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THE REPORT

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Tax News, Views & Clues

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Statute Barred Loans

The Tax Commissioner recently released a practice statement on the operation of the shareholder loan (deemed dividend) rules and statute barred loans.

As a general rule, where a loan made before the commencement of these rules becomes statute barred, it may give rise to a deemed dividend. A loan becomes statute barred when the lender can no longer seek recovery of that loan because of legal time limitations.

The Commissioner has decided that he will not undertake compliance action to amend assessments in relation to loans entered into prior to 4 December 1997 which have become statute barred.

The laws concerning when a loan will become statute barred are different in each state and territory. The Commissioner considers that to pursue such loans will give rise to inequality between taxpayers due to the different state and territory laws.

The Commissioner also considers that if a loan is refreshed after the statutory recovery period ends, it does not create a new loan to which Division 7A applied.

The practice statement is effective from 4 December 1997.

Building Write-offs

The Tax Office has recently released a practice statement on deductions for construction expenditure on capital works, such as buildings or improvements. Such expenditure is typically deductible at a rate of 2.5% where the relevant building is used for income producing purposes.

Where a taxpayer has deducted an amount, the cost base of that asset is required to be reduced accordingly. Consequently, the deduction is often recaptured when the building is sold.

The Tax Office acknowledges that where a taxpayer acquires an existing building it may not be possible to obtain adequate information to determine the available deduction. While the taxpayer may obtain a valuation to determine the original construction cost, the cost of obtaining the valuation can be prohibitive. In such cases, the taxpayer may simply choose not to claim the available deductions.

Accordingly, the Commissioner stated that where the taxpayer cannot determine the amount of the available deduction, the taxpayer will not be required to adjust the cost base and reduced cost base of the asset to reflect deductions which have not been claimed.

- **NOTE:** If information is available to determine the available deductions, the position outlined in the Commissioner's practice statement is not applicable.

Employee Benefit Trusts and FBT

The Tax Office recently issued a press release on proposed amendments to FBT assessments for employee benefit trust (EBT) arrangements.

Employers who establish EBTs will make contributions to fund future payments for employees. A tax deduction is sought for contributions and fringe benefits tax may be payable.

As a result of several recent cases, contributions made to certain EBT arrangements have been held to be non-deductible. Where the contribution is not deductible, FBT will not be payable for the contribution.

The Tax Office announced that it will therefore be issuing amended FBT assessments to exclude the contributions in those cases. The Tax Office will notify employers if their FBT assessment will be amended.

- **NOTE:** If the amount of FBT is reduced, employers will not be able to claim the full amount of FBT paid as a tax deduction. Employers will be required to include the amount of the reduction as assessable income in the income year when the amended FBT assessment was issued.

No Deductions for EBT Contributions

In a recent decision, the Administrative Appeals Tribunal (AAT) concluded that deductions claimed by a family trust for contributions made under an employee benefit trust (EBT) arrangement were not deductible.

The AAT stated that the contributions did not represent outgoings incurred in gaining or producing assessable income or in carrying on the business of the trust. In particular, there was no apparent business purpose for the contributions made.

The AAT found there was no evidence to suggest that the contributions were made to enhance the loyalty or productivity of the employees, nor to provide an incentive to continue in their employment. According to the AAT, the only motivation for making the contribution was tax savings.

- **TIP:** We recommend that any taxpayers with EBT arrangements review them and consider the likelihood of any non-deductible amounts or FBT amendments.

Business Costs — ‘Blackhole’ Expenditure

The Government recently released draft legislation which expands the circumstances under which a deduction is available for ‘blackhole’ expenditure. This is expenditure which is incurred by a business where there is no deduction available under tax law.

Under the current rules, taxpayers could deduct specific expenditure on a straight-line basis over five years. This included expenditure incurred to establish a business structure, convert a business structure, raise equity, defend a business against a takeover, and costs related to ceasing a business.

Under the proposed rules, taxpayers will continue to be entitled to a deduction on a straight-line basis over five years for certain business expenditure. The available deductions are expanded to include expenditure which is incurred in relation to a past, present or prospective business, to the extent that the business is, was, or is proposed to be carried on for a taxable purpose.

This includes expenditure on a business plan, the establishment of business premises, research into likely markets or profitability of a business, and capital investment in assets of the business.

In addition, shareholders, beneficiaries of trusts and partners will be able to deduct liquidation and deregistration costs where the company, trust or partnership carried on the business.

The deduction will only be available if the expenditure cannot be deducted under any other part of the tax law. It is noted also that if a taxpayer is not carrying on a business, the deduction will not be available.

If passed, the new rules will apply to expenditure incurred on or after 1 July 2005.

CGT Cost Base

Under the same draft legislation, the Government also announced that it will expand the type of expenditure that can be included in the cost base and reduced cost base of assets for capital gains tax (CGT).

The following expenditure may now be included:

- Incidental costs of acquisition: Marketing expenses, search fees relating to a CGT asset, and borrowing expenses.
- Costs of ownership of the assets: The category of costs of ownership of assets acquired after 20 August 1991 has been expanded to include both capital and non-capital costs.
- Other expenditure incurred to improve the asset: Expenditure no longer needs to be incurred for the purpose of increasing the asset’s value and it is no longer required to be reflected in the state of the asset at the time of the CGT event. It can also include expenditure to install or move the asset.

It is noted that the new rules specifically prevent expenditure on entertainment, penalties and bribes from being included in the cost base or reduced cost base of the asset.

If passed, the new rules will apply to CGT events happening after 1 July 2005.

- **TIP:** These new rules provide an opportunity to review asset cost bases in order to minimise potential CGT liabilities.

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DUE DILIGENCE | ACTION CHECKLIST

Tax

1. Review a detailed group structure diagram and provide a summary of share ownership. In particular, review for any ownership by trusts.
2. Review tax returns for the past four years, and supporting work papers, including detailed reconciliations of profit/loss as per the financial statements and taxable income/loss.
3. Review copies of FBT returns and supporting work papers for the past four years.
4. Review copies of company franking accounts for each of those years, including details of dividends paid and the extent of franking.
5. Review copies of both accounting and tax fixed asset registers and related fixed asset reconciliation schedules for those years.
6. Review a schedule of any carried-forward revenue and capital gains tax losses of the company and details of losses utilised during the past five years, and ascertain whether there are any losses transferred in or out.
7. Review any bad debt deductions claimed for tax purposes over the last four years.
8. Review copies of any correspondence with the Tax Office for the past four years, including (but not limited to):
 - all private ruling requests, requests for the Commissioner's opinion or objections lodged, and all responses received;
 - requests for an amended assessment; and
 - requests for information from the Tax Office, whether as part of a formal audit or otherwise, and all responses provided. Otherwise, confirm that the company has no knowledge of any intended audit activity.
9. Review the consolidated group that the company is a member of for tax purposes. Review details of any tax sharing agreements.
10. Review position papers supporting any positions adopted by the company on tax matters in the past four years.
11. Review details of any significant transfers of employee leave entitlements to or from the company in the past four years.
12. Obtain details of any direct or indirect interests held in foreign entities.
13. Determine whether there is any ownership of the company by non-residents, and any interests held by the company in offshore entities.
14. Obtain details of any foreign permanent establishments of the company; including any offices, employees, substantial equipment or projects in foreign countries.
15. Obtain details of all interest, royalties and dividends paid to non-residents and withheld and/or remitted in the past four years.
16. Obtain details of any insurance premiums paid to non-resident insurers in the past four years.
17. Obtain details of all income derived from foreign sources, and foreign taxes paid in the past four years.
18. Review the nature of foreign currency transactions under-taken by the company and its policy concerning the tax and accounting treatment of foreign currency movements.
19. Determine whether there have been any transactions with any international related parties in the past four years. Consider transfer pricing issues.

20. Assess whether any transactions may not have been undertaken on arm's length (market value) terms between related parties, including both domestic and international transactions.
21. Assess the company's interest expense over the last four years, and any interest deductions disallowed under the thin capitalisation rules (if applicable).
22. Determine whether there have been any capital gains tax roll-overs to or from the company since 1985. Obtain details of the assets involved, their cost base and potential market value at the time of transfer.
23. Determine whether the company acquired any of its assets before 19 September 1985.
24. Determine whether there have been any asset rollovers for depreciation purposes involving the company.
25. Review any intra-group asset transfers during the past four years.
26. Obtain details of any changes in share ownership of the company since incorporation. Detail significant or abnormal changes in indirect ownership through interposed group companies.
27. Determine whether any debts owed by or to the company have been forgiven in the past four years, and if so, what tax adjustments or capital loss claims resulted.
28. Determine whether the company received dividends from shares held for less than 45 days, or from shares where there is diminished risk of ownership.
29. Determine whether all appropriate returns have been lodged and all appropriate accruals have been made for applicable taxes, including, but not limited to:
 - income tax;
 - FBT;
 - GST;
 - payroll tax;
 - PAYG;
 - superannuation guarantee charge;
 - stamp duty;
 - customs duty; and
 - franking additional tax, franking deficit tax, or deficit deferral tax.
30. Obtain proof of future tax benefits and/or deferred tax liability balances and:
 - review for reasonableness;
 - ensure appropriate tax rates have been applied; and
 - assess whether the future income tax benefit should be carried forward.
31. Determine whether there are, or have been:
 - any significant items in dispute with the Tax Office (i.e. outstanding ruling requests, ATO audit issues, objections to assessments, appeals);
 - any 'exposures' to inter-company pricing or allocation of expenses between related entities;
 - any aggressive tax positions taken in tax returns and whether they are adequately provided for in the relevant balance sheets; and
 - any liabilities for tax penalties.
32. Review any private rulings or advice upon which the company is relying.
33. Summarise the taxation implications for the purchaser and the company (the entities and shareholders) that will arise from the proposed transaction; including, but not limited to:
 - entitlement to carry forward tax losses;
 - CGT and cost base issues; and
 - stamp duty and other taxes payable.

GST and Other Indirect Taxes

1. Review GST returns for all periods from 1 July 2000, including summary sheets, schedules and other documents used in the preparation of the BAS returns.
2. Obtain and review a copy of the Running Balance Account from the Tax Office and review.
3. Review copies of any Recipient Created Tax Invoice agreements, sample copies of invoices and adjustment notes issued by the company.
4. Review copies of any material agency agreements, franchise agreements, lease agreements, loyalty payments or rights agreements.
5. Review copies of any assessments or requests for payment received from the Tax Office.
6. Assess whether the entity is part of a group, partnership or joint venture.
7. If a member of a group, determine whether there are any other members of the group with outstanding income tax, GST or other liabilities that could be offset against the Running Balance Account.

8. Determine whether the company transacted with related members of a company group over the past four years and whether GST has been accounted for on such transactions.
9. Determine whether all BASs have been lodged for the period since 1 July 2000 and payments have been made for GST and PAYG.
10. Determine whether payroll tax returns have been lodged and payroll tax paid in each jurisdiction.
11. Consider whether the entity is appropriately grouped or not grouped for payroll tax purposes.
12. Assess whether the amount of salary and wages shown in the accounts approximates the amount declared for payroll tax.
13. Review to ensure that independent contractors have been properly treated for tax purposes.
14. Determine whether there are any outstanding assessments or refund claims.

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Important: This is not advice. Clients should not act solely on the basis of the material contained in this Bulletin. Items herein are general comments only and do not constitute or convey advice per se. Also changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. The Bulletin is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and not be made available to any person without our prior approval.

WorkCover

1. Review copies of WorkCover premiums for the past three years.
2. Review WorkCover correspondence to determine whether there are any documents advising of WorkCover premium rates or industry classifications, outstanding claims or claims history.
3. Determine whether WorkCover premiums and payments are up to date.
4. Assess whether there are any outstanding obligations, assessments or challenges currently undertaken in relation to WorkCover.

Superannuation

1. Review copies of all superannuation guarantee payments for the most recent financial year.
2. Determine whether all superannuation guarantee payments have been made.
3. Determine whether there have been any shortfall penalties in the past four years.