust, no beneficiary of the loss trust was presently entitled to any of the income purportedly distributed by the Raftland trust.

McNally v FCT [2007] FCA 51

This case considers whether an adjustment for the "timing difference" caused by unbilled work-in-progress should be assessable to a partner in a partnership under section 92 of the ITAA 1936 where the partner leaves before the end of the income year.

Section 92(1) provides that "the assessable income of a partner in a partnership shall include: (a) so much of the individual interest of the partner in the net income of the partnership of the year of income as is attributable to a period when the partner was a resident".

In this case (which was decided on 2 February 2007), the Federal Court (Jessup J) has held that the AAT erred in law in concluding that the assessable income of a departing partner included accounting "timing differences" referable to work in progress. However, the Court was not prepared to say that no part of the "timing differences" should have been included; rather, it remitted the matter to the AAT for determination in accordance with the Court's reasons. Similarly, in upholding the Commissioner's cross appeal, the Court held that the AAT had erred in law in holding that an amount of $500,000 received by the departing partner from the partnership was an undissected lump sum and thus not assessable. This matter was also remitted to the AAT for determination in accordance with law. The Court said that the question in relation to both amounts (the timing differences amount and the amount of $500,000) was how much was included in assessable income pursuant to section 92 of the ITAA 1936.

Keycorp Limited v FCT [2007] FCA 41

This case considers the application of the provisions which enable the transfer of losses between group companies under Division 170 of the *ITAA* 1997, and in particular whether section 170-10 is wide enough to encompass any calculated part of a tax loss, including a part incurred in a more limited time period than the whole income year.

Section 170-10 of the *ITAA* 1997 provides as follows:

(1) A company (the "loss company") can transfer an amount of its tax loss for an income year (the "loss year") to another company (the "income company") if the conditions in this Subdivision are met.

(2) The amount transferred can be the whole or part of the tax loss.

In this case (which was decided on 7 February 2007), the Federal Court (Allsop J) has held that when section 170-10 ITAA 1997 refers to "part of the tax loss", it is not referring to part of a tax loss that is referable to part of an income year. The Court said, at paragraph 88:

"Section 170-10 deals with concepts that are referable to, and take their meaning from, a whole income year. The phrase "tax loss", through section 995-1, is understood by reference to section 36-10. That provision takes one to all deductions "for an income year". This is, with some irrelevant qualifications, a financial year that is a period of 12 months beginning on 1 July."

As a result, the taxpayer was prevented from transferring a loss that was incurred in that part of an income year that followed a disqualifying change of ownership.

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Consolidation: transfer of losses

Taxation Determinations **TD 2006/75** and **TD 2006/76**, both released on 6 December 2006, deal with losses transferred from a joining entity to the head company of a consolidated group under section 707-120 of the *ITAA* 1997, due to the transferor satisfying the tests contained in section 165-20 of the *ITAA* 1997.

In **TD 2006/75**, the principal issue was whether a transfer of loss due to the operation of section 165-20 was a COT loss as defined below.

A COT (continuity of ownership test) loss is defined in section 707-210 of the *ITAA* 1997, and one of the conditions is that the transferor must satisfy section 165-12 of the ITAA 1997 (refer section 707-210(1A)(a)). Consequently, where the transferor does not meet the conditions in section 165-12 but the loss is transferred based on satisfying the tests contained in section 165-20, the loss cannot be a COT loss as defined in section 707-210.

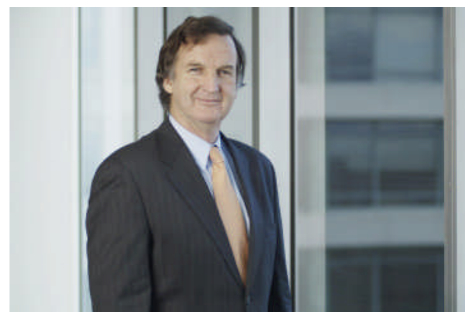
This TD originally issued as Draft TD 2006/D37 and is unchanged from the earlier draft.

In **TD 2006/76**, the principal issue was whether a loss can be written off over 3 years.

The transfer of a tax loss under section 707-120, where it could have been utilized by the transferor in the trial year under section 165-20, does not result from the real loss maker satisfying the conditions in section 165-12. Since section 707-350 of the Income Tax (Transitional Provisions) Act 1997 only applies where the real loss maker satisfies the conditions in section 165-12, it cannot apply to the loss, which means that it cannot be written off over 3 years. Consequently, the loss must be written off using the available fraction method.

This TD originally issued as Draft TD 2006/D38 and is substantially the same as the earlier draft. The only addition is the inclusion of an alternate view (as an appendix to the TD), which argues that there may be circumstances where the loss can be written off over 3 years. The transferred loss can meet the condition in section 707-350(1)(c) if the real loss maker meets the conditions in section 165-12 in respect of the part of the loss year examined under section 165-20. However, the Tax Office does not accept this view.

Further info



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