

## THE REPORT

July 2004

### Tax News, Views & Clues

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## MONTHLY REPORT

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### High Court Rules Against Split Loans

The High Court has ruled against the use of ‘split’ loans in the case *FCT v. Hart* [2004] HCA 26. The High Court unanimously upheld the ATO’s appeal in ruling that the taxpayer used the split loan for the dominant purpose of obtaining a tax benefit.

The ‘split loan’ was essentially one loan split into two accounts (one account for a home loan and the other for an investment property loan). The loan was labelled a ‘wealth optimiser’ and its structure allowed the taxpayer to stream repayments (inclusive of rental payments from the investment property) exclusively to the ‘home loan’ account while unpaid interest accrued on the ‘investment loan’. The taxpayer subsequently capitalised the unpaid interest on the ‘investment loan’ resulting in significantly greater interest on that component which was then claimed as a tax deduction.

The case had been heard twice previously in the Federal Court with the taxpayer winning on appeal.

The Full Federal Court ruled in favour of the taxpayer as it did not accept that the structure of the loan presented a scheme to which the general anti-avoidance rule in Part IVA could apply. The Court held that the loan was a commercial arrangement and was entered into by the taxpayer to refinance the two properties.

The High Court rejected the Full Federal Court’s decision, stating that the wealth optimising aspect of the loan gave the loan a distinctive character and thus constituted a scheme. This aspect was based on the taxpayer obtaining further tax benefits resulting from the deductibility of the additional interest on the investment property loan.

The High Court concluded by stating that it was obvious that the loan’s dominant purpose was to obtain a tax benefit as no other commercial purpose of the structure made any sense.

- **ACTION:** Taxpayers, in view of Hart’s decision, might consider making a voluntary disclosure to the ATO if they wish to limit potential tax penalties. Advice should be sought when making this critical decision.

### Trust Loss Rules

Where tax losses have been incurred within a trust, the losses will typically be much easier to carry forward and utilise where the trustee has made a family trust election. This applies for both discretionary trusts and unit trusts.

In addition, where the election is made, assets or income can be more easily transferred into the trust to assist in loss utilisation.

The Tax Office recently announced an amnesty for taxpayers to consider retrospective family trust elections, as elections have often been overlooked in practice. This amnesty arrangement was discussed in our June edition.

Given the benefits of making an election where trust losses are an issue, we recommend that taxpayers carefully consider the opportunities to make an election under the amnesty, and also on a go forward basis.

Benefits can also arise in relation to company losses and franking credits, and these issues will be discussed in subsequent editions.

- **TIP:** Taxpayers should seriously consider family trust elections where trusts have losses or franking credits.

## **CGT: Cost-base Adjustment for Capital Works Deductions**

In a recent Interpretative Decision, the ATO has confirmed that the cost base of a CGT asset acquired after 13 May 1997 is to be reduced by any capital works amounts that have been or which can be deducted.

Under current law, a taxpayer is allowed a deduction for capital works expenditure in respect of certain income producing buildings and structural improvements. This qualifying expenditure is deducted over 25 or 40 years depending on the type of building or structural works.

In order to prevent a taxpayer from ‘double dipping’, the allowable deduction amount must be subtracted from the cost base of the CGT asset.

## **Deductibility of Gifts to Clients**

In a recent Interpretative Decision, the ATO declared that a taxpayer is entitled to a deduction for a gift made to a client after the provision of services has ended.

The ATO allows the deduction on the grounds that the taxpayer provides the gift to the client on the expectation that it may assist in generating future business from the client or motivate the client to recommend the taxpayer’s business to others.

Where the taxpayer has no other purpose in providing the gift, the expenditure is considered to be of the nature of business promotion and is hence deductible as an outgoing incurred in the production of assessable income.

## **No Deduction for Estimated Warranty Costs**

In a recent Interpretative Decision, the ATO declared that a taxpayer is not entitled to a deduction for an amount representing an estimate of future warranty costs until a loss or outgoing related to the performance of repairs has been incurred.

Even though a legal liability to make the repairs may have arisen, the loss or outgoing isn’t incurred until a liability to make a payment relating to the repair is incurred. Until that time, a warranty liability is no more than pending, threatened or expected.

## **Assessability of Wages and Salary from Foreign Employment**

The ATO has released three Interpretative Decisions in relation to Australian residents earning foreign employment income. Under the law, the assessable income of a resident taxpayer includes ordinary income derived directly or indirectly from all sources, whether in Australia or not.

The Australian tax law includes an exemption for resident taxpayers engaged in foreign service for a continuous period of not less than 91 days. In such cases, any foreign earnings will typically be exempt from tax in Australia.

However, the law also provides that this exemption will not apply where the foreign income has been exempt from taxation in the foreign country due to application of its domestic law to employment income, or because of the application of a double tax agreement. If the foreign income is exempt in one of those cases, it will be included in the resident’s Australian taxable income.

## **GST: Exploitation of Second-hand Good Provisions**

The ATO has released a Taxpayer Alert announcing an investigation into arrangements that some taxpayers have implemented to exploit the GST second-hand goods provisions. The ATO is concerned that such arrangements appear artificial and contrived, and may result in unlawful claiming of input tax credits.

The arrangements generally involve a GST-registered entity acquiring goods through a non-taxable supply. The entity then on-sells the goods to an associated entity and claims input tax credits on the goods, as allowed under the second-hand goods provisions.

The Alert provides examples including situations of taxpayer’s cancelling their GST registration and situations involving imported and exported goods.

- **CAUTION:** Taxpayers carrying on a business dealing in second-hand goods should ensure that all their records are correct and in order.

### Prepayment of School Fees

The ATO has released three tax determinations regarding the tax implications of the prepayment of school fees.

The ATO has stated that any fee discount provided in relation to the prepayment of the fees is not assessable income of the payer. The discount is not considered to be either ordinary or statutory income if there is no other benefit or return provided to the school in order to gain the discount.

- **TIP:** If a taxpayer enjoyed discounted school fees as a result of the provision of some goods or services to the school, income tax implications may arise.

### FIRM NEWS

Congratulations to the Hirn Newey “Lincolns” netball team, who participated in this years Institute of Chartered Accountants (ICAA) netball competition on Sunday, 11th July.

The strong performance shown by our staff members Jacquelyn Jellick, Carla Dyer, John Barrett, Sarah Solloway and Bruce Cruickshank won them a spot in the play offs, where they made it to the semi finals.

The Lincolns were narrowly defeated by KPMG, the overall runners up. It was a great day enjoyed by staff and our other supporters.

Watch this spot in two months time as the ICAA Touch Football competition is fast approaching.



The Hirn Newey Lincolns Netball Team (from left):  
Back: Pattie, Carla, John, Sarah, Marion; Front: Jax and Bruce

## **CHECKLIST OF 2003/04 TAX RETURN ISSUES TO CONSIDER**

### **2004 — Individual Tax Returns**

#### **Income**

- Gross salary, wages, allowances, benefits, earnings, tips and directors' fees.
- Income from business activities.
- PAYG Payment Summary amounts.
- Details of any non-cash benefits received.
- Lump sum and termination payments. All documentation should be provided, including an ETP Payment Summary from the employer or fund.
- Government Social Security payments, including pensions, unemployment and sickness benefits.
- Details of any CGT asset sales (e.g. shares and real estate). Please include dates of, and costs associated with, acquisition and disposal. Don't forget, whether you're an individual, company, trust or superannuation fund, you can save tax if you qualify for the various CGT concessions.
- Annuities, including allocated pensions.
- Income from trusts and partnerships. Statements of distribution should be provided.
- Rental income.
- Interest and dividends received and any tax deducted. Include details of franked dividends. New distribution statement required.
- Foreign source (employment and pension) income and details of any foreign tax credits attached to that income.
- Personal services income rules: individual contractors who operate through a company or trust can potentially be taxed on the income as an individual (not the company or trust).

#### **Deductions**

- Investment and property expenses (carefully detail interest claims).
- Subscriptions (not including sporting or social clubs).
- Expenditure records related to a taxpayer's employment, such as work-related motor vehicles, self-education, protective clothing and uniform expenses.
- Donations of \$2 and over, depending on the recipient.
- For self-employed persons and those without employer superannuation support, details of superannuation contributions made.
- Tax agent's fees and other accounting and tax audit fees associated with managing tax affairs.
- Special deductions (Australian films, investment shelters and forestry-type schemes).
- Bank fees (where the credit or deposit represents assessable income).
- Un-recouped prior year losses.
- Non-commercial losses: Individuals must satisfy one of four tests to offset losses from certain non-commercial business activities against other income. A prime example is an employee who seeks to offset hobby type farming or other business losses against salary or investment income.
- Sickness and accident insurance (provided premiums you incur for insurance are against the loss of your income).

#### **Rebates**

- Details of private health insurance, unless your premium is net of the rebate.
- Details of superannuation contributions where no tax deduction can be claimed (Maximum rebate of \$540 for \$3,000 contribution).
- Any changes in dependants (income of spouse should be provided).

- Details of any income received in a lump sum which was accrued in earlier income years (e.g. assessable pensions).
- Medical expenses tax offset: 20% offset on net expenditure over \$1,500.
- Superannuation co-contributions made by eligible employees and an assessable income of less than \$40,000.

**Note: Low income** taxpayers with a dependent child (under 21) or qualifying dependent student should check to see if they are eligible for Family Tax Assistance.

## **2004 — Companies, Partnerships, Trusts and Other Businesses**

### **Income**

- Trading income.
- Other income (e.g. rent, interest, royalties).
- Stock on hand (and basis of valuation) — note any obsolete stock.
- Work-in-progress.
- Primary producer subsidies (if assessable).
- Details of CGT assets (e.g. stock and real estate) sold, including dates of, and costs associated with, acquisition and disposal.
- Dividends, including details of franking credits.
- Income from foreign sources, including details of foreign taxes paid.

### **Deductions**

- Losses can no longer be transferred between group companies.
- Repairs and maintenance (not capital).
- Salaries, including fringe benefits.
- Fringe benefits tax paid.
- Rates, land taxes and insurance premiums.
- Advertising expenses.
- Interest on borrowed monies.
- Deductions relating to foreign-source income are only deductible against foreign income of a similar class.
- Prepayments are no longer deductible (unless identified under the law).
- Retirement payments and golden handshakes.
- Bad debts actually written off during the year.
- Donations of \$2 and over, depending on the recipient.
- Commissions.
- Legal expenses (not capital).
- Lease documents for motor vehicles, premises and equipment.
- Losses of previous years
- Superannuation contributions.
- Subscriptions.
- Car expenses (remember to include petrol, repairs and parking and maintain a log book where necessary).
- Tax agent's fees and other accounting and tax audit fees.
- Royalties paid (only deductible where withholding tax paid).
- Details of the purpose and destination of any interstate or overseas trip. Expenses must be fully documented where travel involves at least one night away from home. Travel diaries should be included where travel exceeds five nights.
- Eligible research and development expenditure by R&D registered company.
- Bank fees (where the credit or deposit represents assessable income).

## Liabilities

- New loans taken out during the year and their purpose, including any new lease or hire purchase agreements.
- Statements from the lending authority detailing the opening and closing balances of existing loans during the financial year.
- Provisions for long service leave and annual leave.
- Creditors on hand at the end of the financial year.
- Details of loan accounts to directors, shareholders, beneficiaries and partners.
- Accrued expenses (e.g. audit fees, interest payments).
- Commercial debts forgiven.

## Assets

- Details of depreciable assets acquired and/or disposed of during this income year, including:
  - type of asset;
  - date of acquisition/ disposal; and
  - consideration received/paid.
- Lease commitments.
- Debtors on hand at the end of the financial year.
- Commercial debts forgiven.
- Division 7A interest and repayments made on any prior year loans to shareholders and associates.

## Other Information Required

- Franking account details/ movements.
- Overseas transactions with related parties, exchange gains/losses.
- Private companies — remuneration or loans to directors, shareholders and their relatives.
- Changes to the capital of the company.
- Whether family trust elections have been made in relation to trusts.
- Consider if a group of companies should consolidate for tax.

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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.