

THE REPORT

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Tax News, Views & Clues

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MONTHLY REPORT

CGT Main Residence Exemption

The Tax Office has released an Interpretative Decision considering the application of the capital gains tax main residence exemption, where a taxpayer has converted their main residence into business premises.

A capital gain or loss arising on the disposal of an individual's main residence is typically ignored for income tax purposes.

Where a taxpayer has been absent from their main residence and has used it for the purpose of producing assessable income, a partial or full exemption from capital gains tax may be available. This rule is broadly referred to as the 'absence rule'.

In the case under review, the taxpayer vacated their main residence and immediately began a process of converting it into business premises. At the end of the conversion, the taxpayer rented the property out and subsequently sold the property for a capital gain.

At the time the taxpayer disposed of the property, he wished to take advantage of the 'absence rule'.

The Tax Office denied the taxpayer's application of the 'absence rule' on the basis that the property could no longer be considered a dwelling as it was no longer suitable as residential accommodation. Consequently, the taxpayer was only entitled to a partial exemption for the period preceding the conversion into commercial premises.

GST Treatment of Residential Premises

The Federal Court has dismissed a taxpayer's appeal that the sale of a strata-titled unit was an input taxed supply for GST purposes.

Broadly, the sale of premises used for residential accommodation is input taxed. However, the sale of residential premises that are 'commercial residential premises' such as hotels, motels, etc. are subject to GST. Likewise, new residential premises will be subject to GST where the vendor is registered for GST.

In the case under review, the taxpayer was a member of a GST-registered partnership. A motel was purchased by the partnership with a view to using it as residential apartments. Following the conversion of the motel, one of the newly fitted apartments was sold at a price excluding GST.

The taxpayer argued that the sale was input taxed as the apartment was not 'new residential premises', as it had been previously sold as residential premises.

The Tax Office disagreed and argued that the original sale of the motel was not a sale of residential premises and accordingly, the sale was not input taxed. GST was therefore to be applied on the sale of the apartment on the basis that it was 'new residential premises' when the apartment was sold.

On appeal, the Federal Court held that the prior use of the premises as a motel did not meet the definition of 'residential premises' as the term 'residence' requires a degree of permanent or long-term commitment which are not characteristics of a motel.

- **TIP:** This case highlights the complexities with property development and the availability of input tax credits. Some careful planning and advice may save businesses thousands of dollars.

Tax Deductible Gifts

The Tax Office has released a draft tax ruling explaining when a gift will be an allowable deduction.

- The draft ruling describes a gift as having the following characteristics:
- the gift results in a transfer of beneficial interest in property;
- the transfer is actually made (i.e. it is not an anticipated or planned gift);
- the transfer is made voluntarily;
- the transfer arises by way of benefaction (i.e. the recipient is advantaged in a material sense as a result of the transfer); and
- no material benefit or advantage is received by the giver by way of return.

Special anti-avoidance rules may also deny a deduction. For example, no deduction is available where the gift recipient bears responsibility as a result of the transfer, so that the recipient ultimately receives a benefit that is considerably less than the nominal value for which the giver seeks a tax deduction.

A deduction may also be denied where the giver or an associate of the giver retains the right to use the donated property.

- **TIP:** Examples of gifts that may be allowable deductions include money and various types of property (including trading stock).

Interest on Compensation Payment Assessable

The Administrative Appeals Tribunal (AAT) recently held that an amount of interest received by a taxpayer was assessable income even though it was calculated on a capital compensation payment which was not taxable.

In the case under review, the taxpayer was a landholder whose land had been compulsorily acquired by a state government department.

Pursuant to a court order, the state government department was to pay the taxpayer \$4,300,400 for the land compulsorily acquired, as well as interest at the rate of 9.75% per annum.

Payments were made by the state government department over a number of years. A dispute arose between the parties concerning an amount which was to represent full and final settlement of the matter.

By the time the matter was finally settled, the taxpayer had ultimately received over \$5.3 million in both cash and property.

The taxpayer disclosed what he thought to be the interest component as income in his income tax return but included a notation that he did not accept that any portion of the compensation proceeds constituted income, and he reserved the right to object. The Tax Office assessed the taxpayer liable to pay tax on the interest, and the taxpayer objected.

The taxpayer put forward an argument that has been successful in prior cases. That is, because the compensation sum could not be precisely dissected between capital and interest, the entire sum should be deemed to be capital and therefore not subject to tax.

The AAT rejected the taxpayer's argument and agreed with the Tax Commissioner that the amounts could be dissected with precision.

Accordingly, the AAT held that the interest component was assessable income.

Small Business CGT Concessions: Trusts

The Tax Office has recently released an Interpretative Decision that focuses on what a *connected entity* is in the context of applying the capital gains tax (CGT) small business concessions for a discretionary trust.

The CGT small business concessions operate to reduce or disregard a capital gain if certain conditions are met.

Broadly, one of these conditions is that the CGT asset must have been an *active asset* used in the taxpayer's business or in the business of a *connected entity*.

An entity will be a *connected entity* if either entity controls the other entity or both entities are controlled by the same third party.

Control of an entity is determined by reference to specific tests contained within the law.

Broadly, in the case of a discretionary trust, an entity controls the trust if it receives at least 40% of the trust's income or capital distributions.

In the case where the trust has made no distributions of income and capital, the trustee can nominate up to four beneficiaries as being controllers of the trust.

For further information, please contact our office.

- **CAUTION:** The Tax Office has recently announced a review of entities claiming the CGT small business concessions. In order to avoid penalties, ensure that all required conditions are met.

FRINGE BENEFITS TAX - 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 the type 1 fringe benefits or the type 2 fringe benefits category.

Which gross-up rate to apply 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 (2.1292).

Type 2 Gross-up Rate

If no input tax credits are available to the provider, then the type 2 gross-up rate will apply (1.9417). 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 2005 is 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 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 2005, 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? Are appropriate evidentiary documents 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 depreciated at the deemed rate of 18.75%.

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 log book 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 2004?
- What are the total running costs of the vehicle?

Log Book 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 log book will need to be kept every five years. The log book 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 log book 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 different methods for valuing the taxable car spaces will need to be considered.
- For 2004/05 the car parking threshold is \$6.28 per day.
- Was the employer entitled to input tax credits for providing the car parking?

Loans and Debt Waivers

- For 2004/05 the benchmark interest rate is 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 2004?

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 had been 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 by the employer on the employer's premises to employees?
- Is 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?

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 employee for the goods provided?
- Would the goods have been tax deductible to the employee if they were 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 benefits can calculate their FBT liability using three different methods. These are the 50/50 split method, the 12-week register method and the actual expenditure method.

Residual Benefits

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

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