TAX UPDATE

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Greetings from the Tax Team

This Tax Update discusses recent changes to the deductibility of interest, for example, the High Court case of *Hart* in relation to split loan accounts, the deductibility of interest in a tax consolidated environment, as well as TR 2004/4 concerning the deductibility of interest prior to and after cessation of income earning activities. In addition, we look at:

- the ATO's procedures for lodging family trust elections and interposed entity elections, and the accompanying declaration forms in accordance with PS LA 2004/1
- expiration of the time limit to claim GST refunds for the September 2000 quarter
- extension of the transitional period for related party at call loans under the debt-equity rules and the provision of a carve-out for small businesses
- the deductibility of consolidation valuation expenses

If you need further information about any of these newsletter items or wish to discuss a tax-related matter, please contact our Tax Team.

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Hart's Case

The High Court case of *FCT v Hart* [2004] HCA 26 confirms the application of the general anti-avoidance provisions to linked or split loan facilities to which *Taxation Ruling* TR 98/22 applies.

In *Hart's case*, the taxpayer husband and wife purchased a new home and turned their existing home into an investment property. In order to finance the purchase, they refinanced their borrowings and elected to split their loan into 2 accounts: an investment loan account and a home loan account.

They chose to pay the home loan first and to leave their investment loan account to build up so that they would obtain interest on the interest on the investment property. They did not have to pay the interest or compound interest until after they paid off their home loan.

The High Court held that Part IVA applied to the arrangement entered into by the taxpayers. The extra interest expense allocated under the split loan arrangement to finance the purchase of the investment property was found to be non-deductible.

Accordingly, the Commissioner is currently revising his view in TR 98/22 on whether interest incurred on these facilities would be deductible and whether the interest disallowed under Part IVA forms part of the cost base of assets financed by such facilities. Consequently, an addendum to TR 98/22 was issued on 11 August 2004 to partially withdraw TR 98/22 following *Hart's case*.

One-Off Concession for Family Trust Election or Interposed Entity Election

On 15 April 2004, the Commissioner of Taxation announced a one-off opportunity for family entities to lodge a late family trust election (FTE) or interposed entity election (IEE). The concession is provided in *Practice Statement Law Administration* PS LA 2004/1.

In August 2004, the ATO revealed details of the procedure for lodging elections and the accompanying declaration forms in accordance with PS LA 2004/1.

Where the entity is not required to lodge a 2004 tax return and has not made an FTE or IEE in a previous year, it must send the FTE or IEE with the relevant declaration form to the ATO by 31 October 2004. If the entity is not required to lodge a 2004 tax return but has made an FTE or IEE in an earlier income year, it must also send the relevant declaration form to the ATO by 31 October 2004.

Where the entity is required to lodge a 2004 tax return and has not made an FTE or IEE in a previous year, it must provide the FTE or IEE and the relevant declaration form when it lodges the 2004 return. If the entity is required to lodge a 2004 return and has made an FTE or IEE in an earlier income year, it must also provide the relevant declaration form when it lodges the 2004 return.

According to the ATO, the procedures do not require copies of earlier year election forms.

We also note that the specific entities that may take advantage of this opportunity is a trust where an FTE is concerned and a company, partnership or trust where an IEE is made.

Copies of the declaration forms are available on the ATO website.

Four Year Limit on GST Refunds

In a Media Release on 16 September 2004, the ATO reminded businesses that there is a four year limit to claim a refund of GST.

Businesses that have lodged a quarterly business activity statement for the September 2000 quarter and have not previously made their claims, will have until 30 September 2004 to claim GST refunds for the September 2000 quarter.

Alternatively, the ATO has said that such businesses can let the ATO know that they intend to make a claim that relates to that quarter.

Amendments to Related Party At Call Loans

Taxpayers will have until 30 June 2005 before their related party at call loans will be deemed to be treated as equity rather than as debt, which is the way most loans are currently treated for tax purposes.

The amendments introduced by *Tax Laws Amendment (2004 Measures No. 4) Bill 2004* will extend the transitional period for related party at call loans under the debt-equity rules to 30 June 2005. After 1 July 2005, these related party at call loans will be deemed to be equity, unless they satisfy certain conditions.

The amendments reflect the Government's decision to provide small businesses with a carve out from the debt-equity rules in cases where related party at call loans have been entered into on or before 30 June 2005. If passed in their current draft, the amendments will give taxpayers additional time to assess and adjust their existing loans to continue treating them as debt.

These amendments were previously announced by the Minister for Revenue and Assistant Treasurer, Senator Helen Coonan, in a Press Release on 24 May 2005.

The technical details of the carve-out will be developed in consultation with interested parties. According to the Press Release, the carve out from the debt-equity rules will ensure that where a company to which the related party loan is made satisfies a combined "maximum net asset value" test and an "interest deductibility cap" at the end of the income year, the loan will remain as debt rather than equity.

This maximum net asset value test is consistent with the existing test used for the small business CGT concession. It is limited to those companies that together with their related entities, have CGT assets with a net value that does not exceed $5 million.

Where the amount of any deductions in respect of the loan in that year does not exceed $100,000, the interest deductibility cap will also be satisfied.

Deductibility of Interest in a Tax Consolidated Environment

In *Taxation Ruling* TR 2004/4, the Commissioner of Taxation confirmed that following the High Court case of *Steele v FCT* (1999) 41 ATR 139, interest incurred *prior to* the derivation of assessable income will be deductible in these circumstances:

- The interest is not incurred "too soon", is not preliminary to the income earning activities, and is not a prelude to those activities;
- The interest is not private or domestic;
- The period of interest outgoings prior to the derivation of relevant assessable income is not so long, taking into account the kind of income earning activities involved, that the necessary connection between outgoings and assessable income is lost;
- The interest is incurred with one end in view, the gaining or producing of assessable income; and
- Continuing efforts are undertaken in pursuit of that end.

Where interest is incurred *after* the relevant borrowings or assets representing those borrowings have been lost to the taxpayer and relevant income earning activities have ceased, it will not fail to be deductible merely because:

- The loan is not for a fixed term;
- The taxpayer has a legal entitlement to repay the principal before maturity, with or without penalty; or
- The original loan is refinanced, whether once or more than once.

The outgoing will still have been incurred in gaining or producing "the assessable income" if the occasion of the outgoing is to be found in whatever was productive of assessable income of an earlier period. This requires a judgment about the nexus between the outgoing and the income earning activities.

If the taxpayer:

- keeps the loan on foot for reasons unassociated with the former income earning activities; or
- makes a conscious decision to extend the loan in such a way that there is an ongoing commercial advantage to be derived from the extension which is unrelated to the attempts to earn assessable income in connection with which the debt was originally incurred,

the nexus between the outgoings of interest and the relevant income earning activities will be broken.

Consolidation valuation expenses not deductible under section 8-1

According to *Taxation Ruling* TR 2004/2, expenses incurred by a head company of a consolidatable or consolidated group, or by an entity that may become a subsidiary member of a consolidated group in obtaining a market valuation for consolidation, is not deductible under section 8-1.

According to TR 2004/2, such expenses are deductible under section 25-5 as explained in Taxation Determinations *TD 2003/10* and *TD 2003/11*, because they are incurred in the course of working out the income tax payable by a head company of a consolidated group under the self-assessment system and as such, are incurred in managing the tax affairs of the consolidated group.

Consolidation valuation expenses are not deductible under section 8-1 as they are not regarded as a normal incident of managing the business of the head company or entity even where a financial report has to be prepared under the *Corporations Act 2001* that complies with the accounting standards and in particular either AASB 1020: *Accounting for Income Tax (Tax-Effect Accounting)* or AASB: *Income Taxes*.

Deductibility of Interest Before and After Income Earning Activities

Taxation Determination TD 2004/36 confirms that a head company of a consolidated group can claim a deduction under section 8-1 for interest paid on funds borrowed before consolidation and on-lent interest free to a subsidiary member of the consolidated group, provided the interest expense satisfies the requirements of section 8-1.

For example, assume a parent company, Parent Co, borrows money to make a loan to its wholly-owned subsidiary, Sub Co, to finance Sub Co's income-producing activities, which returns income to Parent Co in the form of dividends. The interest paid by Parent Co on its borrowings are deductible under section 8-1 as it is incurred in producing Parent Co's assessable income (see *Income Tax Ruling* IT 2606 and *FCT v Total Holdings (Aust.) Pty Ltd* 9 ATR 885).

If Parent Co and Sub Co subsequently consolidates, the application of the single entity rule means that neither the intra-group loan nor any payment of dividends between Parent Co and Sub Co are recognised for purposes of determining Parent Co's income tax liability.

Consequently, Parent Co must now apply the tests in section 8-1 on the single entity basis, so that the deductibility of interest paid on the borrowed funds is determined by reference to the purpose of the borrowing and the use of the borrowed funds by Parent Co.