



Explanatory Memorandum

September 2009

Loans and In-house Asset Rules

In a recent decision, the AAT upheld a non-compliance notice issued to a self-managed superannuation fund (SMSF) under s 40 of the *Superannuation Industry (Supervision) Act 1993* (SIS Act) for breaching the in-house asset rules contained in Pt 8 of the SIS Act: *Re JNVQ and FCT [2009] AATA 522*.

Background

In 2004/05, the trustees of the SMSF made loans to a company that was experiencing financial difficulties. The company was a 'related party' of the SMSF (as defined by Subdiv B in Pt 8). The loans exceeded 95% of the SMSF's total assets and, therefore, breached the in-house asset rules.

In July 2007, the fund's auditor lodged a contravention report with the Tax Office, advising the fund had contravened the in-house asset rules. The Commissioner issued a non-compliance notice under s 40 of the SIS Act in July 2008 after rejecting the SMSF's offers of enforceable undertakings. The Commissioner considered that the trustees' proposed timeframes for repaying the loans were set too far into the future.

The trustees sought a review of the Commissioner's decision not to exercise his discretion under s 42A(5) of the SIS Act to treat the fund as a complying fund despite the contravention of the in-house asset rules. The trustees submitted that the particular circumstances surrounding the loan, combined with the declining fortunes of their related business at the time, as well as other personal factors, were such to warrant a favourable exercise of the discretion. In this respect, the trustees argued that the Commissioner gave too much weight to 'the seriousness of the contravention' without having due regard to their particular circumstances.

Decision

In upholding the Commissioner's decision to issue the notice of non-compliance, the Tribunal held that the seriousness of the contravention, and the length of time taken to redress it, weighed heavily against exercising the discretion under s 42A(5) to treat the fund as complying despite the contravention.

The Tribunal rejected the trustees' contention that the Commissioner had given too much weight to 'the seriousness of the contravention' without having due regard to the other relevant considerations required under s 42A(5). While the Tribunal acknowledged the husband's health issues, the impact of cyclones in North Queensland in 2004/05 and outstanding tax debts in other parts of the family businesses, it said those factors were only relevant considerations up to a certain point, and not throughout.

The Tribunal also said that 'all relevant circumstances' were not simply those that work in favour of the applicant. It noted that the balance of the loan remained outstanding for more than four years after the initial breach, while the trustees had funded other commercial property developments in other parts of their business.

Furthermore, the Tribunal said the trustees had the assistance of professional advisers who had suggested putting the company into administration. However, it found the trustees instead chose to use the SMSF as 'a line of credit to prop the company up, in an attempt to trade through its difficulties'.

In addition, the Tribunal considered the applicant's offer of enforceable undertakings came much too late in the day.

In-house asset rules and loans

A regulated superannuation fund (which includes a complying SMSF) is, generally, restricted from having more than 5% of the total market value of its assets at the end of an income year invested in in-house assets. An 'in-house asset' is defined in s 71 of the SIS Act (unless an exception applies) to include:

- a loan to, or investment in, a 'related party' of the fund;
- an investment in a 'related trust' of the fund; and
- an asset of the fund subject to a lease or lease arrangement with a 'related party' of the fund.

A 'related party' of a superannuation fund is defined very broadly in s 10 of the SIS Act and includes a member of the fund, and a 'Part 8 associate' of a member. A 'Part 8 associate' is defined widely in ss 70B to 70E of the SIS Act to include a relative of a member, and entities that are majority owned or controlled by a member.

The in-house asset rules do not explicitly prohibit an SMSF from extending a loan to a related party. However, the fund cannot lend monies to a member (or a member's relative) because of s 65 of the SIS Act: see ***Loans to members and relatives***. If the fund wishes to loan monies to a related party such as a related company or trust, it is pertinent to ensure the sum of the loan and any other in-house assets at the end of a financial year does not exceed the prescribed limit of 5%. In addition, the SMSF must also ensure other provisions of the SIS Act are not breached.

One of the other provisions of the SIS Act that must not be breached is s 109. This section requires all investments of a superannuation fund to be made and maintained on an arm's length basis. Therefore, an SMSF should ensure a loan to a related party is documented by way of a formal loan agreement. Furthermore, the terms and conditions of the loan should reflect normal commercial practices, including the period of the loan, repayments schedules and interest rate.

Under s 52(2) of the SIS Act, trustees of an SMSF are required to formulate and give effect to an investment strategy that has regard to the whole of the circumstances of the fund. As such, the SMSF must ensure that its investment strategy permits the lending of monies to a related party. In addition, the fund must be able to demonstrate how the provision of a loan to a related party aligns with its investment strategy.

It is also important the trustees of an SMSF are able to show how a loan to a related party satisfies the 'sole purpose test' contained in s 62 of the SIS Act. The sole purpose test requires each trustee of a regulated superannuation fund to ensure the fund is maintained solely for at least one of the legislated 'core purposes', which can be in conjunction with any approved 'ancillary purposes'. The core purposes include:

- the provision of benefits for each fund member on or after the member's retirement;
- the provision of benefits for each fund member on or after the member's attainment of an age not less than 65 years; and
- the provision of benefits to the legal personal representative and/or the dependants of a fund member on or after the death of the member, provided the death of the member occurred before he/she retired or attained age 65.

Loans to members and relatives

A distinction must be made between a loan to a member (or a member's relative) and a loan to a related company/trust.

Section 65(1) of the SIS Act imposes a prohibition on trustees of a regulated superannuation fund from either lending money or giving any financial assistance using the resources of the fund to:

- a member of the fund; or
- a relative of a member of the fund.

It is of paramount importance to note that this prohibition applies even where the in-house asset rules are not breached: see s 65(7) of the SIS Act. A contravention of s 65 occurs even if a loan to a member (or the member's relative) does not exceed 5% of the total market value of the fund's assets at the end of an income year.

A 'relative' of a member is defined in s 10 of the SIS Act to include:

- a parent, grandparent, brother, sister, uncle, aunt, nephew, niece, lineal descendant or adopted child of the member or the member's spouse; and
- a spouse of the member or any other individual referred to in the above point.

(Note that for the purposes of s 65, the definition of 'relative' contained in s 10 applies to a loan or financial assistance provided on or after 4 December 2008. Prior to this date, the definition of 'relative' was found in s 65(6), which has since been repealed.)

The term 'loan' is also defined in s 10 and includes the provision of credit or any other form of financial accommodation, whether or not enforceable, or intended to be enforceable, by legal proceedings. In Self Managed Superannuation Fund Ruling SMSFR 2009/4, the Commissioner states that this definition is inclusive and expands the traditional meaning of a 'loan', which involves a payment and repayment of an amount of money. The Commissioner also states that the definition includes arrangements that are in substance financing arrangements deferring the payment of an amount. Examples of these arrangements are:

- the lending of money;
- the sale of goods or land on credit;
- instalment payment arrangements; and
- arrangements for the deferral of payment of debts or entitlements (including unpaid trust entitlements in some circumstances).

However, the Commissioner acknowledges that not every arrangement where a payment is deferred may constitute a loan under the extended meaning in s 10. The Commissioner concedes the payment of goods on normal commercial terms will not amount to a loan. Late payments which were not agreed to by the trustees of an SMSF will also not amount to a loan, says the Commissioner.

Tax Office Practice Statements

Issuing of non-compliance notice

In ATO Practice Statement Law Administration PS LA 2006/19, the Tax Office outlines the factors the Commissioner will consider in deciding whether a notice of non-compliance should be given to an SMSF under s 40(1) of the SIS Act.

The Practice Statement states that the Commissioner will consider the following factors prior to issuing a non-compliance notice to an SMSF for an income year:

- the taxation consequences that would arise if the fund was to be treated as a non-complying fund;
- the seriousness of the contravention (eg trustee behaviour, effect on fund assets, exposure to risk, number and duration of contraventions); and
- all other relevant circumstances (eg whether the trustee has rectified the contravention, trustee's level of skill and knowledge, fund's compliance history and events which led to the contravention — such as serious illness, death of a trustee/relative or natural disaster).

The Practice Statement also states that each decision will be made on a case-by-case basis, taking into account the individual circumstances of the relevant case. Furthermore, it states that no one factor by itself will be conclusive and the weight given to each factor will vary depending on the circumstances of the case.

The Commissioner says that a notice of non-compliance will generally not be given to an SMSF if he has accepted an undertaking (including an informal arrangement) by the trustees of the fund to rectify a contravention and/or to wind up the fund — provided the trustees are genuinely attempting to satisfy the terms of the undertaking.

The Commissioner says in most circumstances a notice of non-compliance will not be given to an SMSF if he is satisfied the fund has been wound up prior to any Tax Office compliance action **and** any money in the SMSF has been rolled over to another fund, which is independently managed. In the Commissioner's view, a notice in this situation would not be appropriate because any money in the SMSF has effectively been placed in a position where it will no longer be at risk from further contraventions by the trustees. However if the Commissioner finds, after the trustees have wound-up the SMSF, that actions of the trustees preceding the

wind up justify giving the SMSF a notice of non-compliance, he is not precluded from doing so on the basis that the SMSF has been wound up.

Undertakings to correct contraventions

In ATO Practice Statement Law Administration PS LA 2006/18, the Tax Office outlines the factors the Commissioner will consider in deciding whether to accept a written undertaking proposed by the trustees of an SMSF to address contraventions of the SIS Act.

The Commissioner says that an undertaking by the trustees of an SMSF to rectify a contravention will not be accepted if information available to him indicates the trustees will not or cannot comply with the undertaking.

The Practice Statement states that an undertaking must contain, as a minimum, the following essential terms:

- ***Actions to be taken to rectify the contravention*** — The undertaking should specify the manner in which the contravention will be rectified and should set out what actions the trustee will take to achieve this. For example, a loan to a relative of a member will be fully repaid to the fund with appropriate commercial interest.
- ***Timeframe in which the contravention is to be rectified*** — Rectification should be completed by the trustee within a reasonable period of time. What constitutes a reasonable period will depend on the circumstances of the case. For example, it would be reasonable to give a longer period of time to dispose of an asset such as residential property than shares in a publicly listed company.
- ***Progress report for the undertaking*** — The trustee needs to report their progress in fulfilling their commitment under the undertaking. The undertaking should specify how and when the trustee will report their progress to the Commissioner.
- ***Strategies to be implemented to prevent the contravention from occurring again*** — The trustee should provide details to the Commissioner of strategies that will be implemented to prevent the contravention from occurring again. These could involve changes in accounting and management practices.
- ***A commitment to cease the behaviour which resulted in the contravention***

(The Practice Statement contains a template to assist trustees in the construction of an undertaking.)

Personal Services Income

The AAT has affirmed that the Personal Services Income (PSI) provisions contained in Div 86 of ITAA 1997 applied to attribute the income of a company to a taxpayer who was the sole director, shareholder and employee of a company: *Re Horner and FCT [2009] AATA 537*.

Background

The company provided 'enterprise architecture', web design and other technical services. For the relevant years, the company derived all of its income as a result of the services provided by the taxpayer. In both of the relevant years, a dividend of the company's profits was paid to the taxpayer, which was reported as income in his tax returns.

Following an audit, the company made a voluntary disclosure. It provided updated revenue statements and accepted that its income would be attributed to the taxpayer under the PSI provisions. However, it did not submit a Personal Services Business (PSB) Determination application, which would exclude it from the operation of Div 86 of ITAA 1997.

Consequently, the Tax Office issued amended assessments to the taxpayer. The assessments removed the dividends income and attributed income of the company to the taxpayer. In addition, penalties were imposed on the taxpayer.

The taxpayer asserted that the salient issue to be decided by the Tribunal was whether the non-attribution of the company's income to him had resulted in a reduction in the revenue base. He contended that s 86-10

of ITAA 1997 'imposed a 'threshold test' (to determine whether the object of Div 86 is met) and that he is not caught by that threshold (because the object of Div 86 cannot be met)'. Simply put, the taxpayer submitted that Div 86 had no application because its objective was not met.

Alternatively, the taxpayer contended that even if there had been alienation of income, there had been no such reduction because his franking (and other) credit entitlements should not have been taken into account as they merely removed double taxation.

Decision

In affirming the amended assessment, the Tribunal first found that the income derived by the company arose through the taxpayer's skills and personal effort. It then found that the company was not a 'personal service business' (and had not sought a Determination to be classified as such). In particular, it found that the company was not a personal services business in the year in question in terms of 'the results test', 'the unrelated clients test', 'the employment tests' and the 'business premises test' (even though it passed the 'unrelated clients' test in the prior income year).

In relation to the taxpayer's argument about the threshold test, the Tribunal found there was no such threshold test and that s 86-10 had no operative role (or at least not the one contended for by the taxpayer). Instead, the Tribunal stated that once it had been determined the taxpayer was providing personal services, then the operative provisions applied and, subject to any offset claimable under s 86-20 (deductions for personal services entity), the amount was alienated to the taxpayer's individual income.

The Tribunal also confirmed that s 86-35(1) applied to remove from the taxpayer's assessable income the dividend of \$22,000 paid to him from the company and that an adjustment for the omission of the Medicare levy surcharge from his 2005 assessment should be made. Finally, the Tribunal found that no adjustments should be made for the payment of the superannuation guarantee levy by the company as there was no evidence that such payments had been made on behalf of the taxpayer.

The PSI regime

The PSI rules contained in Divs 84 to 87 of ITAA 1997 limit deductions available to individuals in receipt of PSI if they are not able to satisfy the required personal services business tests. The rules also attribute income derived by an interposed entity, after allowing for a limited range of deductions, to an individual providing services to the interposed entity. However, the rules do not apply to individuals or interposed entities carrying on a PSB.

The Commissioner's established views on the attribution of PSI are contained in Taxation Ruling TR 2003/6. In the ruling, the Commissioner explains:

- how the attribution of PSI rules apply to a personal services entity that is not conducting a PSB;
- how amounts distributed from a personal services entity not conducting a PSB are not taxed twice;
- how the attribution of PSI rules will not apply to interposed entity arrangement when the income derived by the head entity (ie the entity contracting with the services acquirer) is earned in the course of conducting a PSB; and
- when an entity's income that is derived from a dealing or transaction with a personal services entity, other than by way of distribution, will be PSI and, therefore, potentially subject to the PSI rules.

Meaning of Superannuation Contributions

The Tax Office has released Draft Taxation Ruling TR 2009/D3, in which it explains the Commissioner's preliminary view as to the ordinary meaning of the word 'contribution', how a contribution can be made and when a contribution is made. The draft ruling also explains some aspects of the provisions contained in Div 290 of ITAA 1997 that apply when a superannuation contribution for an employee or a personal contribution is deducted.

Ordinary meaning of contribution

The draft ruling states that whether an amount is a superannuation contribution is determined by reference to the character of the amount in the hands of a receiving superannuation provider. An amount will be considered a superannuation contribution if it increases the capital of a superannuation fund. In the Commissioner's view, an amount will not be a contribution if it is derived or received as:

- income;
- profit or gain from an investment; or
- proceeds from the realisation of an investment.

The term 'superannuation provider' (in relation to a superannuation plan) is defined in s 995-1 of ITAA 1997 to mean:

- the trustee of a superannuation fund;
- the trustee of an approved deposit fund (ADF); or
- the provider of a retirement savings account (RSA).

How a superannuation contribution can be made

According to the draft ruling, a superannuation contribution can be made in money, money equivalent or *in-specie* contribution. Increasing the value of an existing asset of the fund will also be considered a contribution. The increase in value can occur by making an improvement to the asset or by shifting the value of interests in the asset held by both a person and the fund to the interest held by the fund.

A contribution of money, or money equivalent, includes a contribution of cash (Australian or foreign), a money order, an electronic transfer of funds, a bank cheque, a personal cheque or similar negotiable instrument. However, no contribution will be made if payment of the cheque, promissory note or similar negotiable instrument is not honoured. An investment-related promissory note will be taken to be the contribution of an asset (not money).

In-specie contributions

The meaning of 'contribution' is wider than just a direct payment of money. Subject to the restrictions in the *Superannuation Industry (Supervision) Act 1993* (SIS Act) on a superannuation fund acquiring assets from a related party, a transfer of an asset to a superannuation fund may be an *in-specie* contribution. The amount of an *in-specie* contribution is the market value of the asset at the time the contribution is received by the superannuation fund.

Other forms of contribution

According to the draft ruling, further examples of the form a contribution may take include:

- meeting or reducing an existing liability of a fund;
- paying expenses to a third party to satisfy a liability on behalf of the fund;
- increasing the value of an existing asset of the fund (provided that this increase in value does not reflect a return on an investment made by the fund);
- making of a distribution from another entity (provided that this distribution does not reflect an arm's length return on an investment made by the fund);
- rendering services to the fund (to the extent that those services are not remunerated at fair market value);
- forgiving a loan entered into by the superannuation fund (where permitted); and
- transferring a person's benefits from an overseas superannuation fund to an Australian superannuation provider.

In circumstances where a person contributes an asset to a superannuation fund but receives consideration less than the market value of the asset, the Tax Office says the transfer of the asset is both a contribution by the person and the purchase of an asset by the superannuation fund (which could potentially breach the SIS Act).

Timing of a contribution

The draft ruling states that a contribution is 'made' when it is 'received' by the superannuation fund or RSA.

The timing of when a superannuation contribution is made is relevant for superannuation guarantee purposes and determining the relevant income year for deducting a contribution and including it in the assessable income of a receiving superannuation fund. Increasingly, what constitutes a contribution and its timing is relevant for determining any excess contributions tax liability for an individual.

Cheques and promissory notes

The Tax Office says a contribution by cheque or promissory note (other than an investment-related promissory note) is made when the cheque or promissory note is received by the trustee of the fund, unless it is subsequently dishonoured. If the cheque or promissory note is dishonoured, no contribution will have been made by an individual. A contribution by a cheque that is post-dated is made on the later of the day the cheque or note is received and the date on which payment can be demanded as shown on the cheque.

The Commissioner also expects a trustee to obtain payment on any cheque or promissory note as soon as possible having regard to reasonable commercial practices.

Contribution of property

The draft states that a contribution of property will be received by a superannuation fund when either legal or beneficial ownership of the property passes from the contributor to the superannuation fund. Where there is no formal registration process that evidences ownership, the Tax Office says ownership of property will pass when the provider acquires physical possession of the property.

However, the Commissioner accepts that a contribution of property is made when beneficial ownership of the property is obtained by the superannuation fund (which may be some time before the formal registration of the change of legal ownership occurs for shares in a publicly listed company or Torrens title land). In this respect, the Commissioner accepts that a superannuation fund acquires the beneficial ownership of real property when the fund obtains possession of the requisite transfer forms, provided that there is no legal impediment preventing the superannuation fund from affecting registration of legal ownership of the property.

Off-market share transfers

The Tax Office also recognises that beneficial ownership of shares or units in an Australian Stock Exchange (ASX) listed company or unit trust may also pass prior to legal ownership, particularly where a contributor transfers title to the shares off-market.

The Commissioner accepts that a superannuation fund may acquire beneficial ownership of shares or units in an ASX listed company or unit trust effected through an off-market share transfer, when the trustee obtains a properly completed off-market share transfer form.

However, the Commissioner warns that a contributor or superannuation fund who seeks to argue a contribution of property occurs when beneficial, not legal, ownership of property passes must retain sufficient evidence of the relevant transactions and events to accurately identify when the change of beneficial ownership occurs. The Tax Office says the evidence should show when everything that is required to be done to register the change of ownership occurs. Such evidence would include relevant minutes of any trustee meeting held to consider the acceptance of the *in-specie* contribution, the relevant transfer forms, and any other record of when the relevant transfer took place.

Electronic funds transfer

The Commissioner does not accept that a contribution made by electronic funds transfer (EFT) or via internet banking occurs as soon as the contributor has done everything necessary to effect a payment.

According to the Commissioner, it is not until an amount is credited to a bank account of a superannuation fund that a contribution is taken to be made.

The Commissioner says, in Draft Taxation Ruling TR 2009/D3:

A fund's bank statement will normally provide the best evidence as to when a contribution is received. However, in limited circumstances, the Commissioner will allow other evidence may be used to determine when a contribution is made. For example, a transfer of funds between the linked accounts of a member of an SMSF and the fund held at the same financial institution may result in a contemporaneous debit and credit to the respective accounts with the funds being immediately available for use of the SMSF. When such a transfer occurs on a weekend, it is common for bank statements to show the transaction occurring on the next business day. However, the Commissioner says evidence, such as a computer print-out recording the transaction, may be used to establish the timing of the contribution.

Deducting contributions

The draft ruling also sets out the Commissioner's views on aspects of the rules in Div 290 of ITAA 1997 regarding deducting contributions for an employee and for personal contributions.

Company directors

To deduct a contribution for an employee under Subdiv 290-B of ITAA 1997, the employee must (among other requirements) satisfy the employment activity condition in s 290-70. The Tax Office says a company director is an employee for the purposes of the superannuation guarantee law (and employment activity condition) if the director is entitled to a payment for the performance of duties as a member of the company's executive body. However, the draft ruling states that the company cannot deduct a superannuation contribution for a member of the executive body who is not entitled to payment for the performance of duties as a member of the company's executive body.

Deducting personal contributions

To deduct a personal superannuation contribution it is necessary to satisfy the conditions set out in Subdiv 290-B of ITAA 1997. The draft ruling sets out the Commissioner's views on the key provisions affecting:

- the maximum earnings as an employee condition (the 10% test) under s 290-160; and
- the notice of intent to deduct contributions under s 290-170.

Maximum earnings as an employee — 10% test

Where the person engages in any 'employment' activities (for superannuation guarantee purposes) in the income year, a deduction can only be claimed if the sum of assessable income and reportable fringe benefits attributable to the employment activities is less than 10% of the person's total assessable income and reportable fringe benefits in the income year that the contribution is made: s 290-160 of ITAA 1997.

(Note that since 1 July 2009 'reportable employer superannuation contributions' are included in the 10% test.)

The draft ruling states that all amounts that are attributable to an employment activity are taken into account as assessable income in the 10% test. These include:

- the salary or wages from the activity;
- other payments (such as commission, director's remuneration and contract payments) that are treated as salary or wages for superannuation guarantee purposes;
- an employment termination payment received by a person in consequence of the termination of their employment; and
- certain workers' compensation payments.

In the application of the maximum earnings test, the Tax Office says the relevant employment activity need not be an activity in Australia. Therefore, the Commissioner says that a non-resident with Australian sourced

income that is not attributable to employment activities may be able to deduct a personal superannuation contribution made to an Australian superannuation provider against their Australian sourced income.

Notice of intention to claim deduction

A person who intends to deduct personal superannuation contributions must give their superannuation fund a valid notice in the approved form before lodging their income tax return for the year (or within 12 months of the end of the income year if they have not lodged their return by that time). The trustee of the fund must also acknowledge receipt of the notice.

The Tax Office notes that the person may choose how much of their contributions to deduct and this notice is used to give effect to that choice. For example, the person may choose not to deduct a portion of their personal contributions to ensure they are entitled to the superannuation co-contribution.

Invalid notices

The draft ruling states that a notice is not valid in certain circumstances, including if the notice is given:

- when the person is no longer a member of the fund (eg the person's benefits have been paid to them or they have rolled over their benefits in full to another fund);
- when the trustee no longer holds the contribution; and
- when the trustee has commenced an income stream based in whole or part on the contribution.

In the Commissioner's view, any income stream commenced from a superannuation interest will be based in whole or in part on a contribution made to the account. This is regardless of whether the value of the superannuation income stream is less than the balance of the account as reduced by the relevant year's contributions.

Date of effect

Once it is finalised, the ruling will apply to income years both before and after its date of issue. However, the Commissioner's views on the rules for deducting contributions will only apply to the 2007/08 and later income years.

Deductibility of Interest on Loan to Settle Trust

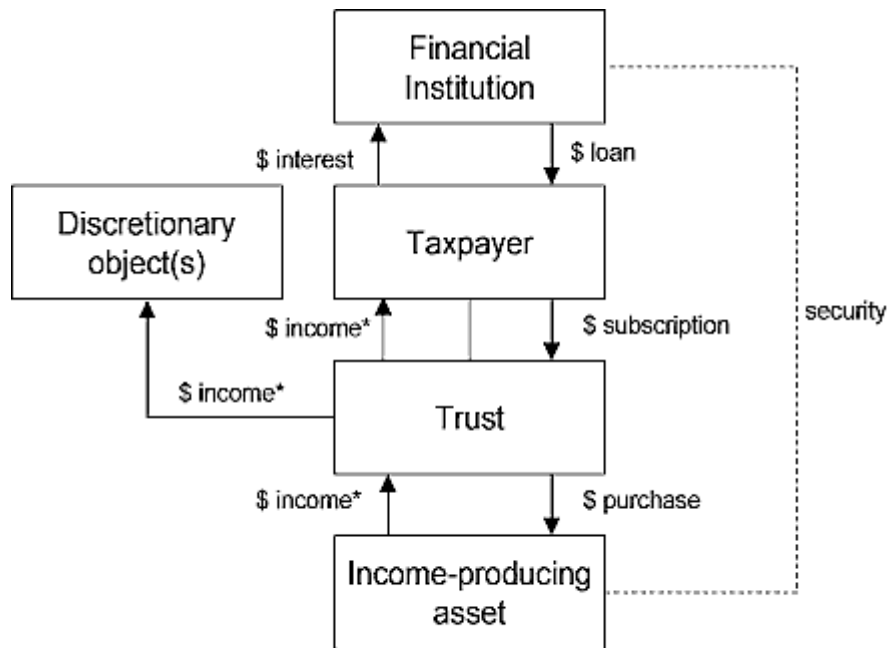
The Tax Office has released Taxation Determination TD 2009/17, in which the Commissioner sets out his views on the deductibility of interest incurred on a loan used to settle a trust to benefit the borrower and others.

According to the determination, interest incurred on a loan used to settle monies on trust to benefit a borrower and others cannot be deducted in full under s 8-1 of ITAA 1997. It states that the interest expense can only be deducted to the extent to which a taxpayer has used the borrowed monies to gain or produce assessable income of the taxpayer. It also states that the interest will not be deductible to the extent that the borrowed monies have been used for the purpose of benefiting persons other than the taxpayer.

The determination states that whether a taxpayer has used the borrowed monies to benefit others will require an objective examination of the terms of the trust. Determining whether the taxpayer has used the borrowed monies for gaining or producing assessable income will also require an objective examination of the terms of the trust. Where the terms of the trust indicate the borrowed monies have been used to benefit both the taxpayer and others, the taxpayer will be required to apportion the interest deduction.

In the Commissioner's view, interest incurred on a loan to settle a trust is not deductible to any extent if the terms of the trust do not indicate a nexus between the interest expense and a taxpayer's assessable income, or where s 51AAA of ITAA 1936 applies. The Commissioner says no perceived connection will be found merely because it is possible that a trustee, in the independent exercise of fiduciary power, might distribute income to the taxpayer in a future income year. This is because the income arises by reason of the exercise of the trustee's discretion, and, therefore lacks a sufficient relationship to the interest expense.

The arrangements addressed by the determination include uncommercial trust arrangements described in Taxpayer Alert TA 2008/3, which are summarised diagrammatically at the top of page 10.



* 'Income' may include capital gains

Source: Taxpayer Alert TA 2008/3

Examples

The following example from the determination explains the Commissioner's view.

Paul arranges for his accountant to set up a trust for himself and his family. Paul and his wife control the corporate trustee.

Paul borrows \$1 million from a bank, in his own name, and settles it on the trust. The trustee issues 1 million units to Paul. Paul's wife and children are also beneficiaries of the trust. The trustee uses the \$1 million to purchase a rental property.

The trust deed provides the trustee with a discretion to appoint the income of the trust to Paul, his wife, or his children. Absent such an appointment, no beneficiary is presently entitled to income. Unit holders are, however, entitled to share in amounts which are attributable to realised capital gains of the trust, in proportion to their unit holdings.

The units Paul acquires are redeemable at the trustee's discretion. The units are redeemable for an amount equal to the sum Paul settled on the trust. Any remaining trust capital is held for the benefit of the other beneficiaries.

Paul's interest expense is not deductible at all. The terms of the trust indicate that Paul has used the borrowed money in part to create a fund for the benefit of his family. The interest will not be deductible to that extent. Nor can a connection be perceived between the incurring of the interest and the production of Paul's assessable income (other than net capital gains: see s 51AAA of ITAA 1936). Such a connection cannot be found merely because it is possible that the trustee might make a gift of income to Paul in a future income year.

Date of effect

The determination applies to income years commencing both before and after its date of issue.

Disallowing deductions under s 51AAA

Under s 51AAA of ITAA 1936, a taxpayer is denied a deduction if:

- the assessable income of the taxpayer for an income year includes a net capital gain by virtue of s 102-5 of ITAA 1997 or s 124ZZB(1) of ITAA 1936; and
- the amount had not been included in the assessable income.

The deduction would, but for the operation of s 51AAA, be allowable to the taxpayer under a provision listed below:

- Subdiv A of Div 3 of Pt III of ITAA 1936;
- s 8-1 of ITAA 1997;
- Div 25 of ITAA 1997;
- Div 30 of ITAA 1997;
- Div 34 of ITAA 1997;
- Div 36 of ITAA 1997;
- Subdiv 40-F of ITAA 1997;
- Subdiv 40-G of ITAA 1997;
- Div 165 of ITAA 1997; and
- Subdiv 170-A of ITAA 1997.

Deductibility of interest

Interest incurred by a taxpayer is deductible if it satisfies the positive limbs of s 8-1 of the ITAA 1997. That is, a nexus must exist between the outgoing and the assessable income: *Ronpibon Tin NL v FCT* (1949) 78 CLR 47; (1949) 8 ATD 431. In addition, it is imperative to consider the 'character of the advantage' which is sought to be gained by incurring the expenditure: *Sun Newspaper Ltd v FCT* (1938) 61 CLR 337. Furthermore, in determining the deductibility of interest, an examination of the taxpayer's intention and usage of the borrowings is crucial.

Generally, the deductibility of interest incurred is determined by considering the precedents established by the courts and the facts of a particular situation. This is because s 8-1 does not provide any guidance to assist a taxpayer in determining the deductibility. A useful reference is Taxation Ruling TR 95/25 which provides the Tax Office's views on the various factors that were derived from legal principles established by the courts. Although an understanding of the rationale of a precedent is important, it is equally important to realise that where the economic substance of a transaction is inconsistent with its form, the incidents of taxation will follow the economic substance rather than the legal substance: *FCT v Sth Aust Battery Makers Pty Ltd* (1978) 8 ATR 879 and *Cliffs International Inc. v FCT* (1979) 9 ATR 507.

An important proposition derived from cases such as *Steele v DCT* (1999) 41 ATR 139, *FCT v Energy Resources of Australia Limited* (1996) 185 CLR 66; (1996) 33 ATR 52 and *Fletcher v FCT* (1991) 22 ATR 613 is that the deductibility of interest requires an examination of the purpose of borrowing and usage of the borrowed funds. Hill J in *FCT v Smith* (1992) 23 ATR 494 acknowledged that 'a rigid tracing of funds will not always be necessary or appropriate'. Further, in Taxation Ruling TR 2004/4, which deals with deductions for interest incurred either prior to the commencement or following the cessation of a relevant income earning activity, the Tax Office states that outgoings of interest are of a recurrent nature.

While it is commonplace knowledge that an expense may be denied deductibility if an expenditure was incurred prior to the income earning activity, a deduction was allowed in Steele's case even though the interest was incurred prior to generating assessable income. Further, a deduction for interest on a loan may be deductible despite not generating any assessable income: *Re Ormiston and FCT* (2005) 60 ATR 1277. The common element that existed in Steele's and Ormiston's cases was the intention of the taxpayers. However, a deduction may still be denied if the period between the incurring of the expenditure and the deriving of assessable income is not reasonable (depending on the facts of the specific circumstances).

Interest Expense on Loan to Acquire Options

In ATO Interpretative Decision ATO ID 2009/71, the Tax Office states that interest incurred by a taxpayer on a loan used to purchase options to acquire shares is not deductible under s 8-1 of ITAA 1997. This is because the interest was not incurred in gaining or producing assessable income.

Context of ATO ID

The ATO ID concerns a taxpayer who entered into a loan arrangement to purchase options to acquire shares under an employee share scheme.

The taxpayer is not carrying a share trading business and holds the options on capital account. In addition, no entitlement to actual dividends or a dividend equivalent arises from the taxpayer holding the options.

Reasons for decision

In the Commissioner's view, whether an interest expense has been incurred in gaining or producing assessable income generally depends on the use to which the borrowed funds have been put. The 'use' test is the basic test for the deductibility of interest and looks at the purpose of the borrowed funds as the main criterion, says the Commissioner.

The Commissioner acknowledges that interest on a loan to acquire shares will be deductible where it is expected that assessable income will be derived from the shares. However, he notes that the options acquired by the taxpayer have no entitlement to dividends. So, while the taxpayer may (in the future) exercise the options and acquire shares from which dividend income may be received, the taxpayer will not otherwise derive assessable income from holding the options.

The Commissioner also acknowledges that there is a possibility the taxpayer may include in their assessable income a net capital gain under s 102-5 of ITAA 1997 arising from the disposal of the options. However, he notes that s 51AAA of ITAA 1936 will operate to deny the interest deduction by reason of the inclusion in assessable income of the capital gain on disposal of the options.

The Commissioner considers the interest expenses to be incurred too early in time. Furthermore, he considers the interest expense lacks the necessary connection to an income producing purpose.

(See also *Deductibility of Interest on Loan to Settle Trust* on page 9.)

Investment Commitment Time

In ATO Interpretative Decision ATO ID 2009/69, the Tax Office states that an option in a contract allowing a taxpayer to defer the construction start time for a depreciating asset does not alter the investment commitment time for the purposes of the small business and general business tax break.

Context of ATO ID

The ATO ID concerns a taxpayer who entered into a contract in August 2008 to acquire a new depreciating asset. Pursuant to the terms of the contract, the taxpayer had the option to delay the time at which the manufacturer started to construct the asset. Upon completion of the construction, the taxpayer started to hold the depreciating asset as the legal owner under item 10 in s 40-40 of ITAA 1997.

Reasons for decision

In the Tax Office's view, the option under the contract was not an option to enter into a contract to become the holder of the depreciating asset at a later point in time. Rather, the exercise of the option would merely delay the time at which the construction of the asset would commence.

The taxpayer's option under the purchase contract to delay the time at which construction of the depreciating asset would commence is not an option to which s 41-25(4) of ITAA 1997 applies. Therefore, the investment commitment time is when the taxpayer entered into the purchase contract in August 2008.

Investment commitment time

One of the requirements for the small business and general business tax break is that the investment commitment time for an eligible asset occurs on or after 13 December 2008.

The 'investment commitment time' for an asset is defined in s 41-25. If an amount is included in an asset's first element of cost (worked out at the time the taxpayer begins to hold the asset), the investment will be made at the point at which the taxpayer:

- enters into a contract to start or hold the asset; or
- starts to construct the asset; or
- starts to hold the asset in some other way.

If an amount is included in an asset's second element of cost (because the amount relates to an economic benefit that contributes to bringing the asset to its new condition and/or location), the investment time will be the point in time when the taxpayer enters into a contract for that economic benefit or commences construction of that economic benefit.

Where a taxpayer enters into a contract prior to 13 December 2008 that 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. This is because s 41-25(4) states that for the purposes of s 41-25, the taxpayer does not enter into a contract under which it holds an asset merely because it acquires an option to enter into such a contract. That is, the investment commitment time is deemed to have occurred when an option is exercised rather than on the date of an original contract.

Assistance for Small Businesses

The Tax Office has recently introduced two measures to assist small businesses in managing their tax payment obligations in the current economic climate. These measures are:

- twelve-month GIC-free payment arrangements; and
- deferral of activity statement payment due dates.

These measures are available to businesses with an annual turnover of less than \$2 million (ie small business entities), subject to satisfying any other eligibility requirements.

Twelve-month GIC-free payment arrangements

Under this measure, a business with an activity statement debt can apply for a GIC-free payment arrangement. The GIC will be remitted for a maximum period of 12 months, provided the payment arrangement is maintained. In addition, there is no limit on the amount of debt under arrangement.

Activity statement debts such as GST and PAYG are eligible for a GIC-free payment arrangement. However, superannuation guarantee charge (SGC) debts are excluded because the GIC component in a SGC debt forms part of employees' entitlements. The GIC-free period commences on the day on which the arrangement is entered into and finishes on the day the final instalment is due. If a business defaults on the arrangement, the GIC-free period ends on the date of default.

A business will be eligible for a payment arrangement if the following conditions are satisfied:

- the business has an annual turnover of less than \$2 million;
- the business has an activity statement debt; and
- the business has negotiated a mutually acceptable and sustainable payment arrangement with the Tax Office that is entered into between 1 June 2009 and 30 June 2010 (inclusive).

Where a business has entered into a payment arrangement prior to 1 June 2009 and renegotiates a new arrangement after that date, the new arrangement will be treated as a GIC-free payment arrangement, subject to the eligibility criteria (as listed above) being satisfied.

Deferral for activity statements payment due dates

A business can also request a deferral of payment on its next activity statement. During the period of the deferral, no GIC will apply.

The maximum deferral period that may be granted will depend on the frequency a business lodges its activity statements. The table below sets out the maximum deferral period:

Lodgment frequency	Maximum deferral period
Monthly	One month
Quarterly	Two months
Annually	Two months

The deferral period commences from the original due date of the relevant statement. A separate request must be submitted for each activity statement for which a deferral is being sought.

The lodgment due date for an activity statement is not affected by a payment deferral. That is, the statement must be lodged on time. However, a business can request a lodgment deferral. Note that activity statements that are lodged late may be subject to failure to lodge penalties.

To be eligible for a deferral of payment, a business must:

- have an annual turnover of less than \$2 million;
- have an activity statement that is required to be lodged but is not yet lodged; and
- makes the payment deferral request on or before the original due date of the statement.

Activity statements eligible for a deferral include:

- monthly statements for the period May 2009 to June 2010 (inclusive);
- quarterly statements for the period June 2009 to June 2010 (inclusive); and
- annual statement for the 2008/09 income year.

However, activity statements or remittance advices that do not need to be lodged are not eligible for a deferral. These statements or advices can be identified by the red form type in the top left hand corner of a statement or a notice. In addition, income tax returns do not qualify for a deferral.

Frequently asked questions

The Tax Office has compiled a list of frequently asked questions concerning the operation of the two measures outlined above. Questions of interest include:

Q3: Can I get a GIC-free payment arrangement if my activity debt is with an external collection agency (ie Dun & Bradstreet, National Credit Management Limited, Recoveries Corporations Group Limited, Baycorp Collection Services Pty Ltd)?

Yes, you will need to negotiate this with the external collection agency.

Q4: I am already in a payment arrangement. Am I still eligible for a GIC-free arrangement?

Yes, subject to satisfying the eligibility requirements detailed above.

Taxpayers may renegotiate their payment arrangements at any time. Normally a payment arrangement would be renegotiated where a taxpayer's circumstances have changed.

GIC-free payment arrangements can not be back-dated. The GIC-free period commences from the date the new arrangement is entered into.

Q5: Am I eligible for a GIC-free payment arrangement if I have outstanding activity statement lodgments?

Yes, but you will need to make a firm commitment to lodge these activity statements as part of your payment arrangement agreement. The GIC-free payment arrangement will be for the existing debt only.

You will need to renegotiate the payment arrangement if you are not able to make full payment for the outstanding activity statements at the time they are lodged. Any new payment arrangement will be treated as a GIC-free payment arrangement subject to satisfying the criteria above, with the GIC-free period commencing from the date the new arrangement is entered into.

Q6: Can I get a GIC-free payment arrangement that is longer than 12 months?

You may negotiate a payment arrangement that is longer than 12 months, but only the first 12 months of this arrangement will be GIC-free, provided the payment arrangement is maintained.

Q7: What if my GIC-free payment arrangement defaults?

If the arrangement defaults, you can request another mutually acceptable and sustainable arrangement. If this proposal is accepted, the GIC-free offer will apply from the date the arrangement is renegotiated.

Refer to <www.ato.gov.au/corporate/content.asp?doc=/content/00196536.htm&page=3&H3> for the remaining questions and answers.

PAYG Withholding — Individuals Engaged in Foreign Service

The Taxation Administration Act 1953 — PAYG withholding — Individuals engaged in foreign service (the Instrument) was registered on the Federal Register of Legislative Instruments on 14 July 2009. The Instrument was necessary in view of the recent changes to s 23AG of ITAA 1936, which came into effect on 1 July 2009.

From 1 July 2009, employers of individuals who derive non-exempt foreign employment income will be required to withhold amounts from salaries, wages, allowances, bonuses and commissions paid to their foreign-based employees.

Employers will also need to consider their FBT obligations for benefits provided to their foreign-based employees. This is because, for FBT purposes, an individual is considered to be an employee if the individual receives salary and wages, which are, in turn, defined to include a payment where an amount is withheld under the PAYG withholding rules. Therefore, fringe benefits provided to employees whose foreign employment income is not exempt under s 23AG may be subject to FBT.

Scope of Instrument

The Instrument ensures the PAYG withholding from payments made to individuals employed in a foreign country closely approximate the Australian income tax that will be payable on the relevant foreign income. This is achieved by taking into consideration an amount of foreign tax that is required to be withheld and paid for the relevant payment period for an individual's foreign service. Simply put, employers are required to reduce the Australian dollar equivalent of the amount that would normally be withheld in Australia under the relevant PAYG withholding tax table by the Australian dollar equivalent of the amount of tax to be withheld and paid to the foreign country.

In the absence of the Instrument, tax withheld for individuals engaged in foreign services could be too high unless they choose to apply for a PAYG withholding variation that takes into consideration their entitlement to a foreign income tax offset.

Example

The Explanatory Statement accompanying the Instrument provides the following example:

Norman is an Australian resident that has been sent to work in Papua New Guinea for 4 months from July 2009. He is to be paid K3,850 weekly by his Australian employer. The tax system in Papua New

Guinea requires that K462 is withheld and paid for the individual's tax purposes (12% is the applicable rate to foreign contractors).

Norman has claimed the tax-free threshold with respect to his Australian employment but is not eligible for any tax offsets, nor does he have a Higher Education Loan Program or Student Financial Supplement Scheme debt. Norman is not entitled to leave loading.

Assume for the purposes of this example, the exchange rate that applies for converting Papua New Guinean Kina to Australian Dollars for the purposes of this example is 2.36.

1. Convert the earnings in K to AU\$:

$$K3,850 / 2.36 = \$1,631.36$$

2. Calculate the Australian amount to be withheld from amount calculated at 1 in accordance with the relevant Pay as you go withholding tax table (NAT 1004):

$$\text{Amount to be withheld from } \$1,631.99 = \$404$$

3. Reduce the amount calculated at 2. by the amount to be withheld and paid to the foreign country:

$$\text{Amount to be withheld and paid to foreign country} = K462$$

$$\text{Convert this amount to AU\$} = K462/2.36 = \$195.76$$

$$\text{Amount to be withheld} = \$404 - \$195.76 = \$208.24$$

$$\text{Rounded to the nearest dollar} = \$208$$

The amount to be withheld for Australian Pay as you go withholding purposes from the payment of K3,850 is AU\$208.

Date of effect

The Instrument applies from 15 July 2009.

Foreign currency conversion rules

The foreign currency conversion rules are contained in Subdivs 960-C and 960-D of ITAA 1997. In particular, the rules specifying the exchange rate to be used to convert a foreign amount into Australian dollars are contained in s 960-50(6) of ITAA 1997. In addition, reg 960-50.01 and Sch 2 to Income Tax Assessment Regulations 1997 (ITA Regs 1997) prescribe alternative translation methods that can be used in lieu of those methods contained in s 960-50(6). Generally, the rules apply to all taxpayers, except authorised deposit taking institutions (ADIs) and non-ADI financial institutions.

Section 960-50(6)

Employers

Item 10 in s 960-50(6) states that an amount subject to the PAYG withholding regime contained in Div 12 of Pt 2.5 of the *Taxation Administration Act 1953* (TAA) will be translated to Australian dollars at the exchange rate applicable at the time when the amount is required to be withheld under Div 12.

Employees

The foreign currency conversion rules contained in ITAA 1997 do not apply to foreign employment income. If an individual derives foreign employment income, the income is to be translated into Australian currency at a rate equal to the average of the exchange rate applicable from time to time during the whole or part year. In addition, any foreign tax paid on the foreign employment income must be translated into Australian currency at the rate applicable at the time the tax was paid.

The foreign currency conversion rules relating to foreign employment income are contained in former s 20(4) of ITAA 1936. The former section read as:

20(4)[Income from approved overseas projects or employment] *Where an amount is derived by a taxpayer during the whole or part of a year of income as described in section 23AF or 23AG –*

- (a) that amount of income shall be expressed in Australian currency at a rate equal to the average of the exchange rate applicable from time to time during the whole or part of that year; and*
- (b) any amount of foreign tax paid in respect of that foreign income shall be expressed in Australian currency at the rate applicable at the time when the tax is paid.*

It is important to note that s 20 continues to apply, albeit the section was repealed by the *New Business Tax System (Taxation of Financial Arrangements) Act (No 1) 2003* (the TOFA Act (No 1)). This is because a transitional provision in that Act continues the application of s 20 in relation to any transactions or events that are not caught by s 960-50 of ITAA 1997.

The transitional provision is contained in s 78 of Pt 2 to Sch 4 of the TOFA Act (No 1) and reads as follow:

- (1) Despite the repeals of sections 20 ... of the Income Tax Assessment Act 1936 ... those sections continue to apply, in relation to a transaction, event or thing:*
 - (a) that involves an amount in foreign currency; and*
 - (b) to which section 960-50 of the Income Tax Assessment Act 1997 does not apply;*
- as if those repeals had not happened.*

Alternative conversion methods

The ITA Regs 1997 prescribe alternative methods that may be used to convert a foreign amount into Australian dollars in any of the circumstances described in s 960-50(6) of ITAA 1997. These alternative methods include:

- **the daily rate method** — a taxpayer may use a daily exchange rate that is appropriate to the taxpayer's business or activities, provided the rate is obtained from an arm's length source (ie not from the taxpayer itself or an associate) unless the Commissioner permits otherwise; and
- **the average rate method** — a taxpayer may choose a period (of not more than 12 months) during which it will use an average exchange rate to translate its foreign currency transactions. The average exchange rates must relate to the period in which the transactions occur and, therefore, must be derived from exchange rates for the relevant period. Furthermore, the average rate used must also be a reasonable approximation of the relevant exchange rates that would otherwise be applicable if the taxpayer had used spot rates at the specific translation times prescribed in the foreign currency provisions. The rates must be obtained from an arm's length source (ie not from the taxpayer itself or an associate) unless the Commissioner permits otherwise.

The election to use either of the above methods does not need to be in writing.

The term 'associate' is defined in s 995-1 of ITAA 1997 which in turn directs a taxpayer to s 318 of ITAA 1936. For the purposes of s 318, an associate of an entity will depend on whether the entity is:

- a natural person (other than in the capacity of a trustee);
- a company;
- a trustee; or
- a partnership.

Claiming of foreign income tax offset

A taxpayer is entitled to claim a non-refundable foreign income tax offset (FITO) under Div 770 of ITAA 1997 in the year that an amount on which foreign income tax **has been** paid is included in the taxpayer's assessable income.

Differences between the Australian and foreign tax systems may result in a situation where the taxpayer pays foreign income tax in a different income year from that in which the foreign employment income is included in their assessable income for Australian income tax purposes. Where the taxpayer pays the foreign income tax after the year in which the relevant foreign employment income has been included in their tax return, they can claim a FITO by lodging an amended assessment for that year, subject to the amendment tax limits.

Tax Returns Not Necessary for New SMSFs

In the Tax Office Lodgment Program 2009/10, it was announced that newly registered self-managed superannuation funds (SMSFs) that have not legally been established and have not commenced operating in their first year of registration do not need to lodge a tax return for that first year.

To be eligible for this concession, an SMSF must:

- be registered in April, May or June of the first income year;
- not be operating by 30 June of the first income year; and
- not have received contributions or rollover amounts by 30 June of the first income year.

The Tax Office says that an SMSF will not be required to pay the supervisory levy of \$150 for the first year of the fund's registration because a tax return does not need to be lodged.

In absence of this concession, an income tax return for a new registrant (taxable and non-taxable) SMSF is, generally, due for lodgment by a tax agent on 28 February 2010.

The Tax Office advises that a tax agent can notify the Tax Office of 'return not necessary' for an SMSF by completing a Lodgment of income tax return/s not necessary form (NAT 0536-08) and faxing the form to 1300 550 256.

Currency:

This issue of Client Alert takes into account all developments up to and including 29 July 2009.