



Explanatory Memorandum

December 2010 / January 2011

CURRENCY:

This issue of Client Alert takes into account all developments up to and including 17 November 2010.

Trust Entitlements and Loans: Tax Office Issues Guidance

On 14 October 2010, the ATO released its keenly awaited Practice Statement on Div 7A and trust entitlements, PS LA 2010/4. It is effective from 14 October 2010 and is lengthy, running to 218 paragraphs. The Commissioner said it provides practical ways on how to follow Taxation Ruling TR 2010/3, issued 2 June 2010. That ruling contains the Commissioner's view on when a private company with an unpaid present entitlement makes a loan to the trust estate which generated the entitlement, for the purposes of Div 7A of the ITAA 1936.

The Commissioner said he is aware of the importance of this issue to businesses, particularly small businesses, which use a trust structure. He said the ATO had "given careful consideration to all feedback" it received and had "incorporated further options to address concerns raised by tax practitioners and small businesses".

Mr D'Ascenzo said the Practice Statement provides practical ways for businesses to work towards a compliant structure with minimal impact on their cash flow or how they operate. He said that where businesses had made mistakes in the past, the Practice Statement provides several options for private companies to self-correct before 31 December 2011. "Taxpayers have until 30 June 2011 to work out what to do," he said.

The Practice Statement

The following are important points gleaned from the Practice Statement.

TR 2010/3 considers 2 types of loans, which are referred to as:

- **Section two loans** – these are loans within the ordinary meaning of the term "loan". Such a loan can arise in situations where a UPE is satisfied (eg by being paid out) and the funds are loaned back to the trustee. The UPE will effectively be replaced by an ordinary loan from the private company to the trustee of the trust. PS LA 2010/4 says the ATO has always considered that Section two loans are loans for the purposes of Div 7A;
- **Section three loans** – these deal with subsisting UPEs. A subsisting UPE means a UPE that has not been satisfied, including by being converted into (or replaced by) an ordinary loan. PS LA 2010/4 says a subsisting UPE is not a loan within the ordinary meaning of "loan", but may be a loan under the extended definition of a Div 7A loan if it is the provision of financial accommodation or an in-substance loan. The ATO says it will not apply Div 7A (other than Subdiv EA) to UPEs in existence before 16 December 2009. In the Practice Statement, the ATO says it will not consider a UPE to be a Section three loan if funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary. The Practice Statement sets out 3 options which satisfy the Commissioner that this has occurred ie:

where the amount representing the UPE is set aside separately in the accounts of the main trust as being held on trust for the private company beneficiary;

where separate accounts are prepared for the sub-trust; or

where a separate bank account is opened in the name of the trustee as trustee for the private company beneficiary in respect of the funds within the sub-trust.

Section two loans

For Section two loans, the ATO will treat an arrangement as being an express loan agreement where the agreement is evidenced by: a written agreement; a trust resolution; or another document. Subject to evidence to the contrary, the ATO considers that an implied loan agreement will arise where the amount is recorded in the financial accounts of the private company as an asset in the form of a loan and in the financial accounts of the trust as a liability in the form of a loan. Where a UPE has been forgiven, the ATO says it may consider that a Section two loan has arisen, despite the fact that the amount had been recorded as a UPE in the accounts.

Subject to evidence to the contrary, the ATO says it will consider a Section two loan to have been made at the following times:

- where there is a loan agreement: on the date the amount was loaned to the trust under the terms of the loan agreement;
- where there is no loan agreement: the date the amount is recorded as being debited to the loan account according to the loan account ledger of the private company; or
- in situations where neither of the above dot points apply: the date the amount is recorded as being credited to a loan account in the name of the private company according to the loan account ledger of the trust.

Taxation consequences

The ATO says a Section two loan will be subject to Div 7A. Generally, the ATO will apply s 109D to treat the private company as having paid an assessable dividend to the trust (equal to the Section two loan) at the end of the income year in which the loan is made, unless:

- an exception contained in Subdiv D of Div 7A applies (eg if before the lodgment day for the income year in which the loan is made, the loan is put under a complying loan agreement) – whereby no amount of the Section two loan will be assessable under s 109D;
- the loan is fully repaid before the private company's lodgment day for the income year in which the loan is made; or
- the private company has insufficient distributable surplus such that s 109Y will operate to reduce the amount of the dividend that would otherwise be deemed to have been paid – whereby s 109D will apply to the extent of the amount of the distributable surplus.

Self corrective options – applicable until 31 December 2011

During the consultation process for this Practice Statement, the ATO said it received feedback that some small businesses may have been incorrectly classifying UPEs as loans in their accounts or alternatively were not aware that Div 7A can potentially apply to ordinary loans (as opposed to UPEs) between a private company and an associated trust.

In recognition of the genuine concerns of small business and their willingness to comply, the ATO said it has introduced 2 self corrective administrative options for taxpayers. Provided certain conditions are met, these options allow taxpayers to:

- self-correct accounts where a UPE has been misclassified as a loan;
- operate on the basis that the Commissioner would exercise his discretion under s 109RB to disregard a deemed dividend.

Not a loan but a UPE

The ATO said it will accept that an amount is not a loan but a UPE where all the following conditions have been met:

- the financial accounts of the trust and/or the private company have incorrectly classified the amount, which is in fact a UPE, as a loan from the private company to the trust;
- with the exception of the financial accounts, all available evidence supports the view that the amount is in fact a UPE;
- the private company has never included that amount in calculating the amount of loan reported at Label 8N of the private company's income tax return (label marked "loans to shareholders and their associates");
- the trust has not paid or credited any interest on or in respect of that amount;
- the loan account in which the amount is included is entirely comprised of amounts correlating to UPEs and repayments of such UPEs between the trust and the private company (ie its balance is not affected by any unrelated transactions);
- **on or before 31 December 2011**, the financial accounts of all relevant entities are amended to properly classify the amount as a UPE;
- **on or before 31 December 2011**, the trustee or public officer of the trust, or public officer of the company (as is relevant), signs and dates a declaration setting out all of the above conditions listed in this paragraph in the context of the amount and declaring them to be true and correct.

Where this is the case, the ATO said it will not treat the amount as a Section two loan for Div 7A purposes.

Section three loans

The Practice Statement considers at what point the ATO will consider that a UPE becomes a Section three loan to which Div 7A applies. It says a UPE owing from a trust to a private company in the same family group will become a loan to which Div 7A applies to the extent that:

- it has not been paid out to the private company beneficiary; and
- the trustee fails to hold the funds representing the UPE on sub-trust for the sole benefit of the private company beneficiary by the main trust's lodgment day for the income year in which the present entitlement arises and all times thereafter.

For UPEs arising between 16 December 2009 and 30 June 2010, the ATO says the trustee has until 30 June 2011 to put the funds representing the UPE on sub-trust for the sole benefit of the private company beneficiary.

Sub-trust

A UPE will not be considered by the ATO to be a loan to which Div 7A applies if the funds representing the UPE are held on sub-trust for the sole benefit of the private company beneficiary. The ATO says a sub-trust may be evidenced by a resolution by the trustee to set aside the funds representing the UPE for the sole benefit of the private company beneficiary.

However, the ATO recognises it is common for trust deeds to expressly provide that UPEs are to be held on a sub-trust and that the trustee has wide powers to invest the amount held in the sub-trust. The setting up of the sub-trust may therefore happen without any requirement for the trustee to resolve to do so.

Subject to the expectation that there would only be one sub-trust if the beneficiary is the same, the ATO said it will consider the following to evidence the existence of a sub-trust:

- where the amount representing the UPE is set aside separately in the accounts of the main trust as being held on trust for the private company beneficiary;
- where separate accounts are prepared for the sub-trust; or
- where a separate bank account is opened in the name of the trustee as trustee for the private company beneficiary in respect of the funds within the sub-trust.

The ATO will consider that the funds in the sub-trust are held for the sole benefit of the private company beneficiary where:

- the trustee of the sub-trust invests the funds representing the UPE in the main trust on commercial terms pursuant to a power as trustee to do so; and
- all the benefits from the investment flow back to the sub-trust and the private company beneficiary; and
- all the benefits (eg annual return on investment) are actually paid to the private company beneficiary by the lodgment day of the tax return of the main-trust for the year in which the return arises.

Where there is a Section three loan, when has it been made?

The ATO generally considers it appropriate that a Section three loan be taken to have been made at the trust's lodgment date for the year in which the UPE arose. However, if a UPE arising between 16 December 2009 and 30 June 2010 was treated as a Section three loan made at the trust's 2010 lodgment date, a taxpayer who wished to avoid such a UPE being taken to be a Section three loan may not be given sufficient time to put appropriate arrangements in place. Accordingly, the ATO says a Section three loan will be taken to have been made as at the later of:

- the lodgment day for the main trust for the income year in which the present entitlement arises; and
- 30 June 2011,

as long as the UPE is still a subsisting UPE at that time (ie if the UPE has not been satisfied by that time) and is not being held on sub-trust for the sole benefit of the private company beneficiary.

Taxation consequences

The ATO says the Section three loan will be subject to Div 7A. Generally, s 109D will apply to treat the private company as having paid an assessable dividend to the trust (equal to the UPE) at the end of the income year in which the Section three loan is made, unless:

- the loan is fully repaid before the private company's lodgment day for the income year in which the loan is made. That is the lodgment day for the income year after the year in which the UPE arose; or
- an exception contained in Subdiv D of Div 7A applies (eg if before the lodgment day for the income year in which the loan is made, the loan becomes subject to a complying loan agreement); or

- the private company has insufficient distributable surplus such that s 109Y will operate to reduce the amount of the dividend that would otherwise be deemed to have been paid.

Source: Practice Statement Law Administration PS LA 2010/4 <http://law.ato.gov.au/pdf/psr/ps10_004.pdf>

Industry reaction

The release of the Practice Statement has not been without controversy. According to leading professional tax and accounting bodies, the outdated laws governing the taxation of trusts are ripe for major sweeping reforms. The bodies consider that the fundamental incorrectness of the Tax Office's interpretation of the laws in relation to this issue remains and have called for a test case to be heard by the Federal Court. According to the bodies, the Commissioner had accepted the proposition that a test case is an appropriate vehicle through which to resolve this issue.

Source: Joint media release by ICAA, NIA, TIA and Taxpayers Australia, 18 October 2010 <www.charteredaccountants.com.au/news_releases_2010/september_2010/A124644111>

Tax Office Highlights Common PAYG Instalment Errors

The ATO is in the process of calling tax professionals and business operators in the \$2m to \$100m annual turnover range to discuss instances where the PAYG instalment amount received for the quarter under review is significantly different to the PAYG instalment amount received in a previous quarter.

The ATO says it has found 3 main errors that preparers make when completing PAYG instalment details on business activity statements:

- instalment income amounts are adjusted rather than instalment rates varied;
- no PAYG instalments are returned in the first 2 quarters but are then added to the final 2 quarters;
- only one month's instalment income is included instead of the income for a quarter (this occurred in some cases where GST sales equalled PAYG instalment income).

The ATO says businesses should review their PAYG instalment rate each quarter, for example, to ensure that in the current business climate, they are not paying more than necessary. Further information on how to vary PAYG instalments is available on the ATO website at <www.ato.gov.au/businesses/content.asp?doc=/content/6003.htm>.

SMSFs and Private Companies Investing in Trusts: Tax Office Warning

On 21 October 2010, the Tax Office issued 2 Taxpayers Alerts warning self-managed super funds (SMSFs) and private companies not to invest in trusts with the intention of making funds available for lending to members or shareholders.

SMSFs lending to members via unrelated trusts

Taxpayer Alert TA 2010/5 warns taxpayers about arrangements whereby a self-managed superannuation fund (SMSF) invests money in an unrelated trust that then on-lends the funds to an SMSF member or relative.

According to the Tax Office, such arrangements attempt to circumvent the prohibition on SMSF trustees lending money or providing financial assistance to a member or a relative of the member using the resources of the fund: s 65 of the SIS Act.

Taxpayer Alert TA 2010/5 applies to arrangements with the following features:

1. An organiser sets up a trust (the trust) which purports to offer fixed rate interest yielding investments to allegedly unrelated entities.
2. An SMSF invests in the trust.
3. The organiser (who may also be the trustee of the trust) or a licensee/franchisee of the organiser, sources borrowers (the borrowers) to borrow funds from the trust.
4. The borrowers may include a member of the SMSF that invested in the trust or a relative of an SMSF member.
5. Each borrower enters into a loan agreement (the loan) with the trust. The loan amount (or total loan amounts of all borrowers associated with the SMSF) may be comparable to the amount the SMSF invested in the trust.
6. Terms of the loan may include:
 - (a) a range of available interest rates;

- (b) a range of interest payment terms, including flexibility in the repayment date (provided the funds are paid sometime in the future);
 - (c) security over the loan in the form of a mortgage, personal guarantee or caveat; and/or
 - (d) the use of borrowed funds for multiple purposes, including business, investment or personal use.
7. Each borrower makes interest only repayments on the loan to the trust for a substantial period of the loan.
 8. The trustee of the trust pays the SMSF an interest yield on their purported investment.
 9. Investment and loan fees payable under the arrangement may be considered excessive.

Tax Office concerns

The Tax Office considers that such arrangements may involve a breach of the following SIS Act provisions:

- sole purpose test under s 62 of the SIS Act;
- s 65 of the SIS Act which prohibits a trustee from lending money or giving any other financial assistance to a fund member or relative;
- members of the SMSF may have illegally accessed superannuation benefits if they do not repay the loan from the trust;
- s 109 of the SIS Act which requires that SMSF investments are made and maintained on an arm's length basis;
- the SMSF's investment in the trust may be an in-house asset and therefore subject to the 5% limit; and
- s 85 of the SIS Act may apply to a person undertaking an arrangement to artificially reduce the market value ratio to avoid application of the in-house asset restrictions.

The Tax Office also considers that a loan or financial assistance through another entity may contravene the SIS Act and result in the SMSF becoming a non-complying superannuation fund. The Commissioner also warned that trustees of super funds who provide financial assistance in this way face penalties of up to \$220,000 (\$1.1m for corporate trustees) and/or jail terms of up to 5 years for individuals.

Tax issues

The Tax Office also considers that such arrangements give rise to the following tax issues:

- income derived by the SMSF may be "non-arm's length income" under s 295-550 of the ITAA 1997 which is taxed at 45% (instead of 15%);
- payment of interest above the commercial rate by the SMSF member/relative of the member to the trust, which is subsequently paid to the SMSF as an investment yield may in fact be superannuation contributions for excess contributions tax purposes;
- any fee or commission received by the trust, licensee/franchisee and/or organiser of this arrangement may be assessable income for the relevant income year;
- whether Pt IVA may apply to the arrangement; and
- any entity involved in the arrangement may be a promoter of a tax exploitation scheme.

Further guidance on the prohibition against giving financial assistance using the resources of an SMSF to a member or relative is set out in Ruling SMSFR 2008/1.

TIP: No doubt organisers of such arrangements have relied in part on the following statement in para 23 of Ruling SMSFR 2008/1: "23. Paragraph 65(1)(b) is not contravened if an SMSF invests on commercial terms in an unrelated entity and that unrelated entity, independently of the SMSF and in its own right and from its own resources, gives financial assistance to a member or relative of a member." However, Example 25 in Ruling SMSFR 2008/1 also suggests that such protection from s 65(1)(b) is only afforded where there is no connection between the investment by the SMSF in the unrelated trust and the benefit provided to a member or relative. In addition, such arrangements must comply with the myriad of other investment restrictions in the SIS Act.

Source: Taxpayer Alert TA 2010/5 <<http://law.ato.gov.au/pdf/tpa/tpa1005.pdf>>

Accessing company funds via trust to circumvent Div 7A

Taxpayer Alert TA 2010/6 warns private companies against investing in trusts with the intention of making funds available for lending to shareholders. The Alert describes an arrangement where a private company invests funds in an unrelated trust that then on-lends the funds to a shareholder, or an associate of a shareholder, of the private company. The ATO warns the arrangement may be an attempt to circumvent Div 7A of Pt III of the ITAA 1936.

The Alert applies to arrangement with features that are substantially equivalent to the following:

1. An organiser sets up a trust (the trust) which purports to offer fixed rate interest yielding investments to allegedly unrelated entities.
2. A private company (the company) invests in the trust.
3. The organiser (who may also be the trustee of the trust) or a licensee/franchisee of the organiser, sources borrowers (the borrowers) to borrow funds from the trust.
4. The borrowers may include a shareholder of the company that invested in the trust (or an associate of a shareholder).
5. Each borrower enters into a loan agreement (the loan) with the trust. The loan amount (or total loan amounts of all borrowers associated with the company) may be comparable to the amount the company invested in the trust.
6. Terms of the loan may include:
 - (a) a range of available interest rates;
 - (b) a range of interest payment terms, including flexibility in the repayment date (provided the funds are paid sometime in the future);
 - (c) security over the loan in the form of a mortgage, personal guarantee or caveat; and/or
 - (d) the use of borrowed funds for multiple purposes, including business, investment or personal use.
7. Each borrower makes interest only repayments on the loan to the trust for a substantial period of the loan.
8. The trustee of the trust pays the company an interest yield on their purported investment.
9. Investment and loan fees payable under the arrangement may be considered excessive.

Tax issues

The ATO is concerned that the arrangements described in the Alert may give rise to income tax issues, including whether:

- the borrowing expense incurred by the borrower (shareholder of the private company or their associate) may be deductible under s 8-1 or s 25-25 of the ITAA 1997, and the extent to which it is deductible;
- any investment fee purportedly incurred by the company is deductible under s 8-1 of the ITAA 1997 and the extent to which it is deductible;
- any fee or commission received by the trust, licensee/franchisee and/or organiser of this arrangement should be included as assessable income for the relevant income year;
- the provisions of Div 7A apply to the arrangement, in particular whether the arrangement results in a loan to a shareholder or their associate by virtue of the interposed entity provisions in Subdiv E;
- Pt IVA may apply to all or part of the arrangement; and
- any entity involved in the arrangement may be a promoter of a tax exploitation scheme.

Source: Taxpayer Alert TA 2010/6 <<http://law.ato.gov.au/pdf/tpa/tpa1006.pdf>>

Self-education Expenses for Youth Allowance Recipient Deductible

The High Court has unanimously (5:0) dismissed the Commissioner's appeal and held that a taxpayer was entitled to a deduction under s 8-1 of the ITAA 1997 for expenses incurred in deriving income from receiving Youth Allowance.

Background

The taxpayer was a full-time university student in a teaching degree. She received Youth Allowance that was conditional upon her being:

- enrolled in the degree;
- undertaking at least 3/4 of the normal amount of full-time study; and
- meeting certain criteria for achieving satisfactory progress,

as required under the *Social Security Act 1991* and *Youth Allowance (Satisfactory Study Progress Guidelines) Determination 1998*.

Among other income, the taxpayer disclosed \$3,622 in assessable income from the Youth Allowance, and claimed a total of \$920 in deductions for self-education costs incurred in relation to the degree in her income tax return for the 2006 income year. The claim for \$920 comprised gross self-education costs of \$1,170, including \$692 in depreciation on a computer, less the \$250 reduction for self-education expenditure under

s 82A(1). The Commissioner claimed that such expenses were not deductible by the recipient of a Youth Allowance under s 8-1 of the ITAA 1997. The AAT agreed, but the Federal Court allowed the deduction. The Commissioner appealed to the Full Federal Court.

In *ECT v Anstis* (2009) 73 ATR 483, the Full Federal Court dismissed the Commissioner's appeal and held that the self-education expenses incurred in deriving Youth Allowance were allowable deductions.

Decision

The High Court said the resolution of the Commissioner's appeal turned upon 3 questions relating to:

- (i) assessability of the allowance,
- (ii) whether the expenses were incurred "in gaining or producing" assessable income, and
- (iii) were the expenses of a private nature.

Assessability

The Court considered whether Youth Allowance was assessable income under the ITAA 1997. The Court concluded that it was assessable. The High Court said that Youth Allowance payments enable recipients to rely upon them for regular expenditure, and recipients can expect to receive those payments as long as they satisfy the various requirements of the social security legislation. The Court said it followed that such amounts were income according to ordinary concepts.

Incurred "in gaining or producing" assessable income

The Court next considered whether the taxpayer's self-education expenses were incurred "in gaining or producing" her assessable income. The Court held the expenses were deductible.

The Court said the notion of "gaining or producing" income within the meaning of s 8-1(1)(a) was wider than those activities which may be said to earn income. According to its ordinary meaning, to "gain" means not only to "earn or obtain (a living)" but to "obtain, secure or acquire" or to "receive".

The High Court considered it was essential to identify how the assessable income was (or was expected to be) gained or produced. It noted that the Federal Court said the assessable Youth Allowance income received by the taxpayer was gained or produced by her entitlement to that payment. That right to payment of the Allowance would be retained by the taxpayer so long as she maintained her qualification for the payment by satisfying the activity test by undertaking full-time study. In the Court's view:

"The reason or motive of the respondent for incurring those education expenses, which could be characterised, for example, as obtaining a qualification to undertake future employment as a teacher, is not determinative of the question whether they were incurred in gaining or producing income. The occasion of the outgoings was to be found in what the respondent did to gain or produce, by establishing and retaining her entitlement to, the receipts provided by the terms of the social security legislation."

Were the expenses of a "private" nature?

If the expenses were incurred "in gaining or producing" the taxpayer's assessable income, were they nonetheless to be disallowed as being of a "private" nature? The High Court held they were not of a "private" nature.

The Court observed that the question in the appeal was unusual because the outgoings incurred in the study undertaken by the taxpayer were not deductible by reason of that study bearing some relation to an existing business or existing employment on her part, but were deductible by being incurred in the course of her retention of a statutory right to payment of the Youth Allowance.

The Commissioner contended that the expenditure was private in nature on the basis that it was an attempt by the taxpayer to better herself as an individual; "it was an investment in "human capital"".

The High Court concluded that the taxpayer's desire to obtain a degree, whether to enable her to become a teacher or for some other reason, could not "deny the circumstance that expenses occasioned by her enrolment, full-time study and satisfactory progress in that degree were incurred by her as a recipient of Youth Allowance". The Court said the outgoings did not lose their connection with the "position" she held as a recipient of Youth Allowance "simply because she might have been studying for reasons other than enjoying an entitlement to Youth Allowance".

The Court said there was "no sufficient foundation" for a conclusion that the expenditures by the taxpayer were essentially private in nature within the sense of s 8-1(2)(b) of the ITAA 1997.

ECT v Anstis [2010] HCA 40, High Court, French CJ, Gummow, Heydon, Kiefel and Bell JJ, 11 November 2010

Govt and ATO considering the decision

In a statement on the day the Court handed down its decision (11 November 2010), the Assistant Treasurer said the ATO would release a Decision Impact Statement (DIS) as soon as possible after it had analysed the judgment. Mr Shorten said the Government would “carefully consider” the judgment and DIS before issuing a further response. It is noted that, when the Full Federal Court decision was handed down, the Tax Office said that, until the matter was resolved [which it now has been], it would continue to apply the view set out in Taxation Ruling TR 98/9. That is, education expenses would not be deductible against various Commonwealth educational assistance schemes. The ATO DIS is awaited and presumably TR 98/9 will need amendment or withdrawal.

The ATO says it is giving the matter “urgent attention and will release further information as quickly as possible”. In the meantime, it has asked for patience from those taxpayers who have received a taxable Commonwealth education payment, and believe they may be affected by the decision.

Source: Assistant Treasurer’s media release No 010, 11 November 2010
<[ATO statement, 11 November 2010
<\[www.ato.gov.au/individuals/content.asp?doc=/content/00192011.htm\]\(http://www.ato.gov.au/individuals/content.asp?doc=/content/00192011.htm\)>](http://www.treasurer.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/010.htm&pageID=003&min=brs&Year=&DocType=>”;</p></div><div data-bbox=)

Declaration of Trust over Land Sold, so No Personal Tax Liability

The Supreme Court of Western Australia has granted a taxpayer’s application for declaratory relief to the effect that a valid trust had been created over land he had originally acquired in 1990 in his own name. The trust had been declared in favour of a family trust at the time of the land subdivision 5 years later, in 1995. As a result, the Commissioner could not argue that the taxpayer was personally liable for CGT on the sale of one of the lots for close to \$4m in June 2006. Instead, the gain had been included in the family trust’s tax return for that year and had been negated by the trust’s carried forward losses.

The Court arrived at its decision on the basis of finding that the arrangement was not a sham and that the declaration of trust was made in writing – despite the fact that the one-page “homemade” declaration had not been professionally drawn up and contained a number of technical errors (including referring to the taxpayer as trustee and to a trust being created over the house, rather than the land). The Court also found that the following factors weighed in the taxpayer’s favour as evidence of his bona-fide intention to create a trust over the property:

- the family trust had existed for some 15 years before the declaration of the trust over the land;
- immediately after its execution, the declaration of trust was handed to the taxpayer’s brother (who was a director of the corporate trustee of the family trust); and
- the proceeds of the sale from the lot were paid into an existing bank account in the name of the family trust.

At the same time, the Court dismissed the Commissioner’s counter-arguments including that the property had not been identified in the annual accounts of the family trust after 30 June 1995, that a “licence” agreement entered into between the brothers to allow one of them to reside rent-free in the property for life made no mention of the trust and was inconsistent with the existence of a trust over the land, and that a “low-doc” loan of \$500,000 had been secured over the property by the taxpayer and not the trustee (for construction of new dwellings). In general, the Court found that these matters did not negate the intention to create a trust over the land (in the absence of a sham), and that at most, they might evidence a breach of fiduciary duty by the trustee in relation to dealings with the trust property.

In short, the Court concluded that, as there was no contention as to sham, the matters raised by the Commissioner did not outweigh the force of the written trust deed, particularly once relevant surrounding circumstances were taken into account. Accordingly, the Court granted the declaratory relief sought.

TIP: This may not be the last we hear of this matter. There is the possible application of CGT event E1 to the creation of the trust in 1995 over the land, which the Court did not canvass.

Saunders v DCT [2010] WASC 261, Supreme Court of Western Australia, Martin J, 4 October 2010

Subsidy Paid for Loss-making Contracts Assessable as Income

The AAT has ruled that a taxpayer engaged in the waste disposal business was assessable on a “subsidy” paid to it by a rival business in connection with the taxpayer assuming unprofitable waste disposal contracts that it acquired from the rival under a novation agreement. In finding that the subsidy was assessable as ordinary income, the AAT found that even though it was a one-off transaction, it was entered into in the ordinary course of the taxpayer’s business with a view to making a profit.

Background

The taxpayer was a family company engaged in the waste management business and provided waste management services to local government authorities and private clients along the east coast of Australia and in New Zealand. It also carried on its business by way of participating in joint ventures and partnerships with other companies that possessed special expertise in aspects of the waste management business, and also by way of acquiring such businesses.

After informal negotiations with a rival company that also had waste management contracts with local councils, the parties entered into a novation agreement whereby the taxpayer assumed responsibility for a number of the rival company's loss-making contracts with local councils. As part of the agreement, the rival company agreed to pay the taxpayer a "subsidy" in connection with taking on those contracts. The taxpayer also acquired related plant and equipment and other assets (eg intellectual property and goodwill) from the rival company under the agreement.

In entering the agreement, the taxpayer hoped to achieve economies of scale by combining its operations with those of the rival company to generate cost savings and allow it to profit. The payment of the subsidy was negotiated as part of that objective.

The taxpayer originally included the subsidy and the value of the plant and equipment and other assets it acquired under the agreement in its assessable income. However, it subsequently lodged an objection which the Commissioner disallowed.

Decision

The AAT found that the subsidy was assessable as ordinary income even though it was paid to the taxpayer as a result of entering into an unusual, one-off transaction. This was because the AAT found that the transaction was entered into in the ordinary course of the taxpayer's business (which included acquiring rival businesses) with a view to making a profit. In this regard, the AAT found that the taxpayer was not merely attempting to acquire goodwill or secure its competitive position for the future, but was expecting to make a profit out of this particular transaction.

In short, the AAT was satisfied that the transaction was intimately and incidentally connected with the taxpayer's ordinary business (which included the acquisition of rivals and entering into waste management contracts with local councils), so that the subsidy could be regarded as having arisen in the course of that business even though it was the first, and perhaps only, time the taxpayer would strike such a deal.

The AAT also noted that "while it might be unusual to make a gain as a purchaser under what was described as a sale agreement, it was still an incident of that business, even if not an ordinary incident of that business".

Furthermore, because the plant and equipment were also acquired by the taxpayer as an inseverable part of the agreement, the AAT also ruled that the value of these assets had the character of income in the taxpayer's hands – albeit, the plant and equipment was assessable to the taxpayer under s 21A of the ITAA 1936 as a "non-cash business benefit". In so finding, the AAT dismissed the taxpayer's claim that the subsidy was of a capital nature as it was paid as consideration for capital assets (namely, the plant and equipment and the loss-making contracts).

Re Taxpayer and Commissioner of Taxation [2010] AATA 819

Employing your Spouse? Ensure There's an "Employment Relationship"

Two recent cases before the Administrative Appeals Tribunal dealt with the scenario of a husband employing his wife to assist with looking after rental properties. The details are as follows.

Re France and FCT [2010] AATA 858

The AAT has confirmed that, for the year ended 30 June 2007, a taxpayer was not entitled to deductions for salary and super contributions paid to his wife for assistance with an investment property purchased in 1996. The Tribunal said there was no employment relationship in the circumstances.

Background

The taxpayer purchased an investment property (a unit) in his name in 1996. It was sold in late 2007. The unit was rented for most of the period he owned it. The taxpayer and his wife inspected the property regularly and his wife dealt with some correspondence matters regarding the property. The Tribunal said the taxpayers agreed she spent about an hour a week on average dealing with rental property issues. The Tribunal was also satisfied that the wife was undertaking the same work in the same way during 2006-07 that she had been doing since the property was acquired in 1996.

The taxpayer said he met with his tax agent who suggested a breach of the law may occur if he failed to employ his wife, and said it was necessary to demonstrate they had entered into a genuine employer/employee relationship. The Tribunal also heard evidence from the tax agent who said he gave “advice on how to create an employer/employee relationship and what obligations would need to be imposed to achieve that”. In the year ended 30 June 2007, the taxpayer paid his wife \$5,000 in wages and he also paid \$70,000 into a super fund in her name. He claimed these amounts as deductions, which the Commissioner disallowed.

Decision

The Tribunal said the only thing that had changed was that the taxpayer and his wife decided to formalise the arrangement and start paying the wife. The AAT said it did not think the evidence established that the taxpayer intended he and his wife should enter into a legally enforceable relationship. It accepted the taxpayer intended the relationship should have one legal consequence, which was said to be “a means of accessing an entitlement to a taxation benefit”, but the AAT said it was not the same thing. It said it was clear from the evidence that the taxpayer was “merely repackaging an existing domestic relationship so it took on some of the appearance of an employment relationship”, and acknowledged most of the repackaging was done by the tax agent. The AAT noted “one does not transform an existing relationship simply by calling it a different name, or even adopting some of the forms of a different relationship”.

The Tribunal concluded the salary and super contributions were not deductible as the outgoings were of a private or domestic nature. The AAT also upheld the Commissioner’s imposition of a 25% penalty.

Re France and FCT [2010] AATA 858, McCabe SM, Ref No 2009/4777, 2 November 2010

Re Brown and FCT [2010] AATA 829

The AAT has confirmed that a taxpayer was not entitled to deductions for wages, reportable fringe benefits and allowances totalling \$25,000, and super contributions of \$35,000, paid to his wife for assistance with a rental property.

Background

The taxpayer was the owner of a rental property who said he employed his wife to assist with paperwork and other issues associated with the property during the 2006-07 year of income. He claimed a deduction in respect of the wages paid to his wife and superannuation contributions made on her behalf. The Commissioner disallowed the deductions.

Decision

The Tribunal said it was not persuaded that the taxpayer attempted, nor was motivated, to enter into a genuine employment relationship with his wife, nor that the money was paid to meet a business expense, as opposed to a domestic or private expense. The Tribunal noted that the wife’s “job” was not clearly defined. It also noted that she provided unpaid assistance at another family business, which was not mentioned in the taxpayer’s submission of evidence. The Tribunal said the taxpayer’s evidence was “inconsistent” with the evidence of his wife and tax agent, whose accounts were “more consistent” with each other. The Tribunal said it was not persuaded by the taxpayer’s evidence – it said it was not clear he did anything but talk about employing his wife in order to achieve a tax advantage that would otherwise be unavailable to him.

The Tribunal said the taxpayer had not discharged his obligation of proving that the Commissioner’s assessment was excessive. The AAT also upheld the imposition of a penalty at 25%.

Re Brown and FCT [2010] AATA 829, McCabe SM, Ref No 2009/4778, 26 October 2010

TIP: It is not against the law to employ your spouse. However, the arrangement must be genuine and this requires examining the totality of the relationship when characterising it. As demonstrated by the cases, one cannot transform an existing domestic relationship simply by calling it a different name, or by adopting some aspects of an employment relationship.

Increasing Adjustments in BAS’ as Debts Remain Unpaid

The AAT has held that 3 taxpayers were liable to make increasing adjustments in their later Business Activity Statements to reverse earlier claims for input tax credits (ITCs). The taxpayers accounted for GST on an accruals basis. They attributed the ITCs to the tax period in which the tax invoices were received. However, those invoices remained unpaid after 12 months.

The Commissioner did not dispute that the acquisitions by the taxpayers were for creditable purposes. Rather, he submitted that the obligation to pay for those acquisitions had not been discharged within 12 months, and therefore each taxpayer had an increasing adjustment pursuant to s 21-15 of the GST Act.

In the Tribunal’s view, the evidence produced by the taxpayers did not explain or establish their claims as to the discharge of the tax invoices. It noted the documents tendered were unauthenticated. While the taxpayers submitted that the invoices were paid through a third-party, the Tribunal was not satisfied the

evidence supported this contention. Therefore, the Tribunal found that the taxpayers failed to discharge their onus of proof. Accordingly, the Tribunal affirmed the Commissioner's assessments which increased the taxpayers' net GST payable, and the shortfall penalties imposed.

Re QFP Professional Tomato Project 98 and FCT [2010] AATA 864, Tamberlin DP, Ref No: 2008/1565, 2008/1566 & 2008/1567, 4 November 2010