

the report

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DFK HIRN NEWWEY

Chartered Accountants

MONTHLY REPORT

CGT and Forward
Purchase Agreements

Remission of Penalties

Work-related Expense
Errors

Family Trust and
Interposed Entity
Elections

Settlement Payment
Assessable

Share Buyback
Arrangement

Changes to Small
Business Taxation

DUE DILIGENCE

~ action checklist ~

Tax

GST and Other
Indirect Taxes

WorkCover

Superannuation

MONTHLY REPORT

CGT and Forward Purchase Agreements

Overturning an earlier decision of the Administrative Appeals Tribunal (AAT), the Federal Court has found that an arrangement involving a forward purchase agreement (FPA) for the sale of shares did not give rise to a capital gain in the hands of the taxpayer.

The taxpayer purchased shares in 1993 and sought to sell a large portion of those shares in 1996 by way of an FPA. The taxpayer was to receive \$3.53 per share in 1996 and fully franked dividends for the next four years. The taxpayer granted a warrant over the shares, obliging the holder to buy or sell shares at the contract date, but retained beneficial ownership over the shares.

By entering into the FPA, the taxpayer potentially limited the consideration for CGT and derived dividends over the next four years that would be sheltered from tax by franking credits.

The Commissioner contended that this right to retain ownership for four years had the characteristics of 'property' and hence the capital gain should be included in the taxpayer's assessable income representing the value of the rights to retain ownership and benefit from the dividend flows until completion.

The Commissioner did not accept that consideration for the shares could simply be an amount set by the FPA and sought to assess the taxpayer on what he deemed to be additional 'non-cash consideration'. The Commissioner viewed the arrangement as conferring on the taxpayer a contractual right, as a result of retaining beneficial ownership of the shares over the period of the agreement.

The Court disagreed with the Commissioner's position, and found that the taxpayer's right to retain beneficial ownership of the shares did not constitute property and the right to the dividend stream was an asset for capital gains tax purposes.

Remission of Penalties

The Tax Office has recently released Practice Statement Law Administration PS LA 2007/3, which relates to the remission of penalties. The practice statement specifically covers:

- the failure to issue a tax invoice or adjustment note as required by the GST legislation; and
- an entity and its agent both issuing separate tax invoices or separate adjustment notes contrary to the requirements of the GST legislation.

The practice statement is useful in providing guidance to small and medium sized businesses or partnerships with limited systems for the generation of tax invoices and adjustment notes.

The practice statement only deals with the administrative penalty regime and does not cover the remission of the general interest charge (GIC).

Work-related Expense Errors

The Tax Office has sent out 226,000 letters to taxpayers in respect of incorrect claims for work-related expenses in their 2005/06 tax returns.

Common errors anticipated for 2007 include:

- self education expense claims where there was an insufficient connection between the work activities and the education expense to warrant a deduction;
- car expenses using the cents per kilometre method, where the taxpayer is unable to support the claimed expenses;
- incorrectly claiming the entire amount of an asset purchase rather than calculating the asset's decline in value; and
- incorrect calculations regarding the taxpayer's home office expenses.

Family Trust and Interposed Entity Elections

Under the trust loss rules, a taxpayer is subject to concessional treatment, making it easier to claim prior year losses, if they have made a Family Trust Election (FTE) or an Interposed Entity Election (IEE). Also, elections may be necessary to preserve franking credits flowing through the trusts.

Due to the complexity of these rules and the potentially adverse consequences of failing to make the required elections, the Tax Office has allowed an extension to make retrospective elections as part of the 2004 income tax returns.

The Commissioner recently announced a further extension of time to make a one-off lodgement of an election up until 31 May 2007. This will allow taxpayers to retrospectively submit their FTEs and IEEs for 2004 and earlier income years. The procedures for lodging these extensions have been posted on the ATO website.

Settlement Payment Assessable

The Federal Court has found that a settlement payment made to a former accounting firm partner on his termination from the partnership was assessable income. This overturned a previous decision of the AAT.

Originally, the AAT had held that a large portion of the settlement payment was a non-assessable 'un-dissected lump sum' and therefore should not be included in the partner's assessable income. The AAT did, however, find that the portion of the payment which represented timing differences should be assessable.

The Federal Court overturned this decision stating that the central issue was whether the settlement payment represented the taxpayer's share of the net income of the partnership and not whether the amount represented ordinary income in the taxpayer's hands.

The Court found that the AAT had erred in law and therefore remitted the issue back to the Tribunal for further consideration.

Share Buyback Arrangement

Overturning an earlier decision of the Full Federal Court, the High Court has found that the proceeds from the sale of sell-back rights granted by St George Bank were assessable as ordinary income.

In February 2001, St George Bank granted sell-back rights to its shareholders as part of an off-market share buyback. The sell-back right entitled the shareholder to sell back one of their shares to St George at a fixed price above the current market value of the shares.

The mechanics of the arrangement resulted in the taxpayer receiving and then disposing of her sell-back rights.

The High Court held (in a 4:1 majority decision) that whether a receipt is income depends upon its nature in the recipient's hands and not the nature of the expenditure incurred by the other party.

The Court said that while the rights acquired by the taxpayer were a product of her shareholding, they were 'severed' from that shareholding, and accordingly, the market value of the sell-back rights was held to be ordinary income.

The Tax Office has identified that this case affects over 80,000 taxpayers and it will be contacting them to provide advice on the decision and what it means for them.

Changes to Small Business Taxation

In an attempt to standardise the eligibility criteria for small business tax concessions, the government recently released the Exposure Draft Tax Laws Amendment (Small Business) Bill 2007.

The current regulations require small business to undertake separate eligibility tests for tax concessions relating to CGT, GST, PAYG and FBT. The proposed Bill aims to simplify the system by defining a small business entity as one which has turnover of less than \$2 million. Eligible entities would have access to the following concessions:

- simplified trading stock rules;
- simplified depreciation rules;
- amended assessment period limited to two years;
- immediate deductions for expenses which were previously required to be deducted on a pro-rata basis; and
- accounting for GST on a cash basis, enabling taxpayers to claim input tax credits when they actually pay for acquisitions.

[return to contents](#)

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. Consider all tax consolidations considerations, including whether the target is a head company with tax attributes.
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 undertaken 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 in the past four years. 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 in the last four years:
 - 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.
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 in the last four years 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.

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.

GST and Other Indirect Taxes

1. Review GST returns for all periods in the last four years, 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.

[return to contents](#)

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