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Tax Update

06

Welcome to …

… the November 2006 edition of the Tax Update. Despite being so close to Christmas, there is no let-up of material being released from the ATO as rulings or interpretative decisions and decisions from the Courts and Tribunal.

In this update, we set out some more interesting things we have seen recently and wish to share with you. 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.

Amendments to CGT treatment of testamentary trusts

Peter Dutton, the Minister for Revenue and Assistant Treasurer, announced on 17 October 2006 that the Government would amend the income tax legislation that applies to certain trusts created under a Will (i.e. testamentary trusts). The amendments will improve the taxation treatment of income beneficiaries in testamentary trusts, such as life tenants. They will also allow the trustee of a testamentary trust to choose to be assessed on some part or all of an amount of net capital gain that is included in the net income of the trust where:

- that part or all of the net capital gain would be assessed to a presently entitled income beneficiary of the trust; and
- that beneficiary is not entitled under the terms of the trust to benefit from the gain.

The Minister said that these amendments will ensure that an income beneficiary is not assessed in respect of trust capital gains from which they will not benefit.

Allowing the trustee to make the choice on a beneficiary-by-beneficiary basis will ensure the trustee is not assessed on part of the capital gain in circumstances where no tax would have been paid on the gain by the income beneficiary, for instance where the income beneficiary is an exempt entity or a foreign resident.

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CGT treatment of testamentary trusts

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Legislation giving effect to this announcement will be introduced as soon as practicable, following consultation with industry on the design and the implementation of the amendments. The amendments will apply to the 2005/2006 and later income years.

Income tax &volunteer foster carers

In Taxation Determination TD 2006/62, the issue was whether payments to a volunteer foster carer to provide foster care are assessable income.

In this Determination, it was held that such payments (which are discussed further below) are not assessable income.

The basis for this decision can be summarized as follows. Payments to a volunteer foster carer will be assessable income if they are income according to ordinary concepts (ordinary income) under section 6-5 of the *Income Tax Assessment Act 1997* ("ITAA 1997") or statutory income under section 6-10 of the ITAA 1997.

In determining if an amount is income according to ordinary concepts, consideration must be given to whether the amount is the product of any income producing activity. Such an activity could include employment, carrying on a business or rendering services.

The volunteer foster carers covered by this Determination are not employees, are not carrying on a business and are not paid any amount for their time or to reward them for any personal services they provide. The payments therefore do not have the character of income according to ordinary concepts.

The Note to sub-section 6-10(1) of the ITAA 1997 refers to the summary list in section 10-5 of the ITAA 1997 of particular types of assessable income. Allowances and benefits in relation to employment or rendering services are included in this list, and reference is made to paragraph 26(e) of the ITAA 1936.

The payments to volunteer foster carers covered by this Determination are made in order to help meet the expenses associated with caring for foster children, and not as a reward or recompense for any employment or rendering of services by the carer.

As such, the payments do not have a sufficiently proximate connection with any employment or services rendered to be considered to be a product or consequence of such activities. Accordingly, the payments cannot be said to have been provided in respect of, or for or in relation to, such activities and are not assessable income under paragraph 26(e) of the ITAA 1936.

Consolidation Determinations

There have been several recent Taxation Determinations in relation to consolidation. Following is a summary of these Determinations, which were released on 27 September 2006.

TD 2006/58 states that upon deregistration, a subsidiary company ceases to satisfy the requirements for subsidiary membership of a consolidated group. Consequently, a subsidiary company that is deregistered will be treated as a "leaving entity" for the purposes of applying Division 711 of the ITAA 1997.

This determination also refers to section 701-15 of the ITAA 1997, pursuant to which the tax cost of each membership interest in an entity that ceases to be a subsidiary member of the consolidated group is set just before the cessation time at the interest's tax cost setting amount ("TCSA"). A TCSA for membership interests will be calculated under Division 711 when a company is deregistered and thereby ceases to be a subsidiary member of a consolidated group.

TD 2006/59 states that the unsatisfied debts of a subsidiary company at the time of deregistration are accounting liabilities under section 711-45(1) of the ITAA 1997. This is because, in accordance with accounting standards and statements of accounting concepts made by the Australian Accounting Standards Board ("AASB"), they are liabilities of the subsidiary at the leaving time that can or must be identified in the subsidiary's statement of financial position under section 711-45(1) of the ITAA 1997.

The relevant accounting standards and accounting concepts state that the legal extinguishment of an obligation is necessary before it is no longer recognized as a liability for accounting purposes. On a winding up, the Tax Office view is that the debts of the entity are not extinguished. Accordingly, any unsatisfied debts of a subsidiary just before deregistration are recognized as accounting liabilities that should be identified in the subsidiary's statement of accounting position under section 711-45(1).

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Consolidation Determinations

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Finally, **TD 2006/60** states that a deferred tax liability can only be treated as a liability of a joining entity at the joining time under section 705-70(1) of the ITAA 1997 where AASB 1020 (AAS) was adopted for the recognition and measurement of the liability for financial reporting purposes in the period during which the joining time occurs.

Under consolidation, the joining time is treated as a reporting date. All accounting standards that are applicable as at that date will then be applied to the recognition and measurement of liabilities at that time for the purposes of applying section 705-70 of the ITAA 1997.

This Determination states that a reporting entity can only early adopt AASB 1020 or AAS3 if the directors of the entity have elected to early adopt that standard for financial reporting purposes for the reporting period within which the joining time occurs. The Tax Office rejects the view that section 705-70 provides joining entities with a choice of what accounting standard can be used to calculate the value of liabilities at the joining time.

Recent cases

W R Carpenter Holdings Pty Ltd v FCT [2006] FCA 1252

In the above case (which was decided on 20 September 2006), the Federal Court (Lindgren J) has refused the taxpayer's application for particulars of the matters taken into account by the Commissioner in making 3 determinations under ss 136AD(1), 136AD(2) and 136AD(4) of ITAA 1936, against which the taxpayer had objected and appealed.

In his introductory remarks, his Honour noted: "...the Commissioner relies on the fact that he made the various determinations, copies of which he has provided to the Taxpayers. Section 136AD does not make the antecedent procedure of the making of the determinations an element of liability to tax: it makes only the actual making of them an element of that liability, and, accordingly, the Commissioner relies only on the fact, not the process, of the making of them.

The question is whether the Commissioner must provide particulars, not of something on which he relies, but with a view to equipping the Taxpayers with information on the basis of which they may be able to bring down the determinations and thereby establish that the assessments are excessive. This would be an unusual role for particulars, akin to discovery or interrogatories in relation to an issue raised by the party seeking such procedural aid. (It is asserted by the Commissioner in submissions that the Taxpayers have, in substance, already had discovery of the documents that were before the Commissioner, pursuant to the *Freedom of Information Act* 1982 (Cth).)"

After examining all the authorities, his Honour concluded: "The first reason why the Commissioner should not be required to supply the particulars sought relates to the Commissioner's primary and more general submission. I hold, in accordance with Peabody, Sleight and Syngenta, that the Commissioner should not be required to supply the particulars sought because, under the statutory provisions mentioned, it is not open to the Taxpayers to make the Commissioner's state of mind and reasoning processes leading to the making of the determinations under s 136AD an issue in the appeals."

His Honour further concluded: "The second reason why the Commissioner should not be required to supply the particulars sought is that he has not asserted, and does not propose to assert, a positive case as to his state of mind or reasoning processes, of which, in accordance with the general principles governing the supply of particulars, particularisation might be appropriate (cf George, (Kitto J), discussed at [46] above). In the light of ss 136AD and 177(1) of the ITAA [1936] and 14ZZO of the [Taxation Administration Act], the Commissioner is entitled not to assert any particular state of mind or reasoning process, and simply to rely on his assessment."

More info

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First case on GST anti-avoidance provisions

The Administrative Appeals Tribunal (AAT) has handed down its findings in the first reported case on the operation of the GST anti-avoidance provisions (Div 165 of the GST Act). It has affirmed the Commissioner's decision to disallow input tax credits amounting to $70,000 claimed by the taxpayer in its April 2003 BAS, on the basis that Div 165 of the GST Act applied to the transaction. The AAT also upheld the penalty imposed of $35,000: AAT Case [2006] AATA 821, VCE and FCT (AAT Ref VT2005/192, Forgie DP, 26 September 2006, to be reported in ATR).

Background

The taxpayer company, known only as VCE, acquired a rental property from its sole director for $770,000 in April 2003. The purchase price was to be paid in instalments, with a deposit of $550 payable up front and the bulk of the purchase price due on 30 June 2018. Legal ownership of the property was to pass on the payment of the final instalment in 2018. The taxpayer lodged its first BAS for the April 2003 tax period showing capital purchases of $770,000 and the entitlement to an input tax credit of $70,000. The Commissioner made a declaration in November 2004 under s 165-40 that the taxpayer's net amount for the April 2003 tax period was nil, cancelling the input tax credit claimed. A penalty of $35,000 was also imposed.

Decision

The AAT concluded that Div 165 did apply and that there was a scheme for the purposes of s 165-10 and the sole or dominant purpose of the taxpayer or the vendor in entering into the scheme was to enable the taxpayer to obtain a GST benefit.

The consequence of the scheme was that GST became attributable to the April tax period. As the vendor accounted on a cash basis he only became liable to the GST on the $550 he actually received in that tax period. However, the taxpayer became entitled to claim an input tax credit for the full amount of the consideration payable. In other words, payment of the bulk of the GST liability was deferred for 15 years but was immediately refundable. The benefit to the taxpayer only came about because of the terms of the agreement between the parties.

In the absence of Australian authorities on Div 165 of the *GST Act*, the AAT referred extensively to cases on Pt IVA of the ITAA 1936, finding that the principles contained in the two provisions were very similar. The Tribunal concluded that "even if a person were not familiar with Part IVA of the *ITA Act*, it is apparent from the scheme of the *GST Act* that there is meant to be some degree of conformity between the GST that is paid on a taxable supply and the input tax credit on that taxable supply."

The taxpayer VCE is now appealing this decision to the Federal Court of Australia. (Rigby Cooke Lawyers acted for the taxpayer at first instance and is also acting in the appeal.)

Debonne Holdings Pty Ltd v FCT

In the above case (decided on 19 October 2006) the Administrative Appeals Tribunal held that a purchaser of a hotel business under two separate contracts, one relating to land and improvements and the other relating to the business including goodwill, plant, fixtures, fittings and stock, was not entitled to claim input credits in respect of the purchase of the land and improvements, because of the "going concern" provisions in the *GST Act*.

Downes J held that "the relevant going concern was the total subject matter of both contracts, because the business or enterprise of a hotel cannot be conducted without land from which to conduct it." This was despite the fact that the parties had only agreed in the contract for the purchase of the business that the sale of the business was the sale of a going concern. In contrast, the other contract stated only that "the Purchase Price does not include GST".

His Honour rejected the purchaser's argument that there were two contracts which, although providing for simultaneous settlement, were separate, and that the provision in the business sale contract operated only with respect to the subject-matter of that contract and accordingly excluded the land sale, entitling it to claim input tax credits in respect of the purchase of the land.

His Honour said: "The present enterprise is the business of the hotel. It is attached to land. The parties intended that the supply would be of the business carried on where it was conducted at the time of the sale. The [purchaser] correctly conceded that the land was one of the things necessary for the continued operation of the hotel business.... The relevant going concern for the purposes of the *GST Act* was accordingly the business and the land on which it was situated. The phrase "going concern" might have an alternative meaning in a different context but that was its meaning in the present circumstances for the purpose of the *GST Act*."

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