Explanatory Memorandum

May 2010

Currency:

This issue of Client Alert takes into account all developments up to and including 15 April 2010.

Tax Planning

Put simply, tax planning is the arrangement of a taxpayer's affairs so as to comply with the tax law at the lowest possible cost. A common mistake is to believe that tax planning is optimised when every opportunity to reduce tax is taken. This is because some opportunities to reduce tax rely on strained interpretations of the law. Therefore, tax planning involves much more than taking the option that at first appears to result in lower tax costs. It involves objectively assessing and actively managing tax risk.

Common tax planning techniques are deferring the derivation of assessable income and bringing forward deductions. It is equally important that consideration be given to any pending changes to the tax legislation, especially when a proposed amendment will be backdated.

Deferring Assessable Income

The timing of when income is included in the assessable income of a taxpayer will depend on whether it is statutory income or ordinary income. Statutory income is included in assessable income at the time specified in the relevant provisions dealing with that income. Ordinary income is included in assessable income when it is derived unless a specific provision includes the amount in assessable income at some other time.

Consideration must be given to the nature of an income, ie revenue or capital, because of the difference in their tax treatment, which ultimately will have an impact on a taxpayer's tax position.

Business income

When ordinary income of a business is derived and to be included in assessable income will depend on whether the business returns income on a cash basis or on an accruals basis.

If a business uses the cash basis, ordinary income is, generally, derived in the year in which it receives the income. Conversely, if the business is reporting income on an accrual basis, ordinary income is derived when a recoverable debt is created such that the taxpayer is not obliged to take any further steps before becoming entitled to payment.

Payment received in advance

Income received in advance of services being provided, generally, is not assessable until the services are provided (the *Arthur Murray* principle). This principle applies regardless of whether a taxpayer is reporting its income on an accrual basis or on a cash basis.

- **STOP:** For the Arthur Murray principle to apply, a taxpayer's accounting records must classify the unearned income separately from income already earned. This may be done by a single journal entry at year-end or periodically during the year.

Work in progress

In relation to manufacturers, partly manufactured goods that are not 'finished' goods are treated as trading stock and it is necessary to determine the difference between the opening and closing value of the trading stock for the income year. (*See* **Trading Stock** on page 10.)

- **TIP:** Taxpayers who provide professional services may consider, in consultation with their clients, rendering accounts after 30 June to defer the income.

Income from property

Income from property is essentially all income that is not personal exertion income and includes interest, rent, dividends, royalties and trust distributions. The time of when such income is derived for non-business taxpayers is as follows:

Category	When income is derived
Interest	In the year of receipt
Rental income	In the year of receipt
Dividends	In the year of receipt
Royalties	In the year of receipt
Trust distributions	In the year the distribution is declared

- **STOP:** Where the income has been applied or dealt with on behalf of a taxpayer, the taxpayer is taken to have received the income as soon as it is so applied or dealt with (principle of constructive receipt, albeit the taxpayer has not physically received the income): see s 6-5(4) of ITAA 1997.

Sale of depreciating assets

A taxpayer is required to calculate the balancing adjustment amount resulting from the disposal of a depreciating asset. The balancing adjustment amount is calculated by comparing the termination value against the adjustable value. If the termination value is greater than the adjustable value, the difference is included as assessable income of the taxpayer. If the termination value is less than the adjustable value, the difference is a deduction available to the taxpayer.

If the disposal of an asset will result in assessable income, a taxpayer may want to consider postponing the disposal to the following income year. However, if it is not possible to delay the disposal, consideration may be given to whether a balancing adjusting rollover relief is available. If the disposal of an asset will result in a deduction, it may be beneficial to bring the disposal forward to the current year.

Balancing adjustment rollover relief

Balancing adjustment rollover relief effectively defers a balancing adjustment until the next balancing adjustment event occurs. Broadly, the rollover relief will apply automatically if the conditions listed in s 40-340(1) of ITAA 1997 are satisfied. If the automatic rollover relief applies, the transferor must give a notice containing sufficient information about the transferor's holding of the asset for the transferee to work out how Div 40 applies to the transferee's holding of the depreciating asset.

An optional rollover relief is available in a partnership scenario if the composition of the partnership changes or when assets are brought into or taken out of the partnership. To defer any balancing adjustments, the existing partners and the new partner can jointly elect for the rollover relief to apply.

- **TIP:** A small business entity can access the optional rollover relief.

- **STOP:** The optional rollover relief is not available unless the original holder retains an interest in the asset after the change.

Maximising Deductions

Deductions are divided into general deductions and specific deductions. General deductions are allowable under s 8-1 of ITAA 1997 whereas specific deductions are those provided for by sections of ITAA 1936 and ITAA 1997. If an item of expenditure would be a deduction under more than one section, it is deductible under the provision that is most appropriate.

Meaning of incurred

In Taxation Ruling TR 97/7, the Commissioner states his view on the meaning of incurred for the purposes of s 8-1 of ITAA 1997. The following general rules assist in most cases in defining whether and when an outgoing has been incurred:

(a) a taxpayer need not actually have paid any money to have incurred an outgoing, provided the taxpayer is definitively committed in the year of income. There must be a presently existing liability to pay a pecuniary sum;

(b) a taxpayer may have a presently existing liability notwithstanding that the liability may be defeasible by others;

(c) a taxpayer may have a presently existing liability although the amount of the liability cannot be precisely ascertained, provided it is capable of reasonable estimation;

(d) whether there is a presently existing liability is a legal question in each case, having regard to the circumstances under which the liability is claimed to arise; and

(e) if a presently existing liability is absent, an outgoing is incurred when the money is paid.

The phrase 'presently existing liability' means that a taxpayer is definitively committed (or completely subjected) to the outgoing, ie the liability is more than impending, threatened or expected.

An outgoing is still incurred even if the amount cannot be quantified precisely, provided it is capable of approximate calculation based on probabilities.

If a taxpayer could have claimed a deduction for an outgoing that was incurred but not paid in the particular income year but failed to do so, the taxpayer cannot claim a deduction in the year in which the liability is discharged, as the outgoing has not occurred in that year. The taxpayer is required to seek an amendment of the assessment for the previous year, within the statutory limits.

- **TIP:** An outgoing may be incurred in one income year even if the liability is not discharged until a later year. Therefore, a taxpayer can claim a deduction for the outgoing.

- **STOP:** Small business entities which were Simplified Tax System (STS) taxpayers who are still using the mandatory cash accounting rules under the former STS can only deduct an outgoing under ss 8-1 (general deductions), 25-5 (tax-related expenses) and 25-10 (repairs) of ITAA 1997 when the outgoing is paid.

Managed investment schemes

Expenses incurred in a managed investment scheme (MIS) are generally deductible. In *Hance v FCT* 74 ATR 644; [2008] FCAFC 196, the Full Federal Court allowed two taxpayers' deductions relating to their investment in an almond MIS. In that test case, the Full Court concluded that the relevant outgoings of the taxpayers would be incurred as operating expenses in carrying on each taxpayers' business and that they were deductible pursuant to s 8-1 of ITAA 1997.

Following the failure of various schemes during the global financial crisis, the Tax Office issued three Taxation Determinations which deal with various scenarios and whether participants are still entitled to relevant deductions:

- TD 2010/7: A change of Responsible Entity of a registered agricultural MIS does not affect the tax outcomes for participants if the arrangement continues to be implemented in accordance with the relevant product ruling. In other words, the Commissioner continues to be bound by the ruling and a participant will continue to be able to rely on the ruling. However, where any change results in there being a material difference in the implementation of the scheme, the participant will not be able to rely on the product ruling for the scheme.

- TD 2010/8: The disposal or termination of an interest in a non-forestry MIS which arises as a result of circumstances outside the control of the taxpayer does not result in the denial of deductions previously allowed under s 8-1(1)(b) of ITAA 1997 in respect of contributions to the scheme.

- TD 2010/9: A payment received by an investor in a non-forestry MIS upon the winding-up of the scheme, that does not involve the disposal of an interest in the scheme to another person, is not necessarily ordinary or statutory income under ITAA 1997. However, the Taxation Determination says "whilst the proceeds received from a scheme that has been wound up ***may*** constitute assessable

ordinary or statutory income, it will depend very much on what the payment is for actually for". [Tax Office emphasis.]

- **TIP:** Each of the above Taxation Determinations contain an example illustrating the Commissioner's view on the operation of the tax law. Taxpayers seeking to claim a deduction should ensure that the facts surrounding their circumstances are similar to the facts in the examples.

Bad debts

A debt that is written off as 'bad' in an income year is an allowable deduction under s 25-35 of ITAA 1997, provided:

- the amount owned was either previously brought to account as assessable income in the current or a former income year or lent in the ordinary course of a money-lending business of the taxpayer;
- there must be a bad debt in existence at the time of writing off;
- the debt must be bad; and
- the debt must be written off as bad during the income year in which the deduction is claimed.

Taxpayers should review their debtors prior to year-end and assess which debts may be written off as 'bad'.

In Taxation Ruling TR 92/18, the Tax Office sets out the list of circumstances in which a debt may be considered to have become bad. These circumstances may include the death or the disappearance of a debtor leaving little or no assets of which the debt may be satisfied, or a corporate debtor going into liquidation or receivership with insufficient funds to pay the debt.

Before a debt can be written off as 'bad', a taxpayer must have taken appropriate steps in an attempt to recover the debt. The Tax Office, in TR 92/18, lists the steps to be taken to establish that a debt is bad. These include attempting to contact a debtor, issuing reminder notices and taking more formal measures.

It is important to note that while the factors listed in TR 92/18 are indicative of the circumstances in which a debt is considered bad, ultimately the question of whether the debt is bad is one of fact and will depend on all the facts and circumstances surrounding the debt.

- **TIP:** Notwithstanding that a bad debt is not deductible under s 25-35, it may be deductible under s 8-1.

- **TIP:** A bad debt does not need to be written off in the account books of a taxpayer. In the case of a company, the requirements of s 25-35 will still be satisfied in the following circumstances:

  — a Board meeting authorises the writing off of a debt and there is a physical record of the written particulars of the debt and Board's decision before year-end but the writing off of the debt in the taxpayer's books of account occurs subsequent to year-end; and

  — a written recommendation by the financial controller to write off a debt, which is agreed to in writing by the managing director prior to year-end followed by a physical writing-off in the books of accounts subsequent to year-end.

- **TIP:** A bad debt deduction is also available for a partial write-off of a debt, provided the requirements of s 25-35 are satisfied. One debt may, over a period, be subject to several partial write-offs.

Additional requirements for companies

A company must pass either the continuity of ownership test (the primary test to be applied) or the same business test in addition to satisfying the requirements of s 25-35.

Companies that have undergone a change in underlying ownership due to a sale of the business during the year will need to pass the 'same business test' to claim a deduction for bad debts.

- **STOP:** A company cannot claim a deduction for a debt incurred and written off as bad on the last day of an income year.

- **STOP:** Consideration must be given to the specific anti-avoidance provisions contained in Subdiv 175-C.

- **STOP:** A deduction is denied where a company was purchased through an asset sale because the requirements of s 25-35 have not been met, albeit the same business test has been satisfied: see *Easons Ltd v C of T (NSW)* (1932) 2 ATD 211.

Additional requirements for trusts

Special rules apply to deny trusts a deduction for bad debts unless certain strict tests are passed. The applicable tests will depend on the nature of the trust. (*See* **Trust losses** on page 16.)

Footballers and management fees

In *Spriggs v FCT; Riddell v FCT* 239 CLR 1; [2009] HCA 22, the High Court unanimously held that two professional footballers were entitled to a deduction under s 8-1 of ITAA 1997 for management fees, even though the fees were paid for the negotiation of new playing contracts. In doing so, the High Court dismissed the Commissioner's argument that it was necessary to separate their playing activities from their off-field business (promotional) activities and find that the fees were non-deductible capital costs incurred as employees in procuring new employment contracts.

Instead, the High Court held that the fees were deductible as the players were obtaining and performing employment contracts as part of the business they carried on as professional sportsmen. Furthermore, it noted that the definition of 'business' in s 955-1 of ITAA 1997 did not preclude an employment contract being carried out as part of a business. In addition, it held that the fees were not of a capital nature as the 'advantage sought' was the obtaining of playing contracts which were of a revenue nature in circumstances where a professional footballer enters into a number of playing contracts, with different clubs, in the course of their business.

Students on Youth Allowance and self-education expenses

In *Anstis v FCT* 180 FCR 288; [2009] FCAFC 154, a full-time student in receipt of Youth Allowance was allowed a deduction for various self-education expenses (eg a student administration fee, books and depreciation on a computer) as they were considered to be incurred in deriving the Youth Allowance, which was assessable income. The Full Federal Court rejected the notion that the purpose of the expenditure (to obtain a degree so that the taxpayer could become a teacher rather than to obtain Youth Allowance) was relevant to determining whether the expenditure was deductible under the first limb of s 8-1 of ITAA 1997.

The Commissioner has sought special leave to appeal to the High Court against the decision. The Tax Office said that, until the matter is resolved, it will continue to apply the view set out in Taxation Ruling TR 98/9. That is, education expenses are not deductible against various Commonwealth educational assistance schemes.

Carried forward losses

The deductibility of tax losses carried forward from previous income years will depend on the entity claiming the losses.

Corporate tax entities

The entitlement of corporate tax entities to deductions in respect of prior year losses is subject to certain restrictions. An entity needs to satisfy the continuity of ownership test before deducting the prior year losses. If the continuity of ownership test is failed, the entity may still deduct the loss if it satisfies the same business test.

- **TIP**: A corporate tax entity can choose the amount of prior years losses it wishes to deduct in an income year. That is, the entity can choose to 'ignore' the carried forward tax losses and pay tax for the income year to generate franking credits for its distributions.

Other taxpayers

The method for deducting earlier tax losses incurred by other taxpayers is governed by s 36-15 of ITAA 1997. If a taxpayer derives net exempt income for an income year, the carried forward loss will need to be firstly offset against net exempt income before being available for deduction against assessable income.

- **TIP**: Carried forward losses do not need to be offset against non-assessable non-exempt income derived by a taxpayer. It is net exempt income that is offset against any carried forward tax losses and not exempt income. Net exempt income is defined in s 36-20 of ITAA 1997 and exempt income is defined in s 6-20 of ITAA 1997.

- **TIP**: Try to avoid deriving exempt income in an income year if there are carried forward losses.

Depreciation (Capital allowances)

A deduction may be available on the disposal of a depreciating asset if a taxpayer stops using and expects never to use it again. Therefore, asset registers may need to be reviewed for any assets that fit this category.

The effective life of an asset can be recalculated at any time after the end of the first income year for which depreciation is claimed by a taxpayer, if it is no longer accurate because of changed circumstances relating to the nature of use of the asset. Therefore, consideration may be given to the use of an asset to determine whether its effective life can be recalculated, which may result in an increased or decreased rate of depreciation

Immediate deduction

Non-business taxpayers

Non-business taxpayers are entitled to an immediate deduction for assets costing $300 or less, provided:

- the asset is used predominantly to produce assessable income that is not income from carrying on a business;
- the asset is not part of a set of assets that the taxpayer started to hold in the income year if the total cost of the set of assets exceeds $300; and
- the total cost of the asset and any other identical, or substantially identical, asset that the taxpayer starts to hold in that income year does not exceed $300.

➢ **TIP:** If two or more taxpayers jointly own a depreciating asset, a taxpayer is still eligible to claim an outright deduction, provided his or her interest does not exceed $300 (even if the asset costs more than $300).

Small business entities

A small business entity (*see* **Small Business Entities** on page 19) that chooses to apply the capital allowance rules contained in Div 328 of ITAA 1997 is eligible for an outright deduction for the taxable purpose proportion of the adjustable value of a depreciating asset in the income year it first starts to use the asset or installs it for a taxable purpose if:

- it starts to hold the asset when it is a small business entity, and
- the asset is a 'low cost asset', ie its cost is less than $1,000.

The entity is also entitled to an immediate deduction for any addition to a low cost asset, provided the cost of the addition is less than $1,000. If an asset costs more than $1,000, the entity is required to pool the asset into either a general pool or a long-life pool depending on the effective life of the asset. (See **Pooling**.)

Business taxpayers

For business taxpayers that are not small business entities, all capital items must be written off over their effective life under Div 40 of ITAA 1997, regardless of the cost (including low-value items). However, the Tax Office has adopted an administrative practice allowing an outright deduction for low-cost capital assets in certain cases.

Broadly, an expenditure of $100 or less (inclusive of GST) incurred by a taxpayer to acquire a capital asset in the ordinary course of carrying on a business will be assumed to be revenue in nature and therefore deductible in the year of the expenditure. It is important to note that because the threshold includes GST, for a business registered for GST, the threshold is effectively **$**90.91.

This administrative practice does not apply to expenditure incurred by a taxpayer on:

- establishing a business or business venture;
- building up a significant store or stockpile of assets;
- assets held under a lease, hire purchase or similar arrangement;
- assets acquired for lease or hired to, or that will otherwise be used by, another entity;
- assets included in an asset register maintained in a manner consistent with reporting requirements under generally accepted Australian accounting standards;

- any asset that forms part of a collection of assets that is dealt with commercially as a collection;
- trading stock or spare parts; and
- items that are part of another composite asset, ie items that are not functional on their own.

Pooling

Certain depreciating assets can be pooled, with the result that the decline in value is calculated for the pool instead of the individual assets.

For a small business entity, two pools are available:

- a general pool for assets with an effective life of less than 25 years; and
- a long-life pool for assets with an effective life of more than 25 years.

If the cost of the asset is less than $1,000, the small business entity is entitled to an outright deduction.

For other taxpayers, there is the option of pooling 'low-cost' and 'low-value' assets to a low-value pool. A 'low-cost' asset is a depreciating asset that costs less than $1,000. A 'low-value' asset is a depreciating asset that has been depreciated using the diminishing value method, has an opening adjusted value of less than $1,000 in an income year, and is not a 'low-cost' asset. If a taxpayer sets up a low-value pool, all low-cost assets have to be allocated to the pool. However, low-value assets do not need to be allocated to the pool.

Category of taxpayer	Assets allocated to pool during year are depreciated at:	Assets allocated to pool in a previous income year are depreciated at:
Small business entity — General pool	15%	30%
Small business entity — Long-life pool	2.5%	5%
Other taxpayers — Low-value pool	18.75%	37.5%

➢ **TIP**: If two or more taxpayers jointly own a depreciating asset, a taxpayer can set up a low-value pool to take advantage of the accelerated rate of depreciating, provided his or her interest is less than $1,000, even though the asset costs more than $1,000.

Small business and general business tax break

Small businesses and general businesses may be eligible for a one-off bonus deduction for new investment in tangible depreciating assets made between 13 December 2008 and 31 December 2009 (inclusive). Key details of the bonus deduction include:

- The deduction is limited to new tangible, depreciating assets for which a deduction is available under Subdiv 40-B of ITAA 1997 and new investment in existing assets. An asset is new if it has never been used or installed ready for use by anyone, anywhere. Second-hand assets are not eligible for the deduction.
- New investment in relation to an asset (usually the asset's GST-exclusive cost) needs to exceed a certain threshold before it can qualify for the deduction. The new investment threshold is $1,000 for small business entities and $10,000 for all other taxpayers.
- Generally, the new investment threshold needs to be met for each individual asset. However, multiple investments — or recognised new investment amounts — in the same, individual asset may be amalgamated in meeting the new investment threshold.
- The asset must be used principally in Australia for the principal purpose of carrying on a business. The deduction will not be apportioned for any non-taxable use of the asset.
- Assets that a taxpayer held, or entered into a contract to hold, on or before 12 December 2008 will not qualify. However, additional investment in such assets undertaken from 13 December 2008 may be eligible for the deduction.
- The deduction is worked out using a rate of either 50%, 30% or 10%, depending on the entity, when the taxpayer committed to investing in the asset, and when the asset is first used or installed ready for use. The deduction can be claimed in the income year that the asset is first used or installed ready for use. The following table summarises the different rates relating to key dates for different entities:

Business entity	Investment commitment time (inclusive)	Date of first use or installed ready for use (inclusive)	Rate
Small business	13 December 2008 to 31 December 2009	By 31 December 2010	50%
Other business	13 December 2008 to 30 June 2009	By 30 June 2010	30%
	1 July 2009 to 31 December 2009	By 31 December 2010	10%
	13 December 2008 to 30 June 2009	1 July 2010 to 31 December 2010	10%

Other key points to keep in mind:

- ***Option to acquire a new asset*** — If a taxpayer enters into a contract prior to 13 December 2008 which includes an option to acquire an eligible asset at a later point in time and the option is exercised on or prior to 31 December 2009, the taxpayer may still be eligible to claim the tax deduction. The investment commitment time is deemed to have occurred when an option is exercised rather than on the date of an original contract.
- ***Jointly held assets*** — If an asset is jointly held, a taxpayer will be able to recognise all other business interests in the asset for the purpose of meeting the threshold that applies to that taxpayer individually but will only be able to claim the tax deduction on its interest in the asset.
- ***Self-constructed assets*** — A taxpayer who self-constructs an eligible asset may still qualify for the tax deduction. In determining whether the taxpayer qualifies for the deduction, the taxpayer must demonstrate a clear intention or commitment to proceed with the construction, which is analogous to a case where a taxpayer enters into a binding contract.
- ***Batches and sets of assets*** — A taxpayer is permitted to aggregate its investment in assets that are identical, or substantially identical, and in assets that form a set for the purposes of meeting the investment threshold. The taxpayer still needs to consider each asset individually. The assets forming a batch or a set will need to satisfy the basic requirements to qualify for the tax deduction. A batch or set of assets does not need to be acquired in the same transaction or in the same income year.
- ***Carried over for threshold purposes*** — Notwithstanding that a taxpayer has claimed an amount relating to the tax deduction for a new qualifying asset or new expenditure on a qualifying asset, the amount can still be used towards meeting the investment threshold for subsequent years. That is, the amount can be carried over for the purposes of meeting the investment threshold but it cannot be claimed again.

➢ **TIP:** If a taxpayer is in a tax loss position, the bonus deduction will form part of that loss and carry forward to the following income year.

➢ **TIP:** If an entity is classified as a small business entity based on its actual aggregated turnover (ie less than $2m at the end of the income year), the investment threshold of $1,000 will apply to all investments.

➢ **TIP:** Where an eligible asset is used for private and business purposes, a taxpayer does not need to apportion the cost of the asset between the different usages, provided the asset was required principally for a business use. Further, the bonus depreciation will not be clawed back in future years even if its usage changes.

➢ **STOP:** Where an eligible asset is held by a partnership, it is the partnership rather than the partners that is eligible to claim the bonus deduction.

Donations

A taxpayer may make a written election to spread a deduction for a donation over a period of up to five years if:

- the donation was a gift of money of $2 or more;
- the donation was property valued by the Tax Office at more than $5,000;
- the donation was made under the Cultural Gifts Program; or
- the donation was a heritage gift.

- ➢ **TIP**: A taxpayer must specify in the written election the percentage (if any) to be deducted each year. If a taxpayer anticipates an increase in assessable income in a future year, a taxpayer may consider allocating a greater percentage to that year.
- ➢ **TIP:** As a general proposition, try to avoid making donations in a year of losses. This is because a deduction for a donation cannot add to or create a tax loss for a taxpayer.
- ➢ **TIP:** Charitable donations of $2 or more are deductible, as long as receipts are retained. However, documentary evidence is not required where the gift does not exceed $10. An example would be a 'bucket donation' of less than $10 to a deductible gift recipient (DGR).

FBT and salary sacrificing donations

Donations to a deductible gift recipient (DGR) made under a salary sacrifice arrangement no longer result in an employer incurring an FBT liability from the 2008/09 FBT year. The legislative amendments which brought this into effect are contained in *Tax Laws Amendment (2009 Measures No 4) Act 2009*. It should be noted that employers who make donations under salary sacrifice arrangements are not entitled to claim an income tax deduction for the donations in their own tax return.

- ➢ **STOP:** Donations to an overseas disaster appeal (eg Haiti earthquake in January 2010) are tax deductible if the organisation operating the appeal is endorsed as a DGR and is an overseas aid fund.

Legal expenses

It is impossible to formulate an all-encompassing 'rule' as to the deductibility of legal expenses because each expense must be considered on its own merits.

Non-commercial losses

An individual taxpayer should consider whether a loss from his or her business activity (whether carried on alone or in partnership) will be deferred under the non-commercial loss rules, which are contained in Div 35 of ITAA 1997. This is because the individual's overall tax position will be impacted when the loss is deferred.

In essence, an individual may only offset a loss arising from a business activity against other income derived in the same income year if the business activity satisfies at least one of the four commerciality tests – the assessable income, profits, real property, and other assets tests. If the individual does not satisfy at least one of the tests, the loss is carried forward and applied in a future income year against assessable income from the particular activity.

The Commissioner has the discretion to override the provisions of Div 35. Further, an exemption is available for individuals who carry on a primary production or professional arts business and whose assessable income for the year from other sources (eg salary and wages) does not exceed $40,000.

- ➢ **TIP:** The $40,000 threshold excludes net capital gains derived by a taxpayer.

High-income earners

From 1 July 2009, losses incurred by individuals with an adjusted taxable income of $250,000 or more from non-commercial business activities will be quarantined even if they satisfy the four commerciality tests. The effect of this is that they will not be able to offset excess deductions from non-commercial business activities against their salary, wage or other income.

The 'adjusted taxable income' is the sum of an individual's:

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

Any excess deductions from a non-commercial business activity that are subject to Div 35 are to be disregarded in working out the adjusted taxable income of the individual.

While an individual with an adjusted taxable income of $250,000 or more is precluded from accessing the four commerciality tests, they will be able to apply to the Commissioner to exercise his discretion to not apply the non-commercial loss rules where they can satisfy the Commissioner, based on an objective

expectation, that the business activity will produce assessable income greater than available deductions within a commercially viable period for the industry concerned.

Two provisions in the *Income Tax (Transitional Provisions) Act 1997* 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 the Div 41 Business Tax Break (the Small Business and General 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.

Prepayments

One of the simplest methods to accelerate deductions is the prepayment of deductible expenses.

Excluded expenditure

The prepayment rules do not apply to 'excluded expenditure', ie a taxpayer is able to claim an outright deduction. Excluded expenditure is defined as:

- expenditure that is less than $1,000;
- expenditure that is required to be made under a court order or by law (eg car registration fees and audit fees); and
- expenditure that is for salary or wages.

➢ **TIP:** If a taxpayer is entitled to an input tax credit in respect of an expenditure, the $1,000 is the GST-exclusive amount. If the taxpayer is not entitled to an input tax credit, the $1,000 is the GST-inclusive amount.

Small business entities and non-business individuals

Small business entities and non-business individuals are able to access the 12-month prepayment rule. If the prepaid expenditure is not excluded expenditure, it is deductible outright in the income year it is incurred, subject to two provisos: the eligible service period does not exceed 12 months, and ends in the expenditure year or the income year immediately following. If the prepayment has an eligible service period of greater than 12 months, the expenditure will be apportioned over the relevant period (on a daily basis) up to a maximum of ten years. The eligible service period is the period over which the relevant services are to be provided.

Other taxpayers

If the eligible service period covers only one income year, the expenditure will be deductible in that particular year. If the eligible service period covers more than one income year, the expenditure is apportioned (on a daily basis) over those years up to a maximum of 10 years in accordance with the formula:

$$\text{Expenditure} \quad \times \quad \frac{\text{No of days of eligible service period in the year of income}}{\text{Total number of days of eligible service period}}$$

Speculators and losses from shares

Generally, speculators are denied a revenue deduction for any losses arising for the disposal of shares unless a speculator is carrying on a business in relation to the shares. By way of example, in *AATA Case 6297* (1990) 21 ATR 3747, the Tribunal concluded that a taxpayer's share activities did not amount to carrying on a business and that, as a result, the taxpayer was not entitled to a deduction for losses arising from the disposal of his shares.

Furthermore, in ATO ID 2002/951 the Commissioner ruled that a speculator was not entitled to a revenue deduction for losses under s 25-40 of ITAA 1997 on the sale of post-CGT shares. Interestingly, the Commissioner did not discuss the deductibility of the losses under s 8-1 of ITAA 1997, nor whether the losses were capital in nature.

Trading stock

The tax treatment of trading stock, which is contained in Div 70 of ITAA 1997, impacts on year-end tax planning. This is because a taxpayer is required to either include in or deduct from its assessable income for an income year the difference between the opening and closing value of the trading stock.

Valuation of trading stock

A taxpayer can elect to use the cost, market selling value or replacement value to value each item of trading stock-on-hand. However, this does not apply to obsolete stock or certain taxpayers.

There is no requirement to adopt permanently any one of the three methods of value.

- **TIP:** There is no compulsion to use the same method to value all closing stock. A taxpayer can use different methods for different items of trading stock to maximise its deductions or minimise its assessable income.

Small business entities

If a small business entity elects to apply the trading stock concession under Div 328, it is permitted to ignore the difference between the opening and closing value of trading stock if the difference between the opening value of stock on hand and a reasonable estimate of stock on hand at the end of that year does not exceed $5,000. The effect of electing this concession is that the value of the entity's stock on hand at the beginning of the income year is the same as the value taken into account at the end of the previous income year.

However, a taxpayer could choose to account for changes in the value of trading stock even if the reasonably estimated difference between opening and closing values was less than $5,000.

- **TIP:** Accounting for the difference between the opening and closing stock is a good tax planning method to avoid a large adjustment in the calculation of taxable income in a future year when the benefit of Div 328 is not available or to claim a deduction in the current year for a reduction in the value of trading stock.

Other business taxpayers

It is a requirement to value each item of trading stock at the end of an income year at its cost, market value or replacement value. There is no requirement to permanently adopt any one of the three methods of valuation. Further, there is no compulsion for a taxpayer to use the same method across all items of trading stock.

- **STOP:** Manufacturers who elect to value stock on hand at year end at cost price, and wholesale and retail industries must use the absorption cost method to value their trading stock: see Rulings IT 2350 and TR 2006/8.

Obsolete stock

A deduction may be available for obsolete stock. Therefore, a taxpayer should review its closing stock to identify whether any obsolete stock exists. In Taxation Ruling TR 93/23, the Tax Office states that obsolete stock is either:

- going out of use, going out of date, becoming unfashionable or becoming outmoded (ie becoming obsolete); or
- out of use, out of date, unfashionable or outmoded (obsolete stock).

When valuing obsolete stock, a taxpayer does not need to use any of the prescribed methods (ie cost, market value or replacement value). Rather, provided adequate documentation is maintained, the Tax Office will accept any fair and reasonable value which is calculated taking into account the appropriate factors: see s 70-50 of ITAA 1997.

Repairs and maintenance

A deduction is available for repairs to premises, part of premises or a depreciating asset (including plant) held or used by a taxpayer solely for the purpose of producing assessable income: see s 25-10(1) of ITAA 1997. If the relevant premises or assets are held or used only partly for income-producing purposes, expenditure on repairs is only deductible to the extent that it is reasonable in the circumstances: see s 25-10(2).

A common issue that arises is the distinction between restoration of an item to its former condition (deductible) and improvement of the item (capital and thus not deductible). It is important to realise the

mere fact that different materials from those replaced are used will not of itself cause the work to be classified as an improvement, particularly in circumstances where the previous materials are no longer in current use. If the change is merely incidental to the operation of the repair, the deduction, generally, will be allowed.

Initial repairs, the replacement of the entire item, and improvements are not deductible, but may qualify for a periodic write-off under the capital allowance provisions. In addition, the expenditure may form part of the cost base of an asset for capital gains tax purposes.

- **TIP:** The Tax Office has stated that if a taxpayer replaces something identifiable as a separate item of capital equipment, the taxpayer has not carried out a repair. Therefore, the taxpayer is required to depreciate the item over its effective life.

- **TIP:** Taxpayers should seek an itemised invoice to separate the costs of work where the work includes both repairs and improvements.

Superannuation contributions

Deductions for employer contributions

Employers are entitled to a tax deduction for contributions made to a complying superannuation fund or a retirement savings account (RSA) for the purpose of providing superannuation benefits for their employees. The contributions are only deductible for the year in which they are made: see s 290-60(3) of ITAA 1997. To maximise the deductions available, employers should ensure that the contributions are paid to their employees' superannuation funds or RSAs before 30 June.

- **TIP:** A mere accrual of a superannuation liability or a book entry is not sufficient to qualify for a deduction.

- **TIP:** For employees turning 75, the contribution must be made by an employer within 28 days after the end of the month in which an employee turns 75 to obtain a deduction.

Superannuation guarantee charge

The superannuation guarantee charge (SGC) is imposed if an employer does not make sufficient quarterly superannuation contributions for each employee by the relevant quarter due date. The SGC is also imposed where the employer pays the contributions after the due date, albeit there is no shortfall for the quarter.

Employers who have made a contribution for an employee after the due date for a quarter and have an outstanding SGC for the employee for that quarter may elect (using the approved form) to use the late payment offset to reduce part of their SGC liability.

Since 24 June 2008, employers can elect to use the late payment offset to reduce their SGC liability for a year (rather than a quarter) which becomes payable after that date. From 26 March 2009, an employer will be eligible to use the offset to reduce its SGC liability where:

- the employer has made a contribution for a quarter into an employee's fund after the due date for the quarter;
- the contribution in respect of the employee is made before the employer's original assessment for the SGC for the quarter (original SG assessment date);
- the employer has given election (in the approved form) to the Commissioner to use the offset in respect of the employee to reduce their SGC liability for the quarter; and
- the election is made within four years after the original SG assessment date for the quarter.

- **TIP:** The SGC and late payment offset are not deductible to an employer. Therefore, the employer still has a strong incentive to continue making its superannuation guarantee quarterly payments on time.

- **TIP:** The SGC is the only tax that the Commissioner wants employers to avoid paying.

Personal superannuation deductions

The self-employed and other eligible persons are entitled to a deduction for personal superannuation contributions if less than 10% of a taxpayer's total assessable income and reportable fringe benefits for an income year is attributable to activities that result in the taxpayer being treated as an 'employee' for superannuation guarantee purposes.

The contribution is only deductible for the year in which it is made. Further, the contribution is deductible in full, subject to the restriction that the maximum amount that is deductible is the amount stated in the notice of intention to claim a deduction, which is given to the trustee of a superannuation fund. However, excess contributions tax may apply for contributions above the contributions cap.

- **TIP:** A deduction for personal superannuation contributions should only be made towards the end of the income year when it is certain a taxpayer will satisfy the 10% rule (and other eligibility conditions) and not breach the taxpayer's concessional contributions limit of $25,000 (or $50,000 for those aged between 50 and 74).
- **TIP:** A taxpayer who realised a significant capital gain during the year should evaluate his or her eligibility to claim a deduction for personal superannuation contributions. If the taxpayer is eligible, he or she should consider contributing an amount of the capital gain to superannuation which may reduce the tax payable on the capital gain derived.

Capital Gains Tax

A taxpayer may consider crystallising any unrealised capital gains and losses in order to improve his or her overall tax position for an income year. For example, if the taxpayer is anticipating a significant capital gain in an income year, consideration may be given to reducing the gain by crystallising a capital loss in the same income year. However, consideration must be given to the Commissioner's view on 'wash sales' contained in Taxation Ruling TR 2008/1, particularly if a taxpayer reacquires the assets being disposed or identical assets, or somehow retains dominion or control over the original assets.

Small business CGT concessions

Broadly, the small business CGT provisions contained in Div 152 of ITAA 1997 provide a range of concessions for a capital gain made on a CGT asset that has been used in a business if certain conditions are met. These concessions are:

1. the 15-year asset exemption: a capital gain may be disregarded if the relevant CGT asset has been continuously owned by the taxpayer for at least 15 years. If the taxpayer is an individual, he or she must be at least 55 years of age and the CGT event must happen in connection with the taxpayer's retirement, or he or she is permanently incapacitated at that time. If the taxpayer is a company or trust, a person who was a significant individual just before the CGT event must satisfy the requirements;
2. the 50% reduction: a capital gain resulting from a CGT event happening to an 'active asset' of a small business may be reduced by 50%;
3. the retirement exemption: a taxpayer can choose to disregard all or part of a capital gain up to a lifetime maximum of $500,000; and
4. the asset rollover: a taxpayer can disregard all or part of a capital gain if a replacement asset, which is an active asset, is acquired.

- **TIP:** The concessions do not apply to deny capital losses that a taxpayer has for an income year. That is, the taxpayer is still able to utilise any capital losses against any other capital gains for the income year.
- **TIP:** A taxpayer can choose not to claim the 50% reduction on a gain. If the taxpayer is a company or trust which cannot pass on the full benefits of the 50% reduction to shareholders or unit holders, by not choosing this option, the taxpayer will be able to pass on the full benefits of the retirement exemption.
- **TIP:** Partial use of an asset in the course of carrying on a business will suffice for the active asset test.
- **TIP:** A small business entity wanting to access the small business CGT concessions is exempted from the maximum net asset value test.
- **STOP:** Unless specifically excluded, all assets, including depreciating assets, are taken into account in the maximum net asset value test.
- **STOP:** Consideration should be given to the integrity measures contained in the CGT regime: see ss 115-40 and 115-45, Div 149 and CGT event K6.
- **STOP:** The *Tax Laws Amendment (2009 Measures No 2) Act 2010* amends ITAA 1997 to increase access to the small business GST concessions. Generally, the amendments contained in the Act apply from the 2007/08 income year.

Rollover relief

Rollover relief is available to provide taxpayers with the option to defer the consequences of a CGT event. Apart from disregarding any capital gains or capital losses that would otherwise arise from a CGT event, a rollover usually places the transferee under the rearrangement in the same CGT position as the transferor was before the event occurred. Some of the rollover reliefs will apply automatically while some will require taxpayers to elect the use of the reliefs, which is indicated by the way their tax returns are prepared.

Two types of rollovers are available: the replacement asset rollover and the same asset rollover. A replacement asset rollover allows the deferral of a capital gain or loss until a later CGT event happens to the replacement asset. A same asset rollover allows the deferral of a capital gain or loss arising from the disposal of the asset until the later disposal of the asset by the successor entity.

The table below sets out the common rollover reliefs that may be considered for tax planning purposes:

Type of rollover	Brief description	Election required
Rollover from individual to company	Individual disposes assets to a resident company	Yes
Rollover from trust to company	Trustee of a trust disposes assets to a resident company	Yes
Rollover from partnership to company	Partnership disposes assets to a wholly owned resident company	Yes
Assets compulsorily acquired, lost or destroyed	Disposal of an asset from being compulsorily acquired, lost or destroyed	Yes
Fixed trust to company	Fixed trust disposes all of its assets to a resident company	Yes
Marriage breakdown	Taxpayer disposes assets to his or her spouse pursuant to an order of a court under the *Family Law Act 1975*	No
Small business replacement asset rollover	Taxpayer who is eligible for the small business CGT concessions acquires a replacement asset or improves an existing asset	Yes

Companies

The tax treatment of companies will depend on their classification, that is, a private company or a public company. For example, only a private company is subject to the operation of Div 7A of ITAA 1936. Companies are subject to a flat rate of tax (currently 30%) on the entirety of their taxable income. This rate applies whether the company is public, private, resident or non-resident.

Franking account

It is a requirement that every entity that is (or has ever been) a corporate tax entity has a franking account. The franking account is recorded on a 'tax paid' basis and operates on a rolling balance basis.

Franking of distributions

All distributions are frankable unless specifically deemed unfrankable. Unfrankable distributions include:

- deemed dividends under Div 7A; and
- deemed dividends in relation to excessive payments made by a private company to its shareholders, directors and associates.

Benchmark rule

The benchmark rule requires all frankable distributions made by an entity during its franking period to be franked to the same extent (the 'benchmark franking percentage').

It should be noted that a corporate tax entity would incur an over-franking tax if the franking percentage for a distribution exceeds the benchmark percentage, or a franking debit (for under-franking) if the franking percentage is less than the benchmark rate. (Certain concessions to this rule may apply to public companies.)

If the benchmark percentage varies by more than 20% from the last frankable distribution in the last franking period, an entity must notify the Commissioner in writing.

Franking period

The franking period of a corporate tax entity will depend on whether is it a public company or a private company. The franking period of a private company is the same as its income year. Generally, a public company has a six-month franking period.

Distribution statements

Entities that make frankable distributions must provide their shareholders with a distribution statement. (Note that the information that must be disclosed on the statement is prescribed in s 202-80 of ITAA 1997.) For entities that are private companies, the distribution statement must be given to their shareholders within four months after the end of the income year in which the distribution was made, or such further time as the Commissioner allows. If this statement is not received, the shareholder will not be able to claim a franking credit tax offset.

- **TIP:** As a private company has four months after the end of an income to provide its shareholders the distribution statements, in effect, the company can retrospectively frank a distribution.
- **STOP:** It is an offence under the *Taxation Administration Act 1953* if a corporate tax entity fails to give a distribution statement or makes a misleading statement in connection with a distribution.

Franking account balance

A company's franking account should be reviewed to ensure that the company is not liable for franking deficit tax. If the company is liable for franking deficit tax, it must be paid within a month of the end of the franking period. Franking deficit tax is not a penalty but an early payment of income tax that is offset against future tax obligations.

Concession for private companies

A private company generating profit in its first income year is prevented from making a franked distribution to its shareholders because of insufficient franking credits. However, a concession, which allows the company to make a franked distribution to its shareholders, exists if the following conditions are satisfied:

1. it is liable to pay income tax for the income year that is sufficient to generate franking credits equal to at least 90% of the deficit in its franking account at the end of that income year; and
2. it is the company's first income year.

Private company and Div 7A

The broad thrust of Div 7A of ITAA 1936 is to deem certain loans, payments and debt forgivenesses by private companies to their shareholders and associates to be assessable unfranked dividends to the extent that there are realised or unrealised profits of the company.

Managing your Div 7A risk

To minimise any adverse Div 7A consequences, taxpayers must consider the following:

- repay private company loans by the earlier of the actual lodgment date or the due date for lodgment of the company's return for that year;
- ensure a loan agreement is in place by the earlier of the actual lodgment date or the due date for lodgment of the company's return for that year;
- ensure minimum repayments are made on loans from prior years;

- a deemed dividend can only arise to the extent of a company's distributable surplus, so this issue needs to be considered along with planning opportunities;
- payments under a guarantee can trigger a deemed dividend and must be considered carefully;
- the payment of an actual franked dividend by a company to offset a loan which has been deemed to be a dividend can have adverse implications and should be carefully considered;
- the exemptions available should be considered and used if possible; and
- a deemed dividend can also apply if property is provided, so companies should consider requiring shareholders to pay market value.

Trusts and Div 7A

If a private company beneficiary of a trust has an unpaid present entitlement to an amount of the net income of the trust and the trustee subsequently makes a loan, payment or debt forgiveness to a (non-corporate) shareholder or associate of the private company, it is important to consider the application of Div 7A.

If the actual transaction (a loan, payment or forgiveness) is done by the private company and the shareholder or associate, a deemed dividend arises here. Whether the company's unpaid present entitlement arises before or after the transaction is immaterial.

The amount of the deemed dividend is the lesser of:

a) the amount involved in the actual transaction; and

b) the unpaid present entitlement less any amounts previously treated as deemed dividends.

- **TIP:** If the present entitlement is paid to the private company beneficiary by the earlier of the actual lodgment date or the due date for lodgment of the trust's return of an income year, a deemed dividend will not arise.

Pending amendments

The Government has introduced the *Tax Laws Amendment (2010 Measures No 2) Bill 2010* which seeks to amend the non-commercial loan rules in Div 7A of ITAA 1936. The proposed amendments will prevent a shareholder of a private company (or an associate of the shareholder) accessing tax-free dividends from the provision of company assets, for less than their market value.

The proposed amendments will treat arrangements where a private company has provided an asset to a shareholder (or their associate) for their use (other than a transfer of property, which is already covered by s 109C(3)(c) of ITAA 1936) as a payment for the purposes of Div 7A. These changes are designed to ensure that Div 7A cannot be circumvented by the provision of an asset for use. The amendments in s 109CA(1) do not impact upon the operation of any of the existing payments in s 109C(3).

The Bill also seeks to make other technical amendments designed to strengthen the non-commercial loan rules to ensure that they operate in accordance with their original policy intent and cannot be circumvented by the use of a corporate limited partnership, which is a partnership taxed like a company.

Under the amendments proposed in the Bill, where a corporate beneficiary has a present entitlement to an amount from the net income of a trust estate and the whole of that amount has not been paid, and an entity is interposed between that trust and a target entity (the shareholder of the private company or their associate), the trust will be treated as having directly paid or loaned an amount to the target entity for the purposes of Div 7A. Subdivision EA will then operate as if the trustee makes a payment or loan to the target entity.

It is proposed that the amendments will apply from 1 July 2009. At the time of writing, the Bill was still before the House of Representatives.

Trusts

The provisions governing trust, which include in whose hands trust income is assessed and the amount assessed, can be complex. A good starting point is always the trust deed. This is because the deed governs the operation of the trust.

Trust losses

The trust loss recoupment rules restrict the circumstances in which prior year and current year losses of a trust can be claimed as a deduction when calculating the net income of the trust. The applicable tests that must be satisfied will depend on the type of trust. These tests must also be satisfied when the trust is seeking to claim a bad debt deduction.

Type of trust	Category	Ownership/control tests			Income injection test
		50% stake test	Pattern of distribution test	Continuity of ownership test	
Fixed	Ordinary fixed trust	✓	N/A	N/A	✓
Non-fixed		✓[1]	✓	✓[2]	✓
Excepted	Family trust	N/A	N/A	N/A	✓

1. Only when certain fixed entitlements exist.

2. Not relevant for current year losses.

Trust distribution minutes

The drafting of the distribution minutes needs to take into account the following tax issues:

- if there is a corporate beneficiary, will the distribution to the corporate beneficiary create an 'unpaid entitlement' and thus potential Div 7A issues? (*See* also **Pending amendments under Private Company and Div 7A**.)
- if a family trust election has been made, is the income being distributed to a person outside the family group?
- if the trust does not have any net income for the year, does it need to nominate a controlling individual to ensure the relevant trust loss recoupment rules are satisfied?
- if applicable, does the distribution of dividend income to the beneficiaries require a family trust election to be made to satisfy the 'holding period rule'?
- if applicable, have the relevant trust loss recoupment rules been taken into account when drafting the minutes to ensure access to the small business CGT concessions for the beneficiaries?

➢ **TIP:** A minor (ie under age 18 at the end of an income year) can receive up to $3,000 in non-taxable distributions for the 2009/10 income year.

➢ **TIP:** If possible, all income should be distributed to the beneficiaries. This is because income retained in the trust will be subject to tax under s 99 or s 99A of ITAA 1936.

➢ **TIP:** If the trust deed permits, a trustee may want to consider streaming income to beneficiaries that are able to benefit the most from the distribution. However, consideration should also be given to the operation of the general anti-avoidance provision and any specific anti-avoidance provisions.

➢ **STOP:** The trustee's minute distributes 'trust income' (ie accounting income) not 'taxable income'.

➢ **STOP:** If a trustee has distributed income to a minor up to the minor's non-taxable limit and the trust's net income is subsequently amended, the minor would need to receive an additional amount in proportion to the original distribution. The additional amount will, normally, be taxed at the top marginal rate (ie 45%).

Trusts and unpaid entitlements to private companies

A 'loan' from a private company to a trust can generally trigger a Div 7A deemed dividend under s 109D of ITAA 1936 where:

- the company's shareholders can directly or indirectly benefit from the trust;
- the company has sufficient distributable surplus; and
- the loan is not repaid, or a loan agreement that complies with s 109N is not executed before the earlier of the lodgment date or due date for lodgment of the company's tax return.

An unpaid present entitlement may result in a s 109D loan where either:

- the trustee and the private company beneficiaries have entered into a written loan agreement; or
- the parties have entered into a consensual agreement for the provision of credit or other form of financial accommodation.

Distribution of income

Trustees can use two methods to distribute the income of the trust: the quantum approach and the proportionate approach. The preferred method is the proportionate approach based on the volume of case law regarding trust distribution, which distributes the income based on the proportions of the trust income to the beneficiaries. For example, if a beneficiary is presently entitled to 10% of the trust income, he or she will be taken to be presently entitled to 10% of the net income for tax purposes.

Bamford case

In *FCT v Bamford* [2010] HCA 10, the High Court confirmed that it is correct to apply the proportionate approach if the net income of a trust for tax purposes exceeds its accounting income. The Court also upheld a decision that a capital gain made by a trust, but distributed as trust income, should be treated as income of the trust for tax purposes. However, the Court did not address the issue if capital gains are derived by the trust and there are separate classes of beneficiaries, ie income and capital. (*See* **Capital gains distribution**.)

Consequent to the decision of the High Court, trustees should review prior years income tax returns lodged. If the trustees distributed income using the quantum approach, they should determine whether the returns should be amended to redistribute the income using the proportionate approach, subject to the time limits for amending returns. In addition, the trustees should consider whether the trust deeds should be amended to give them the discretion to treat receipts as income.

Capital gains distribution

A strict application of the proportionate approach will result in an anomaly if capital gains are derived by the trust and there are separate and distinct income beneficiaries and capital beneficiaries. This is because under s 97 of ITAA 1936, a beneficiary who is entitled to the 'income' would be taxed on all of the 'taxable income' (including the capital gains, even though the beneficiary has not received any of the capital distribution). To overcome this anomaly, in Practice Statement PS LA 2005/1 (GA), the Commissioner has stated that he will permit the use of the capital beneficiary approach or the trustee approach. However, for a trust to be able to use either one of these approaches, documentation must be entered into within two months of year-end.

Capital beneficiary approach

The capital gain may be assessed to a beneficiary (or a trustee on his or her behalf) if:

- the beneficiary has a vested and indefeasible interest in the trust capital representing the trust's capital gain;
- the beneficiary would have had an interest if the trust's capital gain had been a 'deemed' amount for tax purposes or the gain had been represented by actual trust capital; or
- the beneficiary has been allocated the trust's capital gain as a present entitlement no later than two months after the end of the income year.

A capital beneficiary must agree in writing on the approach to be used, and he or she must prepare his or her tax return in a way that corresponds to the agreement. The agreement must be made within two months after the end of the income year, or such further time as the Commissioner allows. The trustee resolution allocating the capital gain must also be made by the time the agreement is made.

Trustee approach

If there is a capital gain that is not to be included in the share of the net income of a beneficiary, the trustee will be assessed under ss 99 or 99A of ITAA 1936.

This approach can only be used if the beneficiaries and trustee have agreed in writing to use it. Any agreement must be made within two months after the end of the relevant income year.

If a party does not prepare his or her income tax return in accordance with an agreement, the Tax Office will ignore the agreement in assessing the capital gain.

Small Business Entities

Under the small business entity regime, a taxpayer does not need to elect to enter into the regime. Instead, it will be apparent from a small business entity's tax return whether it has used the tax concessions.

Concessions available

The concessions available under the small business entity regime are:

- the simpler depreciation rules;
- the simpler trading stock rules;
- the entrepreneurs' tax offset;
- the prepaid expenses rules; and
- the two-year period of review.

In addition, a small business entity will be able to access other various concessions (subject to any additional criteria set out in the particular concessions themselves). These are:

- the CGT 15-year exemption, CGT 50% active asset reduction, CGT retirement exemption and CGT roll-over;
- the use of the GDP-adjusted notional tax method to work out PAYG instalments;
- the FBT car parking exemption; and
- the choice to account for GST on a cash basis, apportion GST input tax credits annually and pay GST by instalments.

➢ **STOP:** If the entity is classified as a small business entity based on the actual method, that is, the entity's aggregated turnover is determined as at the end of an income year, it is precluded from accessing any of the GST concessions available to small business entities for the income year.

Definition of a small business entity

An entity will be classified as a small business entity for an income year if:

- it is carrying on a business in the current year; and
- it had an aggregated turnover for the previous year of less than $2 million or an aggregated turnover for the current year that is likely to be less than $2 million.

The aggregated turnover is the annual turnover of the entity's business plus the annual turnover of any businesses that the entity is connected to or affiliated with. The aggregated rules are similar to the former STS grouping rules.

An entity satisfies the aggregated turnover test if:

- its aggregated turnover for the previous income year was less than $2 million;
- its aggregated turnover for the current income year, worked out as at the first day of the income tax year, is likely to be less than $2 million; or
- its aggregated turnover for the current income year, worked out as at the end of the current income year, is actually less than $2 million.

➢ **STOP:** The meaning of a small business entity contained in s 328-110 of ITAA 1997 was amended by the *Tax Laws Amendment (2009 Measures No 2) Act 2010* to provide that a partner in a partnership cannot be a small business entity in their capacity as a partner. This amendment applies from the 2007/08 income year.

Personal Services Income

Broadly, the personal services income (PSI) rules attribute income derived by an interposed entity to the individual providing services to the entity. This is achieved by 'forcing' individuals to include the income generated by their personal skill or efforts in their personal tax returns. The deductions of a taxpayer who

receives PSI are, generally, limited to the amount that he or she would be entitled to deduct if they had received the income as an employee.

However, the PSI rules do not apply to individuals or interposed entities if one of the required personal services business (PSB) tests (results test, unrelated clients test, employment test and business premises test) is satisfied. The primary test to be applied is the results test. If this test is met, there is no further requirement to self-assess against the other tests and the PSI rules do not apply. Taxation Ruling TR 2001/8 provides the Tax Office's interpretation of the results test. The ruling states that the results test is based on the traditional criteria for distinguishing independent contractors from employees.

In addition, the Commissioner has the power to grant a Determination, which has the effect of exempting a PSB from the PSI regime. Generally, a Determination will be granted if unusual circumstances existed that prevented the business from satisfying the tests or the business would have had, but for the unusual circumstances, two or more unrelated clients in the current income year.

- **STOP:** If a taxpayer fails the result test **and** the 80% rule in an income year, the taxpayer is not permitted to self-assess itself against the remaining tests. The PSI rules will apply unless a PSB determination is obtained from the Tax Office.

General anti-avoidance and PSB

It is a common misconception that income earned by a PSB is income from a business structure. The income derived by a PSB is still categorised as PSI for income tax purposes if it is income that is mainly a reward for an individual's personal efforts or skills. Therefore, the income (as distinct from income from a business structure) that is derived by the PSB may be subject to the application of Pt IVA, if:

- the income is split with an associate; or
- the income is split with another entity associated with the individual; or
- the income is retained in a company and taxed at the lower company tax rate.

However, remuneration paid to an associate (or service trust) for bona fide services related to the earning of PSI will not attract the application of Pt IVA if the amount is reasonable.

The Tax Office has stated that Pt IVA will not apply in the following situations:

The PSB is conducted through:	Situation
a company	There is no income splitting and no retention of profits in the company.
	If there is a bona fide attempt to break even, a relatively small amount of taxable income may be returned by the company provided that income is distributed to the individual by way of a franked dividend in the following year.
a trust	If the trustee is a corporate trustee, the situations are the same as for a company.
a partnership	If a partnership income results from the services of employees or the use of income-producing assets.

- **TIP:** A partnership with a spouse will not attract the operation of Pt IVA if it is a genuine partnership.

Superannuation

Superannuation should not necessarily be viewed as a year-end planning matter but rather as a long-term retirement savings approach. However, it is worth reflecting on the various concessions and deductions available under the superannuation system which may impact on the tax position of a taxpayer.

Benefit withdrawal and re-contribution strategy

A re-contribution strategy may still produce tax benefits for those seeking to access superannuation benefits before age 60 or for estate planning purposes. In particular, the taxable component of a superannuation interest remaining after the death of a member is still subject to 16.5% tax when ultimately paid in a lump sum to a beneficiary who is not a 'death benefits dependant'.

Broadly, the aim of a re-contribution strategy is to convert part of a superannuation interest from a taxable component to a tax-free component. This strategy is relevant where benefits are paid to a person under age 60 (eg a transition to retirement pension) as the pension is deemed to comprise a portion of the total value of the superannuation interest reflecting the tax-free and taxable components. The underlying components also become relevant again upon the death of a member if the remaining benefits are paid to a non-dependant.

Re-contribution personal superannuation contributions are classified as non-concessional contributions and are therefore restricted by the annual non-concessional contributions cap. A person aged 65 to 74 must also satisfy the work test in order for a fund to accept the personal contributions. As a result, any re-contribution strategy needs to be carefully considered in the light of the taxpayer's particular situation.

Government co-contribution

Eligible low-income earners (including self-employed persons) may qualify for a government superannuation co-contribution payment. For the 2009/10 income year, the amount of co-contribution is equal to 100% of the sum of eligible personal superannuation contributions up to a maximum of $1,000 per annum for a $1,000 personal contribution. The maximum amount is available to all qualifying persons whose total income for an income year does not exceed the lower threshold. For qualifying persons whose total income exceeds the lower threshold but is below the upper threshold, the co-contribution tapers out at a rate of 3.333 cents for each whole dollar of income.

For a self-employed individual, the total income will be reduced by amounts for which the individual is entitled to a deduction as a result of carrying on a business.

To qualify for a government co-contribution, a person must:

- have made one or more eligible personal superannuation contributions during the income year for which no deduction has been allowed to a complying superannuation fund or retirement savings account. The contribution must be made to obtain superannuation benefits for the person making the contribution or, in the event of the person's death, her or his dependants;
- have at least 10% of their total income for the income year from carrying on a business (ie self-employed) or attributable to activities that result in the person being treated as an 'employee' for superannuation guarantee purposes, or a combination of both;
- have a total income for the year that does not exceed $61,920 for 2009/10. Total income is the sum of assessable income and reportable fringe benefits;
- be aged under 71 on 30 June of the year in which the contributions are made. For persons aged 65-70, the additional work test rules (ie gainful employment for at least 40 hours in a period of not more than 30 consecutive days in the financial year in which the contribution is made) must also be satisfied for a complying superannuation fund or retirement savings account to accept contributions from a person;
- lodge an income tax return for the year; and
- not have held an eligible temporary resident visa during the income year.

➢ **STOP:** From the 2009/10 income year, total income of a taxpayer for the purposes of the Government co-contributions includes 'reportable employer superannuation contributions': see **Reportable employer superannuation contributions**.

Superannuation splitting

A member of an accumulation fund (or a member whose benefits include an accumulation interest in a defined benefit fund) is able to split with her or his spouse superannuation contributions made from 1 January 2006. The spouse contributions splitting regime has also been extended to cover employer contributions to untaxed superannuation schemes and exempt public sector superannuation schemes.

While the relevance of spouse contribution-splitting has been reduced following the abolition of reasonable benefit limits and end benefits tax for those aged 60 and over, splitting contributions between spouses can still be a useful strategy to effectively transfer concessional contributions to the older spouse who will reach age 60 (and tax-free benefit status) first. In addition, contribution splitting may be relevant to access two low rate cap thresholds for superannuation benefits taken before age 60. However, it is not possible to split 'untaxed splittable contributions' (eg non-concessional contributions made after 5 April 2007).

A superannuation fund does not need to offer a contributions-splitting service for its members. However, a trustee that accepts a valid application must roll over, transfer or allot the amount of benefits in favour of the receiving spouse within 90 days after receiving the application.

Tax treatment

A member's contribution that is split and paid to another fund is considered a 'contributions-splitting superannuation benefit' and treated as a roll-over superannuation benefit for the receiving spouse. Therefore, the contributions-splitting amount rolled over or transferred for the benefit of the member's spouse is not subject to the 15% contributions tax in the hands of the fund.

Where a contributions-splitting superannuation benefit is transferred to an account within the same fund and paid to a taxpayer because her or his spouse is a member of the superannuation fund, the receiving spouse is deemed by s 307-5(6) to be the member of the fund for tax treatment of the superannuation benefit.

At the benefit payment stage, a contributions-splitting superannuation benefit is deemed to consist entirely of a taxable component of a superannuation benefit.

A person entitled to a tax deduction for a personal superannuation contribution who wants to split personal contributions and claim a deduction must provide a notice under s 290-170 of ITAA 1997 to her or his superannuation fund before requesting the fund to split the contributions. Once a contribution has been split, a self-employed person is not able to make a new s 290-170 election to claim a deduction or amend an existing election in respect of the split amount.

Spouse contributions tax offset

A tax offset is available up to $540 under s 290-230 of ITAA 1997 for a resident taxpayer in respect of eligible contributions made by the taxpayer to a complying superannuation fund or a retirement savings account for the purpose of providing superannuation benefits for the taxpayer's low-income or non-working resident spouse (including a de facto spouse).

A taxpayer is entitled to the spouse contributions tax offset only if:

- the contribution is made on behalf of a person who was the taxpayer's spouse when the contribution was made;
- both the taxpayer and the spouse were Australian residents and were not living separately and apart on a permanent basis when the contribution was made;
- the total of the spouse's assessable income, reportable fringe benefits and reportable employer superannuation contributions for 2009/10 is less than $13,800;
- the taxpayer cannot and has not deducted an amount for the spouse contribution as an employer contribution under s 290-60 of ITAA 1997; and
- if the contribution is made to a superannuation fund, it must be a complying superannuation fund for the income year in which the contribution is made.

If the spouse in respect of whom the contribution is made is age 65 or over, the contribution cannot be accepted by the fund unless the spouse satisfies the requisite work test. Likewise, a regulated superannuation funds is not able to accept contributions on behalf of a spouse aged 70 to 74.

- **STOP:** From the 2009/10 income year, a spouse also includes a same sex partner where they live together on a genuine domestic basis in a relationship as a couple, or a partner (whether of the opposite or same sex) where the relationship is of a prescribed kind that is registered under a prescribed State or Territory law.

Spouse's income test and limit on amount of tax offset

The assessable income, reportable fringe benefits and reportable employer superannuation contributions of the spouse must be less than $10,801 in total to obtain the maximum tax offset of $540, and less than $13,800 to obtain a partial tax offset.

The taxpayer's own assessable or taxable income, and whether he or she qualifies for a deduction or tax offset for any superannuation contributions made on behalf of herself or himself, is irrelevant to entitlement to the rebate. Similarly, whether the spouse has any other superannuation is also irrelevant.

There is no limit on the amount of the actual contributions that can be made on behalf of the spouse, merely a $3,000 limit on the contributions for which a tax offset can be obtained. Where less than $3,000 is

contributed, the tax offset is 18% of the actual amount of the contributions. Where the sum of assessable income and reportable fringe benefits (if any) of the spouse is greater than $10,800, the $3,000 maximum contributions subject to the tax offset is reduced by $1 for each dollar of assessable income and reportable fringe benefits in excess of $10,800 and an 18% tax offset applies on actual contributions up to this maximum.

Transition to retirement pensions

Broadly, a transition to retirement pension (TRP) allows a taxpayer who has reached preservation age to access his or her superannuation benefits by commencing a non-commutable pension or annuity without having to retire permanently from the workforce. At the same time an individual can salary sacrifice employment income back into retirement savings. However, the pension cannot be cashed or commuted to a lump sum while the taxpayer is still working, unless a condition of release with a 'nil' cashing restriction has been satisfied (eg attaining age 65). All superannuation funds including self-managed superannuation funds are able to offer such a product to their members, provided the fund's deed allows it.

A TRP can take the form of a non-commutable allocated pension but has a maximum annual payment limit of 10%. Both the minimum and maximum annual payment amounts are calculated according to the 'account balance' under Sch 7 of the Superannuation Industry (Supervision) Regulations 1994. Further, the minimum annual payment amount is determined by the age of the taxpayer at the start of each financial year.

Therefore, it is necessary to decide how much superannuation capital needs to be set aside to guarantee a TRP within the minimum/maximum annual payment limits. Due consideration must also be given to the make-up of the capital, which consists of taxable components and/or non-taxable components, because the composition will impact upon the tax treatment of a pension received by a taxpayer under age 60.

Tax treatment

A TRP paid from a taxed source to an individual aged 60 or over is totally tax free, ie non-assessable non-exempt income. As such, it is not counted in working out the tax payable on any other assessable income of the individual.

Conversely, if an individual is under age 60, the 'taxable component' of a TRP paid from a taxable source is included in the individual's assessable income. Where the individual is above his or her preservation age (but below age 60) a 15% tax offset in respect of the tax component of the pension is available.

The tax-free component of a TRP paid from a taxed source is tax free, regardless of an individual's age.

Salary sacrifice and TRP

An advantage of a TRP is that instead of employment income being taxed at an individual's marginal rate, the salary sacrifice superannuation contributions are only taxed at the rate of 15% on entry into the superannuation fund. This, generally, result in less overall tax being paid on the pension income (as compared to employment income). However, it is important to note that the amount available for salary sacrificing is effectively restricted by the annual concessional contributions cap, which is determined by reference to an individual's age.

Another advantage is the income tax exemption available to superannuation funds in respect of income derived from assets that are segregated to support a fund's current pension liabilities.

Reportable employer superannuation contributions

From 1 July 2009, reportable employer superannuation contributions are counted towards the maximum employee earnings limit for deducting personal contributions, the co-contribution income test and other income tests for various tax concessions and government assistance programs.

A reportable employer superannuation contribution is an amount contributed to a superannuation fund by an employer (or an associate of an employer) for the benefit of an employee (eg under a remuneration package), but only to the extent that the individual has or had, or might reasonably be expected to have or have had, the capacity to influence the size of the amount and/or the way the contribution is made (so that the employee's assessable income is reduced.

However, a contribution made by an employer that meets the employer's requirements under the superannuation guarantee scheme is not a reportable employer superannuation contribution, nor is a contribution made under an arm's length industrial agreement that the employee had no capacity to

influence. In addition, a contribution is not a reportable employer superannuation contribution if the amount is included in the employee's assessable income, ie contributions made from 'post-tax' income).

Reportable superannuation contributions

A person's reportable superannuation contributions are the sum of their reportable employer superannuation contributions' and any deductible personal contributions for a financial year. Reportable superannuation contributions form part of a person's adjusted taxable income for various purposes including:

- the Medicare levy surcharge (but not the Medicare levy);
- the pensioner tax offset and senior Australians tax offset;
- the spouse superannuation tax offset; and
- the dependant tax offsets.

Pensions — minimum annual payment amounts

Account-based pensions and annuities must meet the minimum payment rules set down in Sch 7 of the SIS Regs. The payment rules specify minimum annual limits only. For the 2008/09 and 2009/10 financial years, the minimum limits have been halved by 50%.

Minimum annual drawdown factors (50% reduction for 2008/09 and 2009/10)		
Age of beneficiary (years)	**Minimum annual drawdown for 2008/09 and 2009/10 (%)**	**Minimum annual drawdown for 2010/11 onwards (%)**
0–64	2	4
65–74	2.5	5
75–79	3	6
80–84	3.5	7
85–89	4.5	9
90–94	5.5	11
95+	7	14

- **TIP:** The halving of the limits ends on 30 June 2010 and the original limits will return. Pensioners who are concerned whether they have adequate monies to fund their long-term retirement should consider taking advantage of this concession.

Tax Office focus

The Tax Office has flagged several compliance issues in relation to superannuation funds and their members.

SMSF reporting errors

According to the Tax Office, poor contributions reporting by some self-managed superannuation funds (SMSFs) is leading to excess contributions tax issues for fund members. The Tax Office indicated that a key error involves SMSFs reporting personal contributions, which the member notified the fund they intended to claim as a tax deduction, as employer contributions (and sometimes the taxpayer not reporting the income tax deduction at the correct label). The Tax Office stated that it uses information from the member's own tax return to take account of these deductions for the contributions caps and for the super co-contribution.

The Tax Office indicated that it is currently targeting exempt current pension income (ECPI) as it is often calculated incorrectly. The Tax Office also said a number of annual returns include incorrect responses to the regulatory questions. The Tax Office has begun a pilot exercise involving nearly 250 active SMSFs who have not lodged their annual returns.

TA 2010/2 — Circumvention of excess contributions tax

In Taxpayer Alert TA 2010/2, the Tax Office warns that it has looked at SMSF trust deeds that include clauses that seek to avoid excess contributions tax. The Taxpayer Alert describes an arrangement where a clause or clauses are inserted into an SMSF trust deed in an attempt to circumvent the imposition of the excess contributions tax. The clauses are purported to create separate trusts which are intended to exclude from the fund any contributions that cause, or caused, a member to exceed their concessional or non-concessional contributions caps. It is implied that this would prevent the member from being subject to excess contributions tax.

Under the arrangement, a clause is inserted into the SMSF trust deed to restrict the trustee from accepting all or part of a contribution if it would cause the member to exceed a contributions cap. If the trustee does accept the contribution, the trust deed directs the trustee to hold the contribution in a separate trust, even though the amount has been treated as a contribution and mixed with other assets of the super fund.

The Commissioner considers these amounts represent super contributions and the clauses are an attempt to avoid the excess contributions tax. In the Commissioner's view, the arrangements are ineffective and a fund member may still have to pay excess contributions tax on these amounts, even if the trustee repays the amount back to the member. The Commissioner also considers that the arrangements may contravene the *Superannuation Industry (Supervision) Act 1993* and its Regulations.

Developments since 1 July 2009

It is important to note the changes to the tax legislation which are effective for the 2008/09 income year and later income years. Some of the changes are discussed below.

Foreign income

From 1 July 2009, foreign employment income derived by Australian resident individuals will not be exempted from income tax, except in specified circumstances. Therefore, foreign employment income that is not exempt under s 23AG of ITAA 1936 may be subject to Australian income tax. In such cases, taxpayers will be eligible to claim a non-refundable foreign income tax offset (FITO) under Div 770 of ITAA 1997 for foreign income tax paid on that income.

Earnings derived by an Australian resident individual engaged in continuous foreign service for not less than 91 days will only be eligible for exemption if the foreign service is directly attributable to any of the following:

- the delivery of Australia's overseas aid program by the individual's employer;
- the activities of the individual's employer in operating a developing country relief fund or a public disaster relief fund;
- the activities of the individual's employer being a prescribed institution that is exempt from Australian income tax;
- the individual's deployment outside Australia by an Australian government (or an authority thereof) as a member of a disciplined force; or
- an activity of a kind specified in the regulations.

The foreign earnings of individuals engaged in foreign service that are directly attributable to one of the activities referred to in s 23AG (1AA) will not be exempt if one of the conditions for non-exemption contained in s 23AG (2) applies. Section 23AG (2) applies, to deny an exemption, if the foreign earnings are exempt from tax in the foreign country only because of one or more of the following reasons:

- a double tax agreement (DTA) with Australia or a law giving effect to a DTA;
- the foreign country does not impose income tax on employment or personal services income, or similar income; or
- a law of the foreign country or an international agreement to which Australia is a party, which deals with diplomatic or consular privileges and immunities, or privileges and immunities for people connected with international organisations (such as the United Nations).

Trust cloning exceptions

The *Tax Laws Amendment (2009 Measures No 6) Act 2010* repealed the trust cloning exceptions to CGT events E1 and E2. The Act also inserts new Subdiv 126-G into ITAA 1997 that provides an optional CGT roll-over for the transfer of assets between 'fixed' trusts. The effect of the roll-over is to defer the making of any capital gain or loss in respect of the asset transfer. It also results in adjustments to the cost base of interests held by beneficiaries.

The Act also clarifies that a mere change of the trustee of a trust does not change the 'entity' that is the trustee. That is, the trustee will be the same entity even if there is a change in the person who holds the office of trustee.

The amendments apply to CGT events happening on or after 1 November 2008.

Employee share schemes

Significant changes to the taxation of benefits under employee share schemes (ESS) have been enacted. The rules have been rewritten in Div 83A of ITAA 1997 and have replaced the former rules in Div 13A of Pt III of ITAA 1936 (ss 139 to 139GH).

Key changes include:

- employees who are taxed upfront on the discount received on their ESS interests may be entitled to a maximum concession of $1,000 if their adjusted income does not exceed $180,000, subject to satisfying various conditions. Adjusted income is the sum of the taxpayer's taxable income, reportable fringe benefits total, reportable superannuation contributions and total net investment loss for the income year; and
- if certain conditions are met, the taxation of ESS interests can be deferred. Where taxation is deferred, an amount is to be included in the taxpayer's assessable income for the income year in which the ESS deferred taxing point occurs. The deferred taxing point will depend on whether an ESS interest is a beneficial interest in a share or a beneficial interest in a right to acquire a share. The timing of a deferred taxing point requires an employee to consider whether there is a real risk of forfeiture or loss of the share or right.

The new rules generally apply to ESS interests acquired on or after 1 July 2009 and also to ESS interests acquired before that date, where the taxing point has been deferred beyond 30 June 2009. ESS interests that have not been brought within the new ESS rules will continue to be governed by the relevant provision in ITAA 1936.