

## THE REPORT

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*Tax News, Views & Clues*

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## MONTHLY REPORT

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### Compensation Payments

In a recent case, the Administrative Appeals Tribunal (AAT) has confirmed that compensation payments received by a taxpayer after turning age 65 were assessable income even though the taxpayer argued that they were capital in nature.

The taxpayer was unable to work due to ill health and received fortnightly compensation payments. Upon turning age 65 in March 1994, the taxpayer's payments continued to be taxed as income. The taxpayer objected on the grounds that the receipts represented payment of a capital sum for loss of earning capacity.

In response, the Tax Office argued that the payments were ordinary income in the hands of the tax-payer regardless of age and should therefore be included in assessable income. The Tax Office argued that payments were ordinary income because they were received periodically, on a regular basis, and they supplemented income.

The AAT agreed with the Tax Office's arguments and held that the payments were assessable income. The AAT held that the amount could not be capital as it was not a fixed sum and it was unable to be redeemed (i.e. received as a capital lump sum).

### Small Business CGT Concessions

Certain small business taxpayers may be entitled to CGT concessions on disposal of their CGT assets.

In order to apply the small business CGT concessions, the asset disposed of must have satisfied the active asset test. The test requires that the asset must have been an active asset in the taxpayer's business just before the earlier of:

- its disposal; and
- the cessation of the relevant business (if the relevant business has ceased in the previous 12 months before the disposal).

In regard to the second requirement, the Tax Office has declared in a recent Interpretative Decision (ID) that the sale of shares in the relevant business is not a *cessation* of that business.

The ID examines a case where the taxpayer owned premises that were used in the business of a partnership. One of the partnership entities was connected to the taxpayer through a common controller. As a result, the premises were an active asset of the taxpayer even though the taxpayer did not use the premises in the course of carrying on its own business.

At a later date, the partnership entity ceased being connected to the taxpayer when the common controller sold its shares. However, the entity continued to carry on the same business.

Subsequently, the taxpayer sold the premises and made a capital gain. The taxpayer argued that the premises were an active asset just before the cessation of the partnership business, which occurred on disposal of its shares.

Therefore, the active asset test would be satisfied and the concessions would be available to reduce the capital gain.

The Tax Office rejected this argument and emphasised that the sale of shares did not constitute a cessation of business. As such, the taxpayer was not entitled to the CGT concessions, as the active asset test could not be satisfied.

- **TIP:** Small businesses should carefully consider their entitlement to small business CGT concessions whenever an asset is sold.

## Foreign Rental Income

The Tax Office has recently released an Interpretative Decision (ID), which considers whether rental income from property outside of Australia is assessable income of Australian tax residents.

The assessable income of an Australian resident includes income from all sources, whether in or outside of Australia. However, in relation to foreign-sourced income, a Double Tax Agreement (DTA) between Australia and the contracting nation must be considered, as the DTA typically takes precedence.

This ID reviews the assessability of income derived by an Australian resident taxpayer from a rental property in Switzerland.

Under the DTA between Australia and Switzerland, rental income derived by an Australian tax resident from real property in Switzerland may be taxed in Switzerland.

The Tax Office considers that the phrase 'may be taxed' indicates that Switzerland has a non-exclusive taxing right. Accordingly, the rental income may potentially be taxed in both countries.

Where foreign tax has been paid on income subject to Australian tax, a foreign tax credit is typically available against the Australian tax payable.

- **CAUTION:** It is critical to receive professional taxation advice when dealing with foreign income to ensure that correct tax is paid and any available foreign tax credit is claimed.

## Deductibility of Legal Fees

The Administrative Appeals Tribunal (AAT) has recently held that a taxpayer company was entitled to deduct legal expenses incurred in settling a damages claim even though it had not produced any income.

The taxpayer owned a large rural property that had a leased dwelling situated on it. In lieu of rental payments, the tenant agreed to provide certain services on the property with the taxpayer's agent being responsible for maintenance on the dwelling. A legal dispute arose following the tenant's injury in connection with maintenance of the property. In settling the dispute, the tax-payer and its agent incurred approximately \$39,780 in legal fees.

The Tax Office disallowed the legal expense deduction on the basis that there was no nexus between incurring the legal expenses and the tax-payer's income producing activities.

However, the AAT accepted that the taxpayer held the dwelling separately for the purposes of producing assessable income and that the function of maintaining the property by the agent was incidental and relevant to that purpose.

Consequently, even though no rental income was derived, the AAT found that the legal expenses incurred by the taxpayer were an allowable deduction.

## Changes to GST Laws on Property Sales

The Federal Government has recently introduced a number of important changes to the GST laws, which will impact the sale and purchase of real property.

The new laws are, in part, designed to stop arrangements whereby entities reduce or eliminate GST on supplies of real property through the use of the going concern, GST group and GST joint venture provisions.

It is very important that sellers of residential properties undertake a review of their structures and operations in order to ensure that there are no adverse GST implications or 'hidden' GST costs.

- **CAUTION:** GST needs to be carefully considered prior to completing any sales or purchase of real property.

## Evidence for Expenses Substantiation

The Tax Office has recently released a Practice Statement (PS) providing guidance to individual taxpayers as to generally accepted documentation that may be used to substantiate deductions in the tax return.

The PS outlines that individuals without a receipt for work-related expenses may still be able to claim a deduction by maintaining other records, which include:

- online banking and credit card statements;
- online, email and photo-copied receipts; and
- BPay records.

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## FEDERAL BUDGET

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### Personal Tax Cuts

The 2005/06 Federal Budget includes the most significant personal tax cuts seen for many years.

Most importantly, the top marginal tax rate of 47% has been pushed back substantially. The top rate currently applies to taxable income over \$70,000. It will only apply to income over \$95,000 during 2005/06, and income over \$125,000 during 2006/07 and subsequent years.

In addition, the current 17% rate will be cut to 15% and the 30% band will be widened.

Overall, these measures will save taxpayers up to \$2,162 for the 2006 year and \$4,502 for the 2007 year.

The tax rates for 2004/05, 2005/06 and 2006/07 are summarised below.

Current Tax Year		2005/06		2006/07	
Income Range \$	Tax Rate %	Income Range \$	Tax Rate %	Income Range \$	Tax Rate %
0 – 6,000	0	0 – 6,000	0	0 – 6,000	0
6,001 – 21,600	17	6,001 – 21,600	15	6,001 – 21,600	15
21,601 – 58,000	30	21,601 – 63,000	30	21,601 – 70,000	30
58,001 – 70,000	42	63,001 – 95,000	42	70,001 – 125,000	42
70,001+	47	95,001+	47	125,001+	47

### Non-residents — CGT

It is proposed that CGT will no longer apply to a broad range of assets owned by non-residents.

In future (following legislation) CGT will only apply to Australian real property and certain business assets owned by non-residents.

CGT will no longer apply to other Australian assets owned by non-residents, such as shares in Australian companies. This should significantly encourage foreign investment into Australian businesses.

## Surcharges Abolished

The superannuation surcharge and termination payments surcharge will be completely abolished from 1 July 2005. The surcharges currently apply at a rate of 12.5% once adjusted taxable income exceeds \$99,710.

## Splitting of Superannuation Contributions

From 1 July 2006 eligible couples will be able to split their employer and personal superannuation contributions with their spouse.

This will provide significant financial and retirement planning opportunities.

## Company Loss Recoupment Rules

The Federal Government has deferred its proposal to remove the availability of the same business test (SBT) for companies with annual income of \$100m or more.

The income ceiling will now apply to tax losses incurred in income years commencing on or after 1 July 2005.

The Government has also confirmed amendments which will make it easier for widely held companies to satisfy the continuity of ownership test (COT).

## Foreign Loss Quarantining

Overall losses incurred in deriving foreign source income are currently quarantined and cannot be offset against Australian assessable income.

The Government has announced that quarantining will be abolished when proposed new legislation receives Royal Assent.

The change should reduce tax liabilities and compliance costs for taxpayers with international activities.

## Business Blackhole Expenditure

The Government has announced tax relief for blackhole capital expenditure including:

- a broader range of expenditure to be included in CGT cost bases;
- a deduction over five years for certain pre-commencement business expenditure; and
- a deduction over five years for business blackhole amounts (provision of last resort).

## GST Changes

In relation to GST, the budget foreshadowed changes including increased audit activity concerning imported goods, anti-avoidance measures covering certain sales of real property and a range of incidental amendments.

## Consolidation — Deadline Extended for Making Irrevocable Elections

The Government has confirmed that it will extend the deadline for making or revoking certain elections under the consolidation regime from 31 December 2004 to 31 December 2005. This extension will apply to elections in respect of setting the tax cost of the group's assets and for the utilisation of carried forward losses.

Importantly, the election to form a consolidated group will remain irrevocable despite this announcement.

## Consolidation — Available Fraction

Entities that have an available fraction of nil due to rounding, will be able to round up to the nearest significant digit, with effect from 1 July 2002.

## Tax Exemption for Temporary Residents

The Government has announced a four-year tax exemption for most foreign source income derived by temporary Australian residents, including capital gains on foreign assets.

Interest withholding tax obligations will also be removed and foreign investment fund rules will cease to apply.

## Non-commercial Loans

From 1 July 2004, private companies now have until their tax return lodgement due date for a loan to a shareholder to be repaid or put on commercial footing to avoid the operation of the deemed dividend provisions.

## CGT and Marriage Breakdown

Assets transferred between spouses on marriage breakdown will now be subject to broader CGT rollover relief.

## Superannuation — Choice of Fund Rules

Following the introduction of the choice of fund rules, employers can continue to contribute to existing superannuation funds until 30 June 2008 if an employee has not chosen a fund and the existing fund does not meet the choice of fund insurance requirements.

## Extension — Deduction on Forestry Prepayments

The 12-month prepayment rule for forestry managed investments, which allows immediate deductions for investors, will be extended for an additional two years (up to 30 June 2008).

## Cosmetic Procedures Excluded

From the 2005/06 income year, purely cosmetic procedures will be excluded from the medical expenses offset.

## Sundry Tax Changes

- The tax law will be amended to deny deductions (and CGT cost bases) for expenditure incurred in relation to illegal activities.
- To be FBT exempt, contributions to approved worker entitlement funds will no longer need to be made under an industrial instrument.
- The Medicare levy low-income thresholds have been increased for individuals, families and pensioners from 1 July 2004.
- Superannuation Guarantee (SG) support will apply to the payment of wages made after employment ceases.
- The Government has introduced a number of changes in relation to franking deficits tax (FDT) with effect from 1 July 2002.
- The share capital tainting rules will no longer be triggered for certain transfers to share capital accounts as a result of debt/equity swaps.
- Effective life depreciation will now apply to film copyright expenditure incurred on or after 1 July 2004.

## Business Inputs Tariff Removed

From 11 May 2005, the Government will remove the 3% concessional tariff on business inputs where there are no substitutable goods manufactured in Australia.

## Hedging Rules

The scope of the previously announced tax-timing hedging rules will be extended to all taxpayers in all industries.

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## TAX RETURN CHECKLIST 2004/05

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### 2005 - Individual Tax Returns

#### Income

- Gross salary, wages, allowances, benefits, earnings, tips and director's fees
- Income from business activities
- PAYG payment summary amounts
- 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
- Capital Gains from CGT asset sales (e.g. shares and real estate) [Information relating to dates of, and costs associated with, acquisition and disposal will be required to determine the capital gain (if any). Remember that individuals, companies, trusts and superannuation funds can save tax if they 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 (franked or unfranked) including any tax deducted [Dividend distribution statement will be required to confirm the dividend received]
- Foreign source (employment and pension) income [Details of any foreign tax paid will be required]
- Personal services income [Individual contractors who operate through a company or trust can potentially be taxed personally on the income instead of income being taxed at the company or trust level]

#### Deductions

- Investment and property expenses [Carefully detail interest claims]
- Professional 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
- Superannuation contributions made by self-employed persons and those without employer superannuation support
- Tax agent's fees and other accounting and tax audit fees associated with managing tax affairs
- Special deductions (e.g. 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 premiums, provided the premium incurred is against the loss of income

### Rebates

- Details of private health insurance, unless the premium is net of the rebate [Statement from health insurance provider will be required to determine entitlement to rebate]
- Details of superannuation contributions where no tax deduction can be claimed (maximum rebate of \$540 for \$3,000 superannuation spouse contribution)
- Any changes in dependants [Income of spouse will be required]
- Details of any income received in a lump sum which was accrued in earlier income years (e.g. assessable pensions)
- Details of medical expenses where the total exceeds \$1,500 [Tax offset of 20% available]
- Superannuation co-contributions made by eligible employees [Assessable income must be less than \$58,000]

**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.

## 2005 - 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)
- Capital gains from CGT assets sold (e.g. real estate) [Documentation should include dates of, and costs associated with, acquisition and disposal]
- Dividends [Details of any franking credits will be required]
- Income from foreign sources [Details of foreign tax paid will be required]

### 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 immediately deductible, unless under \$1,000 or required to be prepaid by 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 expenses for motor vehicles, premises and equipment
- Losses from 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 has been paid]
- Travel expenses [Details of the purpose and destination of any interstate or overseas trip should be provided. 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 registered R&D 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 purposes

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