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MONTHLY REPORT

Tax Effective Investment Schemes

In a recent decision, the Administrative Appeals Tribunal (AAT) disallowed deductions relating to a scheme involving a wine grape project.

Readers will be aware from previous editions that the Commissioner is seriously clamping down on tax effective investment schemes that are thinly disguised as providing taxpayers with a commercial benefit.

In this case, the taxpayer sought to claim 'excessive' deductions for a small amount of capital outlay through a series of 'round robin' financing arrangements, which the Commissioner argued served no commercial purpose other than to generate large upfront fees.

The AAT agreed with the Commissioner in applying Part IVA to the scheme, concluding that the taxpayer entered into the scheme with the sole or dominant purpose of obtaining a tax benefit, regardless of whether or not there were genuine commercial objectives.

Commissioner's Discretion — Non-commercial Losses

The Tax Office recently released a draft ruling providing guidelines on how the Commissioner's discretion, contained in the non-commercial loss provisions, may be exercised.

The non-commercial loss provisions prevent taxpayers from offsetting losses generated from a non-commercial business activity (e.g. a hobby farm) against the taxpayer's other assessable income.

There are four tests that apply to determine if a loss can be considered a business loss and hence deductible against the taxpayer's other income.

In addition to these tests, there is also a provision that allows the Commissioner to exercise his discretion in circumstances where he determines it would be unreasonable to defer the loss.

The ruling indicates that the Commissioner may exercise his discretion in the following circumstances:

- **special circumstances:** the business activity has been affected by special circumstances outside of the taxpayer's control, specifically including: flood, drought or natural disaster;
- **nature of business:** an inherent characteristic of the business would necessarily cause the taxpayer to fail one of the tests mentioned above; and
- **objective expectation:** there is an objective expectation that during a commercially viable period of time, the activity will meet one of the four tests.

Partnership Losses Denied

In a recent decision, the AAT affirmed the Commissioner's decision to deny a taxpayer a deduction claimed regarding partnership losses

A partnership's assessable income is calculated as if the partnership were a taxpayer in its own right. However, in calculating the partnership's taxable income, deductions for tax losses are not included in the partnership return, but in the returns of the individual partners instead.

In September 2002, the taxpayer lodged an income tax return in which \$90,000 was claimed as a deduction for the taxpayer's share of the partnership's losses. However, three months later the taxpayer lodged an amended assessment deleting the deduction previously claimed.

The original return was assessed by the Commissioner (creating a tax shortfall amount). The Commissioner then made an amended assessment on the return in which the taxpayer had removed the deduction.

The AAT found that the taxpayer was not entitled to claim a deduction for the partnership losses, as there was no evidence that a partnership existed. In addition, there was no evidence that the liability had ever been incurred.

However, the taxpayer was not liable for an administrative penalty (equivalent to 10% of the tax shortfall) as the AAT held that the tax shortfall in question was not the result of false or misleading statements or taking a position that was not reasonably arguable. The AAT concluded that the shortfall amount arose from the Commissioner assessing the taxpayer on facts that were no longer valid.

Offshore Employee Super Scheme

In a recent decision, the AAT denied a taxpayer trust a deduction for contributions made to a New Zealand superannuation fund on behalf of an employee of the trust.

The taxpayer trust claimed a deduction of \$60,000 for a contribution made to a New Zealand superannuation fund in 2000.

The AAT held that there was only evidence of \$6,000 being contributed by the taxpayer. The balance of the payments were attached to a series of 'round robin' payments between related parties which could not be traced back to the taxpayer.

Furthermore, as the trustee of the fund had sole discretion to distribute the fund income, the fund did not qualify as a superannuation fund. A deduction was also denied as the expenditure was not in the ordinary course of the taxpayer's business.

In the event that the AAT was incorrect in its findings on deductibility, it further found that Part IVA would apply as the dominant purpose of entering into the scheme was to avoid tax.

Division 7A — Audit Selection Criteria

The Tax Office recently released guidelines indicating draft selection criteria for Division 7A audit cases.

Division 7A is a taxation integrity measure which targets payments, loans or debts forgiven by a private company in favour of a shareholder or shareholder's associate, on or after 4 December 1997. The Division applies to deem such payments to be dividends, unless they fall within certain specified exclusions.

The Tax Office has indicated that the broad criteria for case selection are as follows:

- a high proportion of company value being distributed through Division 7A transactions. This is evidenced where annual Division 7A transactions are greater than 50% of net assets;
- Division 7A transactions which have occurred in multiple income years, which would indicate that this type of repeat behaviour may not be inadvertent;
- Division 7A transactions which occurred after 1 July 2004, following changes to the legislation allowing tax practitioners to intervene prior to the lodgement of the tax return; and
- transactions which appear contrived and planned intentionally to avoid Division 7A.

Property Settlement Adjustments

A settlement adjustment is an adjustment that is made between the vendor and the purchaser in relation to matters such as rates and land tax on the sale of a property.

Given the large number of GST errors in relation to 'settlement adjustments' on Business Activity Statements, it is useful to consider GST Determination 2006/3, issued by the Tax Office last year.

This determination considers whether settlement adjustments for rates, taxes and other outgoings are taken into account in determining the consideration for the supply of real property.

It is useful because the legislation does not refer to 'settlement adjustments', and there is no readily available information regarding the GST implications of these adjustments. This determination seeks to help businesses by providing practical examples in relation to different settlement adjustment scenarios.

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FBT RETURN | ACTION CHECKLIST

Gross-up Rates

To ensure the neutrality between an employee receiving a fringe benefit or cash salary taxed at the highest marginal rate within the context of the GST system, employers need to allocate taxable fringe benefits into either Type 1 fringe benefits or Type 2 fringe benefits.

Which gross-up rate is applied depends on whether the provider of the fringe benefit (generally the employer) was entitled to input tax credits for the acquisition of the benefit.

Type 1 gross-up rate

If the provider is entitled to an input tax credit, the Type 1 gross-up rate will apply: 2.0647 (previously 2.1292).

Type 2 gross-up rate

If no input tax credits are available to the provider, then the Type 2 gross-up rate will apply: 1.8692 (previously 1.9417).

This was the only gross-up rate that applied before the introduction of the GST.

After applying the correct gross-up rate, the FBT rate for the year ending 31 March 2007 is 46.5% (previously 48.5%).

Only the Type 2 gross-up rate will apply for reporting amounts on employees' PAYG payment summaries (formerly group certificates), regardless of the gross-up rate used for the FBT return.

Checklist — Types of Benefits

Motor vehicles

- Was the employer entitled to input tax credits for the purchase or lease costs of the vehicle?

Statutory formula method

- What is the cost price of the vehicle (or lease value) and on-road costs GST inclusive?
- What are the costs of any fitted accessories?
- What were the opening and closing odometer readings for the current FBT year?
- How long has the vehicle been owned or leased? (If owned for more than four years on 1 April 2006, the cost base can be reduced by one-third.)
- Were there any days during the year when the vehicle was unavailable for private use? Check that the number of days the 'car was used or available for private use' is correct.
- What running costs have been paid by the employee? Have appropriate evidentiary documents been maintained?
- Confirm the vehicle is a car as defined in subsection 136(1) of the *Fringe Benefits Tax Assessment Act 1986*.
- Cars acquired on or after 1 July 2002 and before 10 May 2006 depreciated at the deemed rate of 18.75% For cars acquired on or after 10 May 2006 use a rate of 25%.

Statutory Car Rates

Kilometres travelled	Statutory %
Less than 15,000	26
15,000 – 24,999	20
25,000 – 40,000	11
Above 40,000	7

Operating cost method

- Is this the first year the car was held? If so, has a logbook been kept for a minimum continuous period of 12 weeks?
- What were the opening and closing odometer readings for the current FBT year?
- Have you made a reasonable estimate of the business kilometres travelled and the business use percentage? (This must be in writing.)
- Where the employer already owned the vehicle at the start of the FBT year, what is its written down value on 1 April 2006?
- What are the total running costs of the vehicle?

Logbook records

These records must be maintained for a minimum continuous period of 12 weeks. This will generally be in the first year of the vehicle's use.

A new logbook will need to be kept every five years. The logbook must at least include:

- the date the business journey began and ended;
- the odometer reading at the beginning and end of the business journey;
- the purpose of the journey; and
- the number of kilometres travelled in the course of the journey.

It is imperative that all entries in the logbook are made at the end of the journey or as soon as reasonably practicable after the journey.

Car parking

- Have car parking benefits been provided? If so, the three different methods for valuing the taxable car spaces will need to be considered.
- For 2006/07 the car parking threshold is \$6.62 per day (previously \$6.43).
- Was the employer entitled to input tax credits for providing the car parking?

Loans and debt waivers

- For 2006/07 the benchmark interest rate is 7.30% (previously 7.05%). What is the interest rate charged on the loan?
- Has the loan been used for income-producing purposes by an employee?
- What is the loan balance at the beginning of the FBT year and has the balance changed during the year?
- What documentation is available for the loan?
- When was the loan granted and was the loan wholly for private purposes?
- Have any employee debts been waived or released since 1 April 2006?

Expense payments/ reimbursements

- Have any expense payments/reimbursements been made on behalf of or to employees?
- Would any of the expenses or reimbursements have been tax deductible to the employee if they were paid for by the employee?
- If so, have appropriate declarations been obtained to substantiate the reduction in taxable value?
- Was the employer entitled to input tax credits for the expense?

Housing and board

- Has the employee been granted a right to occupy a unit of accommodation as the employee's usual place of residence?
- Is board provided to employees where two or more meals per day are provided?
- Was the employer entitled to input tax credits for providing housing and meals?

Living-away-from-home allowance (LAFHA)

- What is the value of LAFHAs paid to employees?
- Has the employee provided a declaration confirming that they are living away from their usual place of residence for housing and meals?
- Is there an employment contract, or similar document, describing the provision of the LAFHA components?

Property fringe benefits

Property includes goods, shares and real property.

- What goods are provided to each employee, excluding goods provided for business purposes?
- What amounts are paid by the employer for goods provided?
- Would the goods have been tax deductible to the employee had they been purchased by the employee?
- Identify employer-provided goods and those provided from other sources.
- Has an allowance for the \$500-exemption for in-house benefits been made?
- Was the employer entitled to input tax credits for providing the property?

Entertainment

The provision of employee entertainment may result in a number of fringe benefits, e.g. a property, expense payment or residual benefit with the taxable value calculated as per the rules of the benefit concerned.

Employers who provide meal entertainment and/or entertainment facility leasing expense benefits can elect to calculate their FBT liability using the 50/50 split method or 12-week register method.

Residual benefits

- If there are any additional benefits provided to employees, determine the value and amount, if any, paid by the employer.
- Would any of these benefits have been tax deductible to the employee if they were paid for by the employer?
- Was the employer entitled to input tax credits for providing the benefit?

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