Explanatory Memorandum

December 2009/January 2010

Proposed Amendments to Tax Laws

On 21 October 2009, the Government introduced the Tax Laws Amendment (2009 Budget Measures No 2) Bill 2009 (the main Bill) into the House of Representatives. The main Bill seeks to:

- make changes to the taxation of employee share schemes;
- tighten the application of the non-commercial losses rules in relation to individuals with an adjusted taxable income of $250,000 or more; and
- require superannuation providers to transfer the balance of a lost member's account to the Commissioner of Taxation.

A discussion of the proposed amendments follows.

Employee share schemes

The main Bill and the associated Income Tax (TFN Withholding Tax (ESS)) Bill 2009 propose changes to the taxation of employee share schemes (ESSs) by:

- replacing the current Div 13A of Pt III of ITAA 1936;
- inserting a new Div 83A into ITAA 1997 dealing with employee share schemes; and
- inserting a new Subdiv 14-C in Sch 1 to the *Taxation Administration Act 1953* (TAA) dealing with the ESS withholding tax, and a new Div 392 in Sch 1 to the TAA dealing with ESS reporting.

Under the proposed provisions, an ESS interest is defined as a beneficial interest in:

- a share in a company; or
- a right to acquire a beneficial interest in a share in a company.

Consistent with the current law, the proposed law specifically exempts 'ESS interests' acquired under an employee share scheme from being taxed as a fringe benefit under the *Fringe Benefits Tax Assessment Act 1986*.

Upfront taxation

Generally, any discount to the market value of ESS interests in shares or rights provided under an employee share scheme is taxed upfront (ie on acquisition). This means the market value of the discount must be included in an employee's assessable income for that income year.

Employees participating in ESSs who pay tax upfront may be eligible for a $1,000 tax concession. That is, an employee does not include a discount on ESS interests in their assessable income if the value of the combined discount is $1,000 or less. Where the discounts are greater than $1,000, the employee is assessed on the excess over $1,000.

To be eligible for the upfront concession, an employee must satisfy the following conditions:

- the employee has a taxable income (after adjustments) of $180,000 or less. The taxable income of the employee is adjusted by adding the employee's reportable fringe benefits, reportable superannuation contributions and total net investment loss for the relevant income year;

- the employee must be employed, at the time of acquiring the ESS interests, by the company offering the scheme or one of its subsidiaries;
- the scheme must be offered in a non-discriminatory way to at least 75% of Australian resident permanent employees with three or more years service (whether continuous or non-continuous service);
- the ESS interests provided must not be at real risk of forfeiture;
- the ESS interests offered under the scheme must relate to ordinary shares;
- the ESS interests provided cannot be disposed of for three years unless the employee ceases employment at an earlier time; and
- the employee must not receive more than 5% effective ownership of the company, or control more than 5% of the voting rights in the company, as a result of participating in the scheme.

Deferral of taxation

Although the economic value embodied in employee share scheme shares and rights is equivalent to any other form of employee compensation and should generally be taxed upfront in the same manner, the proposed rules make exceptions to this general principle for two forms of ESS:

- schemes where the ESS interests are at real risk of forfeiture; and
- schemes where the ESS interests are acquired under certain salary sacrifice arrangements.

For the deferred tax rules to apply:

- the relevant ESS interests must be acquired at a discount under an employee share scheme, relate to ordinary shares and be subject to a real risk of forfeiture. Under the proposed new law, an ESS interest will be at real risk of forfeiture if a reasonable person would consider there is a real risk that the employee would lose or forfeit the interest or never receive it, other than by selling or exercising it, by intentionally taking no action to realise the benefit, or through the market value of the ESS interest falling to nil; or
- the relevant ESS interests must be acquired under a salary sacrifice arrangement, and the employee must receive no more than $5,000 worth of shares under those arrangements in an income year. To be eligible for deferred taxation, a salary sacrifice scheme must relate to shares (not rights), the employee must receive the shares for no consideration (discount per share provided through the arrangement is equal to the market value of the share), and the employee must receive no more than $5,000 worth of shares.

Real risk of forfeiture

If an ESS interest is at real risk of forfeiture and the employee share scheme meets the other conditions outlined in the proposed rules, taxation will be deferred until the ESS deferred taxing point (see below). Therefore, it is necessary to consider whether the 'real risk of forfeiture' test is satisfied.

The 'real risk of forfeiture' test is intended to provide for deferral of tax when there is a real alignment of interests between an employee and employer, through the employee's benefits being at risk. The test is a principle based test, intended to deny a deferral of tax where schemes contrive to present a nominal risk of forfeiture, without complying with the intent of the proposed law.

The test will depend on whether the relevant ESS interest relates to a share or a right:

- in the case of a share, there must be a real risk under the conditions of the relevant scheme that the employee will forfeit the share, or lose it other than by disposing of it; or
- in the case of a right to acquire a beneficial interest in a share:
  - there must be a real risk that, under the conditions of the scheme, the employee will forfeit the right, lose it other than by disposing it, exercising it or letting it lapse; or
  - there must be a real risk that, under the conditions of the scheme, if the employee exercises the right to get a beneficial interest in a share, they will forfeit the interest, or lose it other than by disposing of it.

The test does not require employers to provide schemes in which their employee share scheme benefits are at a significant or substantial risk of being lost. However, under the proposed amendments, 'real' is regarded as something more than a mere possibility. Something is not a real risk if a reasonable person would

disregard the risk as highly unlikely to occur or as nothing more than a rare eventuality or possibility. Examples of real risk include situations in which:

- a share or share is subject to meaningful performance hurdles; and
- a security will be forfeited if a minimum term of employment is not completed.

The Explanatory Memorandum accompanying the main Bill provides various examples illustrating the real risk of forfeiture test, including:

- compulsory transfers of an ESS interest may be forfeiture;
- contrived risks;
- forfeiture on cessation of employment;
- forfeiture on cessation of employment — a good leaver who leaves for reasons beyond their control;
- forfeiture on cessation of employment — retirement;
- minimal risk contrived to gain deferral;
- fraud or gross misconduct;
- performance hurdles — market share;
- performance hurdles — market price increasing;
- performance hurdles — market price maintained;
- performance hurdles over a portion of ESS interests;
- employee controlled risk;
- employee controlled risk — prohibition on sale of original shares; and
- ESS interests likely to be forfeited if employee ceases employment.

ESS interests provided through salary sacrifice arrangements

The deferral arrangements also allow for ESS interests received at a 100% discount through a salary sacrifice arrangement to be subject to the deferred taxing treatment. The risk of forfeiture is not necessary to get the deferred taxation treatment through a salary sacrifice scheme.

For tax to be deferred under a salary sacrifice arrangement, an ESS interest must be provided:

- because an employee agreed to acquire the interest in return for a reduction in salary or wages that would not have happened apart from the agreement; or
- as part of the employee's remuneration package, in circumstances where it is reasonable to conclude that the employee's salary or wages would be greater if the interest was not part of that package.

It is also a requirement the governing rules of an ESS must expressly state that the deferred taxation arrangement applies to the taxation of the scheme. A statement in the scheme's document would be sufficient to fulfil this requirement. The Explanatory Memorandum accompanying the main Bill provides an example of a sentence that could be included in an offer document:

> *This scheme is a scheme to which Subdiv 83A-C of ITAA 1997 applies (subject to the conditions in that Act).*

Deferred taxing point

The tax on an ESS discount is deferred until the 'ESS deferred taxing point'. The deferred taxing point for shares is the *earliest* of:

- when there is no real risk that the employee will forfeit the shares, or lose the shares other than by disposing of them, and there are no genuine restrictions preventing disposal; or
- when the employee ceases the employment in respect of which they acquired the shares; or
- seven years after the employee acquired the shares.

Conversely, the deferred taxing point for rights is the *earliest* of:

- when the employee ceases employment in respect of which they acquired the rights;

- when there are no longer genuine restrictions on the disposal of the rights (eg being sold), and there is no real risk of the employee forfeiting the rights;
- when there are no longer any genuine restrictions on the exercise of the rights, or resulting shares being disposed of (such as by sale), and there is no real risk of the employee forfeiting the rights or underlying shares; or
- seven years after the employee acquired the rights.

The taxing point for a right is the point at which a taxpayer can take some action to realise the benefit. It does not matter whether or not the taxpayer chooses to do so. The taxing point for an ESS interest (an interest in either a share or a right) is moved to the time the taxpayer disposes of the interest if they dispose of the interest within 30 days of the original deferred taxing point.

ESS interests and CGT

ESS interests are exempted from CGT (in most cases) until the interest has been taxed under the ESS rules. An exception is made where certain CGT events occur (CGT events E4, G1 and K8) that primarily affect the cost base of the ESS interests, which apply throughout the life of the interests.

Once ESS interests have been taxed under the ESS rules, they are subsequently taxed consistently with other capital assets (eg under the CGT regime). The interests will be considered to be reacquired for their market value immediately after the point they are taxed under the ESS rules. For an ESS interest that is taxed upfront, the interest (and the share or right of which it forms part) is taken to have been acquired for its market value from the point at which the taxpayer initially acquired the interest. For an ESS interest over which tax is deferred, the interest (and the share or right of which it forms part) is taken to have been reacquired immediately after the ESS deferred taxing point. This resets the cost base of the ESS interest to market value, and resets the acquisition time, which may be relevant to an employee's eligibility for the CGT discount.

Associates

Similar to the current law, the proposed law treats ESS interests provided to associates of employees in relation to an employee's employment as though the interest was in fact acquired by the employee rather than the associate. (Note the term 'associate' is defined with reference to s 318 of ITAA 1936.)

The main Bill proposes that shares provided to an associate of an employee will be eligible for deferral if an ESS meets the relevant criteria (see page 2 above). At the deferred taxing point, when the shares move into the CGT system, any further capital gains or losses incurred in relation to the shares will be borne by the associate.

Withholding tax

As an integrity measure, the new law also introduces a withholding tax, applicable in limited circumstances. Withholding tax will be payable if an employer provides discounted shares or rights to an employee, and that employee has not quoted their TFN or their ABN to the employer by the end of the income year. The withholding tax will be payable on the amount of ESS discount included in the employee's assessable income for an income year under the general ESS rules. It will be payable 21 days after the end of the income year in which the ESS interest is included in the employee's assessable income.

The rate of withholding tax is calculated by adding the highest individual marginal tax rate to the rate of the Medicare levy.

Employer deductions

Employers will be able to deduct an amount for shares or rights they provide to employees under an ESS if the scheme meets the conditions for an employee to receive the upfront concession. The income test for the upfront concession is disregarded when calculating an employer's eligibility to claim a deduction.

Under the proposed law, a general deduction may be available in relation to the indirect provision of securities to employees under an ESS. An employer may provide money to an employee share trust for the purpose of providing its employees with securities in itself. The employee share trust may acquire the securities by buying them on the market or by participating in a share issue by the employer.

The deduction would generally occur in the income year in which the employer incurred the loss or outgoing. However, the Government was concerned that such an arrangement may allow an employer to artificially

bring forward future deductions by making contributions to the trust that are in excess of its requirements under an employee share scheme. To prevent an artificial bring forward of these deductions, the employee share scheme rules delay the deduction until the employee acquires an ESS interest.

Refund of tax for forfeited shares

The proposed law provides for a refund of tax paid in relation to ESS interests in certain circumstances where those interests are forfeited after the employee has been taxed on the discount.

The refund will only be only available where the employee had no choice but to forfeit the ESS interest (except when that choice was to cease employment), and where the conditions of the scheme were not constructed to protect the employee from market risk. Under such circumstances, the forfeited ESS interest will be treated as never having been acquired, and the taxpayer can claim a refund of income tax by requesting the Commissioner amend their income tax assessment to remove income previously included in their assessable income.

There will be no time limit on amending an assessment to exclude an amount from a taxpayer's assessable income for a share interest which is forfeited, or for a right which was lost without being exercised.

A refund will not be available where the share interest is forfeited due to a choice of an employee (except when that choice was to cease employment). Such a choice may include a choice not to exercise or dispose of an ESS interest, or some other choice of the employee that results in the forfeiture of the ESS interest. Whether or not forfeiture is a result of a choice the employee made will be assessed on a case-by-case basis.

Date of effect

The changes will apply to ESS interests acquired on and after 1 July 2009. A tiebreaker rule provides that if the time of acquisition differs between the new and current law, the acquisition time under the current law will be used. That is, the current law continues to apply to that acquisition.

Note that shares, rights and stapled securities acquired before this time will also be brought within the new rules. However, transitional arrangements will be provided to ensure the effect of the existing law is maintained for ESS interests acquired before 1 July 2009.

Non-commercial losses

The main Bill will amend the non-commercial losses rules contained in Div 35 of ITAA 1997 to prevent high income individuals (ie individuals with an adjusted taxable income of $250,000 or more) from offsetting losses from non-commercial activities against their salary, wage or other income.

Currently, an individual taxpayer who is carrying on a business either as a sole trader or a partner in a partnership can only apply losses arising from the business activity against their other income in an income year if:

- the activity satisfies at least one of four objective tests in that year (see below);
- the losses arise from a primary production or professional arts business and the taxpayer's assessable income for the income year from other sources is less than $40,000; or
- the Commissioner exercises the discretion not to apply Div 35 of ITAA 1997.

The four objective tests are:

- assessable income test — the assessable income generated from the activity must be at least $20,000, or would reasonably be estimated to be at least $20,000 if the activity was carried on for the whole year;
- profits test — the activity must have produced a profit in three of the last five income years, including the current year;
- real property test — the reduced cost base value of real property (or interests in real property) used on a continuing basis to carry out the activity is at least $500,000. Dwellings, and adjacent land used in association with the dwelling, used mainly for private purposes are excluded, along with any tenant's fixtures; and
- other assets test — the reduced cost base of any other assets used on a continuing basis in carrying on the activity is at least $100,000. Relevant assets for this test are depreciable assets, trading stock,

assets leased from another entity and trademarks, patents, copyrights and similar rights. However, cars, motorcycles and similar vehicles are excluded.

The proposed amendments

The main Bill proposes to introduce an income requirement that prevents individuals with an adjusted taxable income of $250,000 or more in an income year from accessing the existing four objective tests. That is, losses from non-commercial business activities will be quarantined where the adjusted taxable income of an individual is $250,000 or more, unless the Commissioner exercises the discretion not to apply the non-commercial losses rules (see **Commissioner's discretion** below).

An individual's adjusted taxable income for an income year is the sum of the individual's:

- taxable income;
- reportable fringe benefits;
- reportable superannuation contributions; and
- total net investment losses.

The main Bill says that in determining if an individual has met the income requirement the individual must disregard any excess deductions from any non-commercial business activity that has excess deductions subject to Div 35.

Commissioner's discretion

Where a taxpayer does not meet the income requirement (ie the taxpayer's adjusted taxable income is $250,000 or more), the taxpayer can apply to the Commissioner to exercise the discretion not to apply the non-commercial losses rules. Before exercising the discretion, the Commissioner must be satisfied, based on an objective expectation, that the taxpayer's business activity will produce assessable income greater than available deductions within a commercially viable period of the industry concerned.

The discretion is not intended to be available in cases where the failure to make a profit is for reasons other than the nature of the business, such as a consequence of starting out small and needing to build up a client base, or business choices made by an individual that are not consistent with the ordinary or accepted practice in the industry concerned (eg the hours of operation, location, climate or soil conditions, or the level of debt funding).

To obtain the exercise of the Commissioner's discretion, a taxpayer will need to complete an approved form. The information required by the form may include:

- details of the nature of the taxpayer's business activity, including when the activity commenced;
- objective evidence from independent sources demonstrating that, because of the nature of the business activity, it does not (or will not) satisfy the objective tests, or does not produce assessable income greater than available deductions in a given income year (whichever is applicable); and
- objective evidence from independent sources that, despite the business not meeting the tests, the business does not (or will not) satisfy the tests that are available to the taxpayer, or does not produce assessable income greater than available deductions in a given income year but will nonetheless meet the tests or produce assessable income greater than available deductions (whichever is applicable) in a period of time that is considered commercially viable for the industry concerned.

An individual is required to establish objectively the commercially viable period for the industry in which their business operates. The Explanatory Memorandum accompanying the main Bill states that evidence of what the commercially viable period for the industry is may include:

- current or projected information about the market for the goods or services (prices and demand) that the business activity produces;
- industry articles, statistics, analyses and market forecasts that support the proposals or projections made in any business plan;
- suitability of the particular business activity to the location where it is undertaken, such as soil and climate conditions, markets for the products or services and transport requirements;
- scientific research or other papers on relevant industries; and
- yield and price forecasts.

The Commissioner must look at the most recent income year that has ended immediately before a taxpayer's application when deciding whether to exercise the discretion.

The examples below, which are from the Explanatory Memorandum, explain when the Commissioner will and will not exercise the discretion.

Situation where the Commissioner *will* exercise the discretion

Karen carries on a business of horse breeding, training and selling horses in partnership. The partnership commenced a breeding program which will, in time, enable the breeding of high quality, sought-after animals.

It is in the nature of breeding and training horses that there will be a lead time before a profit can be expected. Independent evidence from the relevant national association supports the view that the commercially viable period for this industry, in view of the intensive training involved, would be when a horse reaches five to six years of age. This period added to the gestation period of 11 months supports a lead time of six to seven years for the industry.

Provided there is an objective expectation that the partnership business activity will make a tax profit within this commercially viable period, the Commissioner may exercise the discretion to allow losses to be claimed.

Situation where the Commissioner *will not* exercise the discretion

Tracey carries on a business of primary production from breeding and selling cattle. Their profit projections indicate that they do not expect to make a tax profit for six years.

Independent evidence provided by Tracey indicates the lead time period begins from the commencement of the activity and includes the time taken to raise the females to a breeding age, allowing for the gestation period of those animals to finish, and finishes when the progeny have reached a saleable age. On the evidence provided, the period for a typical business activity of breeding and selling cattle to become commercially viable is no greater than three years. Therefore, Tracey will not be able to produce a tax profit within a period that is commercially viable for the industry concerned and the Commissioner will not be able to exercise the discretion to allow the losses.

Transitional measures

The main Bill proposes to amend the *Income Tax (Transitional Provisions) Act 1997* to ensure that:

- the non-commercial loss rules will not apply to a business activity that has greater available deductions than assessable income in a given income year only because of Div 41 of ITAA 1997 (the small business and general business tax break); and
- any discretion that has been applied by the Commissioner before the commencement of these amendments, including about any managed investment scheme, will continue in effect.

Date of effect

The amendments will apply to the 2009/10 and later income years.

Payment of lost member superannuation accounts to the Commissioner

The main Bill seeks to require superannuation funds to transfer certain small and unidentifiable accounts of lost members to the Commissioner as unclaimed monies.

Small and inactive accounts

The main Bill will amend the *Superannuation (Unclaimed Money and Lost Members) Act 1999* (SUMLM Act) to require superannuation funds and retirement saving accounts (RSAs) to transfer the balance of a 'lost member account' (other than a defined benefit interest) to the Commissioner, where the member on whose behalf the account is held is a 'lost member' (as defined in SIS reg 1.03A) and:

- the balance of the account is less than $200 (ie small accounts); or

- the account has been inactive for a period of five years and the trustee is satisfied it will never be possible to pay an amount to the member (inactive accounts of unidentifiable members).

Currently, amounts are only paid to the Commissioner as unclaimed monies when:

- a member reaches age 65 and cannot be found;
- a member dies and the trustee cannot ensure the benefit is received by the person entitled to receive the benefit; or
- the account holder was identified in a notice under s 20C of the SUMLM Act (concerning former temporary residents).

Payments to Commissioner

A trustee of a superannuation fund or RSA will be required to pay to the Commissioner an amount for a lost member account (generally the balance of the account) at the end of the 'unclaimed money day'. The amount due and payable to the Commissioner under proposed s 24E(1) of the SUMLM Act is the amount that would have been due and payable if the lost member had requested that the balance be rolled over to a complying superannuation fund. GIC will apply on the amounts that remain unpaid after it was due and payable.

A trustee of a superannuation fund is discharged from further liability for amounts paid under proposed s 24E. However, an offence is committed if a trustee breaches a requirement under s 24E.

A trustee of a superannuation fund will also be required to give a statement to the Commissioner (in an approved form) for lost member accounts. Such reporting will require information to allow the Commissioner to apply the correct tax treatment to a payment of unclaimed money made for a person under proposed s 24G of the SUMLM Act.

Payments from Commissioner

The Commissioner can pay an amount he receives for a lost member account to a person, if the person has reached eligibility age or the amount is less than $200, unless the person directs the Commissioner to pay the amount to a complying superannuation plan. In the case of payments to a fund, the Commissioner can only pay to a single fund. If the amount is less than $200, the Commissioner can pay it to the person, even if the person is less than age 65.

The Commissioner can make a payment where he is satisfied that he can make the payment, either on receipt of an application in the approved form or by the Commissioner's own initiative.

If the person has died, the Commissioner can pay an amount to a death beneficiary where the Commissioner is satisfied that the superannuation fund would have been required to pay a death benefit amount to one or more death beneficiaries as a result of the person's death, had it not paid the amount to the Commissioner. If the Commissioner cannot be so satisfied, he must pay the amount to the person's legal personal representative.

Income tax amendments

Consequential amendments are proposed to ss 307-5, 307-142, 307-300, 307-350 and 307-120 of ITAA 1997 to ensure payments made by the Commissioner under s 24G in respect of a small and inactive account of a lost member will be treated and taxed as if they were paid from a complying superannuation fund.

Amendments to the *Taxation Administration Act 1953* will also provide that an amount due and payable by a superannuation trustee is a tax-related liability for the purposes of administrative penalties and offences under the Act.

Date of effect

The amendments are proposed to commence on Royal Assent to the main Bill and apply in relation to the last 'unclaimed money day' occurring before 1 July 2010 and later unclaimed money days. The initial transfer of lost member accounts to the Commissioner is proposed to take place during the 2010/11 income year. Transfers will continue to be made for lost member accounts at times to be determined by the Commissioner by legislative instrument.

Collapsed MISs and Tax Consequences for Investors

The Tax Office has released four draft taxation determinations which set out the Commissioner's preliminary views on the tax consequences that may flow from collapsed managed investment schemes (MISs):

- Draft Taxation Determination TD 2009/D13;
- Draft Taxation Determination TD 2009/D14;
- Draft Taxation Determination TD 2009/D15; and
- Draft Taxation Determination TD 2009/D16.

Note that the Tax Office has previously released three draft taxation determinations covering the tax consequences that may flow from collapsed MISs:

- Draft Taxation Determination TD 2009/D9 — change of responsible entity of registered agricultural MISs and tax outcomes for participants;
- Draft Taxation Determination TD 2009/10 — disposal or termination of an interest in a non-forestry MIS that arises as a result of circumstances outside the control of participants and deductions previously allowed under s 8-1 of ITAA 1997;
- Draft Taxation Determination TD 2009/D11 — payments received by participants in a non-forestry MIS upon the winding-up of a scheme, that do not involve the disposal of the participants' interests to another person, and assessable income.

Failure to plant trees under a forestry scheme

In Draft Taxation Determination TD 2009/D13, the Commissioner says a failure to plant trees intended to be established under a forestry scheme does not affect the timing of deductions for expenditure on seasonally dependent agronomic activities where s 8-1(b) of ITAA 1997 and s 82KZMG of ITAA 1936 have previously been ruled to be satisfied. Examples of seasonally dependent agronomic activities include:

- tending seedlings prior to planting, and planting them;
- ripping and mounding the site where the planting is to occur; and
- applying fertiliser, herbicide or pesticide in conjuncture with the planting.

According to the draft, s 82KZMG(2) requires forestry expenditure to be incurred 'in return for the doing of a thing under the agreement'. Therefore, the draft says if it transpires that the 'thing' is not done, for reasons outside the control of the parties, the timing of the deduction would remain governed by s 82KZMG. In addition, the expenditure may still be relevantly incurred for the purposes of s 8-1, at the time the expenditure was made.

Example

The example below from the draft explains the Commissioner's preliminary view.

> *Kane incurred expenditure under agreements that satisfied ss 82KZMG(2) and (3) of ITAA 1936 during the 2008 financial year. The nature of the agreements entered into also indicates that a business is being carried on. Under the agreement, the trees that were subject of the agreement were due to be planted by 30 June 2009. Due to the appointment of a liquidator or administrator, the trees were not planted by 30 June 2009. Nevertheless, the timing of the deduction for the expenditure remains within the scope of s 82KZMG of ITAA 1936.*

Failure to plant all trees under a forestry MIS

According to Draft Taxation Determination TD 2009/D14, a failure to plant all the trees intended to be established under a forestry MIS covered by Div 394 of ITAA 1997 means that the conditions under which an amount can be deducted under the Division are not satisfied. However, the draft says where a taxpayer is carrying on a business (or a business was being carried on), the amount may still be deductible under s 8-1 of ITAA 1997 even though the conditions of Div 394 are not satisfied. The draft also says if the taxpayer is entitled to a deduction under s 8-1, the amount will be subject to the operation of Subdiv H of Div 3 of Pt III of ITAA 1936 (the prepayment rules).

Example

The example below from the draft explains the Commissioner's preliminary view.

> *Zane paid an amount under a forestry managed investment scheme in 2008. Due to the insolvency of the forestry manager, it is apparent that all the trees intended to be established under the scheme will not be planted by 31 December 2009. The content of the agreements indicate that a business is also being carried on. The amounts incurred remain deductible under s 8-1 of ITAA 1997 and are subject to the operation of Subdiv H.*

CGT event and a participant's interest in a forestry MIS

In Draft Taxation Determination TD 2009/D15, the Tax Office says a deduction is not allowable under s 394-10(1) of ITAA 1997 where a CGT event happens in relation to a participant's interest in a forestry MIS within four years after the end of the income year in which the participant first pays an amount under the scheme.

The draft says a taxpayer may still be entitled to deduct an amount under s 8-1 where the taxpayer is carrying on a business (or a business was being carried on) even though the taxpayer fails the test in Div 394 of ITAA 1997. However, the timing of the deduction will be subject to the prepayment rules contained in Subdiv H of Div 3 of Pt III of ITAA 1936. In the Commissioner's view, most arrangements with features initially designed to satisfy the provisions of Div 394 will not meet the requirements of s 82KZMG because the agreements will have an establishment period greater than 12 months. Therefore, the Commissioner says the timing of the deduction is determined by s 82KZMF of ITAA 1936, subject to s 82KZME of ITAA 1936.

Example

The example below from the draft explains the Commissioner's preliminary view.

> *Dane paid amounts under a forestry managed investment scheme during the 2008 financial year. The content of the agreements indicates that a business is also being carried on. During 2009, as a result of the liquidation of the forestry manager, Dane gave up all rights under his forestry interest in return for a share of proceeds from asset realisations. This is a CGT event (either A1 or C2). As a result of the CGT event, s 394-10(5) of ITAA 1997 is failed, and there is no entitlement to claim the deduction for the amounts paid in the 2008 year under s 394-10(1) of ITAA 1997. However, the market vale of the consideration he received is included in Dane's assessable income. Moreover, as a business was being carried on, the amounts incurred would have been deductible under s 8-1 of ITAA 1997 and subject to the operation of Subdivision H. Due to the contracted period within which trees were to be planted, s 82KZMG of ITAA 1936 does not apply. Subject to s 82KZME of ITAA 1936, s 82KZMF of ITAA 1936 would apply to spread the amount paid over the relevant eligible service period.*

(Note the four-year holding period rule only applies to interests in forestry MISs.)

CGT event happens to a taxpayer's interest in a forestry MIS

According to Draft Taxation Determination TD 2009/D16, a deduction will not remain allowable under s 8-1 of ITAA 1997 where a CGT event happens in relation to a taxpayer's interest in a s 82KZMG of ITAA 1936 forestry MIS within four years after the end of the income year in which the taxpayer first incurred expenditure under the agreement. This is because s 82KZMGA of ITAA 1936 applies to disallow the previously allowable expenditure.

A deduction for an amount paid by an initial investor in a forestry MIS on or after 1 July 2007 and on or before 30 June 2008 may be allowable under Div 394 of ITAA 1997. Alternatively, the amount may be deducted under s 8-1 of ITAA 1997 if the requirements of the section are satisfied. Where the amount is deductible under s 8-1, the timing of the deduction may be governed by s 82KZMG.

(Note the four-year holding period rule only applies to interests in forestry MISs.)

Example

The following example from the draft explains the Commissioner's preliminary view.

> *Wane pays an amount under an agreement as part of a managed investment scheme in June 2006 and claims a deduction in that income year pursuant to s 8-1 of ITAA 1997 and s 82KZMG of ITAA*

1936. The manager of the scheme is placed in liquidation in June 2009. Wane's interest ceases to exist under the terms of a liquidation in December 2009 and he receives nothing in return, as there is no value in the interest at that time. Section 82KZMGA of ITAA 1936 applies in the 2009 income year to deny the deduction initially claimable in the 2005/06 income year.

Scope of draft determinations

The draft determinations apply to participants in schemes that are either subject to a current product ruling, or were subject to a product ruling that was withdrawn before any material difference occurred.

Date of effect

When finalised, the determinations will apply to income years both before and after its date of issue.

Proposed amendments to four-year holding period rule

The Government has announced that it will amend the tax law to protect investors in forestry MISs from an unintended and adverse tax outcome: see Assistant Treasurer's press release No 074, 21 October 2009.

The Assistant Treasurer said the collapse of Timbercorp and Great Southern is expected to lead to a number of forestry MISs being wound-up or restructured, which could cause investors to fail the requirement of having held their interest in an MIS for four years as a condition of an upfront deduction. Therefore, under the current law, investors in forestry MISs managed by Timbercorp and Great Southern may have previous years' deductions clawed back because they have not held their interest for four years.

To ensure investors are not unduly penalised for events outside their control, the Government will amend the four-year holding period for forestry MISs to ensure it cannot be failed for reasons genuinely outside the investors' control, such as the insolvency of an MIS manager, the death of the investor or where the MIS interest is cancelled (eg because of trees being destroyed by fire, flood or drought). The Government will also amend the law to ensure that civil penalties can still apply to the promoters of forestry MISs even where the investors' deductions are allowed to stand because of the amendment to the four-year holding rules.

GST Consequences and Partner Taking Goods for Private Use

The Tax Office has released GST Determination GSTD 2009/2, in which it states that when a partner in a partnership takes goods held as trading stock for private or domestic use, there is a supply by the partnership to the partner in the course or furtherance of the partnership's enterprise. A taxable supply by the partnership to the partner will arise if the requirements of s 9-5 of the GST Act are satisfied.

According to the determination, Div 72 of the GST Act will apply if a partnership supplies goods for a partner's private or domestic use other than by way of an in-specie distribution. The determination says if the requirements of s 9-5 are satisfied, the value of the taxable supply will be the GST-exclusive market value of the supply.

In addition, the determination says Div 130 of the GST Act (which sets out whether an entity has an increasing adjustment if it applied solely to private or domestic use goods for which it had claimed a full input tax credit) does not apply to a partnership. In the Commissioner's view, the wording of s 130-5 means that the Division only applies where the same entity that acquired the goods also applies the goods to private or domestic use. Therefore, in the case of the partnership, the entity (ie the partnership) that acquired the goods is different from the entity (ie a partner) that applies the goods to private or domestic use.

In the Commissioner's view, an in-specie distribution of trading stock by a partnership to a partner is made for consideration. The determination says the distribution has the effect of proportionately reducing the partner's entitlement to a distribution of any surplus remaining after the realisation of assets, and payment of debts and liabilities, on the winding up of the partnership. The determination also says the consideration for the supply is the proportion of the partner's interest in the partnership, reflected by the value of goods distributed and may be represented by:

- an amount debited to the capital account of the partner;

- an amount debited to the current account of the partner; or
- a combination of amounts debited to both the partner's capital and current accounts.

The Commissioner says that where a partnership is registered for GST, an in-specie distribution will be a taxable supply under s 9-5 of the GST Act to the extent that the supply is not GST-free or input taxed.

The determination finalises Draft GST Determination GSTD 2009/D1 and is essentially the same.

Examples

The determination provides two examples explaining the Commissioner's view.

> ***Example 1***
>
> *Larry and Ralph are in partnership. The partnership is registered for GST and operates a hardware store in Australia. The partnership, as part of a distribution of partnership profits, supplies Larry, by way of an in-specie distribution, tools held as trading stock for Larry's own private and domestic use. The supply of the tools is for consideration and is made in the course or furtherance of the enterprise carried on by the registered partnership. The in-specie distribution of the tools to Larry by the partnership is a taxable supply by the partnership to Larry.*
>
> ***Example 2***
>
> *Alex and Tom are in partnership operating a corner store in Australia. During the tax period the partnership supplies Alex with bread, milk, soft drinks, confectionary and ice creams. Supplies of milk and bread are GST-free and not taxable supplies. Supplies of soft drinks, confectionary and ice creams are taxable supplies. The market value of the soft drinks, confectionary and ice creams is $330 (inclusive of GST). Alex pays consideration of $100. Division 72 applies to the supplies of the soft drinks, confectionary and ice creams because Alex is an associate of the partnership and has provided inadequate consideration. The GST exclusive market value of the taxable supplies is $300 (10/11 x $330) and the GST payable by the partnership is $30 ($300 x 10%).*

Date of effect

The determination applies to all income years before and after its issue.

Small Business Benchmarks

The Tax Office has released an expanded range of benchmarks, known as the small business benchmarks. According to the Tax Office, the benchmarks provide small businesses 'a snapshot of what, on average, is happening in businesses operating in a particular industry by providing a measure of various business costs in relation to turnover'. In addition, the Tax Office says the benchmarks are a useful tool to assist business owners in assessing their business performance.

The benchmarks

Two types of benchmarks for the small business sector have been developed by the Tax Office:

- performance benchmarks, which are based on information small businesses report to the Tax Office on income tax returns and business activity statements (BASs); and
- input benchmarks, which are based on information industry participants and trade associations provide to the Tax Office.

Fifty-eight benchmarks have been released by the Tax Office. The benchmarks are grouped into categories based on the business industry codes. The categories include:

Category	Benchmarks developed for …
Manufacturing	bakeries and hot bread shops cake shops and patisseries
Construction	air conditioning, refrigeration and heating services bricklaying blocklaying concreting services electrical services fence construction painting services plasterboard installers plastering and ceiling services plumbing services roof guttering installation roof painting and repair roof services (includes roof tiling and metal roofing services) tiling and carpeting services tiling — floor and wall timber floor installation timber floor sanding
Retail trade	clothing retailing computer retailing floor covering retail florists footwear retail fresh fish and seafood retailing fresh poultry retailing fruit and vegetable retailing furniture retailing grocery retailers and general stores houseware retailing liquor retailing meat retailing and butchers newsagents tyre retail
Accommodation and food services	chicken shops coffee shops fish and chips shops kebab shops

Category	Benchmarks developed for …
	pubs, taverns and bars restaurants sandwich shops sushi takeaways takeaway food services takeaway pizza shops
Transport, postal and warehousing	courier services delivery services furniture removalists road freight transport services taxi drivers and operators towing services
Rental, hiring and real estate services	video and other electronic media rental and hiring
Administrative and support services	building and other industrial cleaning services pest control services
Other services	barber and men's hairdressing beauty services hairdressers laundry and dry-cleaning services nail salons

Performance benchmarks

These benchmarks are designed to allow small business owners to compare their business performance with other businesses in the relevant industry. The benchmarks will also assist the owners in checking whether they are complying with their tax obligations, particularly in relation to cash income.

Five ratios are available to help the owners compare and check the performance of their businesses against other businesses in their industry. The ratios are:

- cost of goods sold to turnover — this ratio is calculated as (cost of goods ÷ turnover) x 100;
- labour to turnover — the formula for calculating this ratio is (labour cost ÷ turnover) x 100;
- rent to turnover — the formula for calculating this ratio is (rent ÷ turnover) x 100;
- GST-free sales to turnover — this ratio is calculated as (GST-free sales ÷ turnover) x 100; and
- motor vehicle expenses to turnover — this ratio is calculated as (motor vehicle expenses ÷ turnover) x 100.

(Note the ratios are expressed as a percentage.)

The Tax Office says the ratio ranges will assist business owners to work out whether they fall within or outside the average for their industry. The ratios will also identify how and why their businesses may differ from the industry's average, says the Tax Office.

Input benchmarks

The Tax Office says these benchmarks show an expected range of income for tradespeople based on the labour and materials they use. The Tax Office also says these benchmarks apply to small businesses that work with domestic customers rather than commercial customers.

The benchmarks as a compliance tool

The Tax Office says that where businesses do not report within the ranges of the benchmarks, it may be an indication that the businesses are not recording and paying tax on all of their transactions, especially cash transactions. The Tax Office also says that comparing a business against benchmarks for its industry is one of the methods it uses to identify businesses for an audit or a review.

According to the Tax Office, when it selects a business for audit or review, it looks at the actual records of the business to assess whether it has reported all of its cash income. In addition, the Tax Office may use benchmarks to:

- work out if the business's records are accurate and complete; and
- assist in calculating income tax or GST obligations where the business has provided insufficient or unreliable information.

The Tax Office says that businesses falling outside the benchmarks for a particular industry are more likely to attract its attention. However, the Tax Office acknowledges that there is often a reason why a business falls outside a benchmark, for example, the rent paid by the business may be higher than average because it is located in a city centre. In these situations, the Tax Office recommends that the business:

- reviews its recordkeeping;
- considers how its business operates; and
- checks if it has made a mistake on its tax return or not reported all its income. If so, the business should correct the information and advise the Tax Office.

Tax Office views

In October 2009, a Second Commissioner of Taxation, Bruce Quigley, delivered a speech to the Taxation Institute of Australia. One of the topics covered in his speech was the new small business benchmarks.

Mr Quigley reiterated that the benchmarks will be used by the Tax Office to identify business that may be avoiding their tax obligations. The Second Commissioner also repeated that businesses operating outside of an industry's benchmarks would attract the Tax Office's attention. 'Consistent, long-term performance outside the benchmarks could be a sign a business is not meetings tax obligations', said Mr Quigley.

The Second Commissioner urged tax practitioners to promote the benchmarks to their clients and network.

The question of whether an audit would be triggered if a business performed outside the benchmarks was discussed in the Small Business Consultative Group meeting held on 24 June 2009. The Tax Office explained that performance outside the benchmarks may be a sign a business is not meeting its tax obligation. According to the Tax Office, it applies a filtering approach that may include:

- contacting the business via phone calls for an explanation;
- visiting the business to obtain further information; and
- escalating the business to audit or review.

Superannuation Clearing House Service

The Government has announced a free superannuation clearing house service for small businesses which will be administered through Medicare Australia: see Joint Media Release issued by the Minister for Financial Services, Superannuation and Corporate Law, and the Minister for Small Business, Independent Contractors and the Service Economy No 035, 6 November 2009.

The superannuation clearing house service will commence from July 2010. Small businesses can register for the service online from May 2010. The details of how small businesses will be able to register with Medicare for the service will be announced by the Government in due course.

Key features of the superannuation clearing house service include:

- the processing of superannuation contributions made by employers, including forwarding the contributions to employees' nominated superannuation funds. Initially, payments to the clearing house will need to be made via electronic funds transfer (EFT);
- the discharging of employers' superannuation guarantee obligations when payment of the correct amounts (of superannuation guarantee) are made to the clearing house;
- the superannuation clearing house service will be offered free of charge to small businesses with less than 20 employees; and
- the processing of choice of fund nominations passed on by small businesses.

Currency:

This issue of Client Alert takes into account all developments up to and including 6 November 2009.