Taxation Law 2
BLAW30003

KEY POINTS

Is the Company a resident? Place of Incorporation, CMC, Controlling Shareholders, landholder?
Are there dividend issues? Debt v Equity, does not include return of capital, withholding tax for foreign resident
Are there deemed dividends? Private company, excessive Salary, Div 7A (payments, loans, forgiveness, distributable surplus)
Imputation System; required to have franking account, debit, credits, benchmark rule, deficit tax, franking a distribution?

Receiving a franked distribution? Corporate SH, individual, non-resident, trusts and partnership?
Receiving a franked distribution? Gross-up and offset, excess franking refundable?
Does company have a CFL this year or prior year? Applying FC losses, Continuity of Ownership and Same Business Test
Consolidation? Wholly owned subsidiaries – can be company controlling trusts or partnerships (worth mention for a mark)

Treaties? Chinese foreign resident or PE? Business profits, property, services, students
Is there a foreign resident? Withholding Tax (D, I, R, capital gains), CGT events on Taxable Australian Property
Accruals? Australian CFC, Attributable TP, active income test and tainted income
Accruals? Taxed at comparable rate? Canada, France, Germany, Japan, UK, USA then exempt

Transfer pricing: International agreement with related parties?
Thin Cap: Interest deductions

Timing of "derive" important? Cash v accruals (switching?), dividends, lay-by sales, delays b/c dispute, and unearned revenue
Timing of "derive" important? Constructive receipt (PAYG withholding)
Timing of deductions important? "incurred", leave provisions, bad debts, business ceased to operate
Is the expense over two income years? apportionment (prepaid)
Timing of deductions important? company dividends, earlier income year, reduction future expense, no income generating

Is there Trading stock? Definition (what purpose is it held for?), consumables, spare parts, hire, packaging, partly finished
Is there Trading stock? Acquisition, disposal, end of year adjustment *(concession for SBE diff of $5000)*
Is there a CGT event? We can disregard it if its classified as TS (mention)
Any special rules? Arms-length, outside ordinary course (e.g. gift), special rules (e.g. purpose of TS changes, held for personal)
When is it "on hand"? Lay-by sales, dispositive power, risk and control

What type of partnership? If TAX, it cannot also be common law partnership.
Is there partnership? net income or loss, share of net income/losses, *is there a variation of partners?*
Are there special rules? Salary, superannuation, interest, dividends and FC, treated as direct allocation
Are there special rules? Capital gains in individual partner returns, income retains character (FC), foreign resident partner?

Is there a trust? Fixed or discretionary, present entitlement (disability/foreign resident?), AI, deductions, loss requirements
Notes for trust? Income and net income, share is proportionate, rates for minors, losses trapped at trust level (lose FC)
Large holding in land? Landholder duty

Is there superannuation? Employer contributions, personal contributions, concessional caps, non-concessional contribution
Is there superannuation? NCC cap, extra marks dependent on salary, taxation of funds (15%) and capital gains disc 1/3rd
Benefits paid to members? Income stream or lump sum, taxed or untaxed, age of beneficiary, BDBN, death benefit recipient
Benefits paid to members? Accumulation or pension phase

Is there stamp duty? Property, transaction, value, related party or aggregation,
Is there stamp duty? Exemptions; PPR, transfer between spouse or transfer due to marriage breakdown
Is there landholder duty? $1m unencumbered value, significant interest, and purchasing/cancelling shares in landholder
Land Tax? Imposed 31st Dec, who is owner, taxable value (trust surcharge rates), PPR exemption
Payroll tax? Tax-free threshold, Victorian taxable wages, employee or independent contractor, relevant contract, grouping

Assessment? Full or partial self-assessed, deemed or default
Collection of tax: PAYG, garnishee notice, freezing order, DPO, GIC or SIC
Penalties: prescribed or administrative?
Objection/review/appeal: Grounds, timeframe, onus of proof?
Power of Access and Investigation: Requirement keep record, power to obtain info, LPP and administrative privilege

CGT INFORMATION

CGT Event 104-10

Capital Assets 108-5

- Excludes cars, < $500, trading stock

Capital Proceeds 116-20

- 50% if held for over 12 months (not for companies)

Cost Base 110-25

- 5 elements: cost, incidental costs, maintenance
- Reduced Cost Base: excludes maintenance and indexation

Net Capital Gain/Loss 102-5

- NCG = Capital Proceeds – Cost Base 102-5
- NCL = Capital Proceeds – Reduced Cost Base 102-15

COMPANIES

As per s 995-1 a "company" is;

- A body corporate; or any other unincorporated association or body of person. But does not include a partnership or a non-entity joint venture.

Companies are separate legal entities

Companies may be private or public

- **s 103A(2) ITAA36** - Public companies are listed on stock exchange
- **s 103A(1) ITAA36** - A private company is not a public company

Every company carrying on business or deriving property income in Australia must appoint a **public officer**: **s 252 ITAA36**

- *Public officer* must be a resident, a natural person aged at least 18 years

20/75 Rule:
Cannot be a public company if less than 21 persons hold at least 75% of the value of the share or voting power: **s 103A(3)**

→**s 103A(1) ITAA36** - A private company is not a public company

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Residency

S 6-5(2) ITAA97 - A resident of Australia for tax purposes will be taxed on income from all sources
S 6-5(3) ITAA97 - A foreign resident for tax purposes will be taxed on income from Australian sources only

Company will be a resident if it satisfies one of the three tests in s 6(1), outlined below.

1. Place of Incorporation Test

A company that is incorporated in Australia under CA2001 is automatically a tax resident in Australia, regardless of any other factors.

2. Central Management and Control Test (CMC)

Two limb test, requiring consideration of the facts and circumstances of the case.

1. The company must carry business in Australia; and
TR 2004/15: Commissioner draws a distinction between passive dealings & operational activities

- For Passive dealings (e.g. investment in assets); it is where the decisions are made.
  - This is often same location as CMC
- For Operational activities (e.g. trading, manufacturing); it is where the activities take place

2. Company's central management and control must be located in Australia
Question of fact determined by circumstances of case.

- The CMC is the location of the actual decision making rather than formal execution of the director's resolutions: **Malayan Shipping Co Ltd v FCT**
- Day-to-day control over the business operations of a company does not amount to CMC of the company: **Koitaki Para Rubber Estates v FCT (1940)**
- CMC in Australia where company Directors carried out the wishes of their Sydney based accountant without independent judgment (lack of independent judgment): **Bywater Investments Ltd v FCT (2015)**

Essentially two levels of control.
Where the day-to-day decision-making occurs and where the high level decision-making occurs.
The high-level decision-making may be just a rubber stamp and thus does not constitute high-level decision-making.

3. Controlling Shareholders Test

- Voting power is controlled by SH who are residents of Australia (more 50% of voting power at GM); and
  - SH is the person in the share registry, not beneficiary of the shares: **Patcorp Investments**
- Company is carrying on business in Australia (refer to 1st limb of CMC)

Taxation of Dividends

Assessable income of a resident shareholder of a company (whether company is a resident or not) includes:

- **S 44(a)** Dividends paid to the shareholder out of profits; and
- **S 44(b)** All non-share dividends paid to the SH by the co.

Withholding tax consequences
S 44 does not apply to Foreign Residents, as they are expressly dealt with in S 128D.

Accruals Taxation

Australian residents are taxed on accruals or current basis in respect of:

I. Certain types of income;
II. That is derived by some foreign entities; and
III. Is not taxed at a comparable rate in foreign jurisdiction

Is the company a Controlled Foreign Company (CFC)?
As per **s 340** ITAA36, a foreign company will be a CFC if it satisfies 1 of 3 tests;

1) **Strict control test**
   5 or more Australian associates own/entitled to at least 50% of controlling interest in foreign company
2) **Assumed control test**
   Single Australian entity owns, or is entitled to, at least 40% of controlling interest in a foreign company
3) **De Facto control test**
   5 or fewer Australian associates have effective control of a foreign company

Is the taxpayer an Attributable Taxpayer?

- A TP is an *attributable TP* if they have an associate-inclusive control interest of at least 10% in a CFC (Strict or Assumed) **s 361;** or
- CFC is recognised by the De Facto test; and
  - TP is an Australian 1% entity and the TP is part of a group or five or fewer Australian entities who, alone or with associates, controls the CFC
  - Regardless of whether associates are Australian entities

Attributable taxpayer is attributed a share of attributable income of CFC based on the **'attribution percentage'**

Income subject to CFC regime
S 432: Amounts known as 'tainted income' are subject to the CFC regime and only if the CFC does not pass the active income test

Active income test

- If CFC's portion of tainted income is less than 5%, CFC will satisfy active income test and not subject to CFC regime
  - **s 432**
- 'Tainted income' **s 435** includes passive income (interest, royalties, rent, s 446) and tainted sales and services income (income from services with related party **ss 447, 448**)
- CFC's located in listed countries are exempt from accruals taxation unless it derives designated concession income as they are closely comparable tax systems **s 456**
      - Canada, France, Germany, Japan, NZ, UK USA

Foreign Losses

Income years 2008-09 onwards, foreign losses

- Treated the same way as domestic losses
- Can be offset against domestic income (Australian sourced income)

TAX ACCOUNTING

Financial year means a period of 12 months beginning on 1 July: s 995-1

Timing of assessable income

Taxpayer's assessable income includes ordinary income or statutory income that is "derived": ss 6-5; 6-10
Note assessable income includes net capital gains as statutory income by operation of s 102-5. As the asset was held longer than 12 months, there is a 50% discount (s 116-20) to the net capital gain

Meaning of "derive"

"Derived" is not defined in statute, however in **Brent v FCT, Gibbs J** commented that it is to be determined by the application of ordinary business and commercial principles and by a method of accounting that reflects the TP's true income.

Timing of "derivation"; *constructive receipt rule*

By application of the constructive receipt rule, you have derived an amount when it is dealt on your behalf or as you direct
s 6-5(4) and s 6-10(3)

Cash v accruals accounting

TP can decide whether to calculate their AI on a cash or accruals basis.

- In a business, it is a question of fact
- Case law suggests professional practices and small to medium sized business should account on a cash basis: **Henderson v FCT (1970)**

SBE Taxpayers

- Any business eligible as a SBE can account on a cash or accruals basis.
- Must have average turnover of less than 2 million.

Large firms and businesses

- Accruals system is the appropriate method as per Henderson v FCT

Switching between cash and accruals basis

- Switching accounting methods is permitted and the uncollected amounts earned in a prior year are untaxed earnings: Henderson v FCT.
- If TP keeps changing to derive tax-free income, the ATO could assert that the TP was engaged in tax avoidance under part IVA ITAA 1936

Payment before earning activity has commenced

Moneys received in advance of goods or services' being supplied does not constitute income to be 'derived': Arthur Murray Pty Ltd v FCT.

- TP provided dance lessons. Money was transferred to an unearned account, and then transferred to an earned tuition account when lessons were given. Income was only recognised when the lesson had been given and income earned

Sales under lay-by method

Stores may sell goods on instalment basis and legal title is not transferred nor the physical possession until full payment.

- Income is only derived when legal title passes to the customer and not when the contracted is entered into.
- Could be when full payment, goods delivered or customer defaults on the arrangement
- **NOTE: Still trading stock "on-hand" of the seller**

Dividend income

- Dividends are AI as per s 44(1) ITAA36
  - Dividends are 'derived' when they have been paid (cash or reinvestment), not when declared: **Brookton Co-operative society v FCT**

Delay due to dispute

- For taxpayers that account on an *accruals basis*; and are owed money at the end of the income year that has not been paid due to bona fide dispute
  - The disputed amount is not derived in the year when the goods or services were provided/sold
    - **BHP Billiton Petroleum v FCT**

Timing of deductions and deductibility

Deductions are composed of general deductions (s8-1) and specific deductions (s8-5). To claim a general deduction, positive limbs must be satisfied without satisfying any negative limbs.

S 8-1: 1) You can deduct from your assessable income any loss or outgoing to the extent that:
i) It is **incurred** in gaining or producing your assessable income; or
ii) It is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income

S 8-1 (2)
a) Capital
b) Private/domestic
c) Producing NANE
d) Specifically denied

Deductibility of **interest expenses** will depend on the TP's use of the borrowed funds: ***Munro (1926).*** If used to produce AI, it is deductible under s 8-1.

'**Incurred**' is not defined in statute. Ruling TR 97/7 is relevant to the timing issue concerning the deductibility of expenses.
- You incur an outgoing at the time you owe a present money debt that you cannot escape
- Need not pay any money, if the taxpayer is definitively committed in the year of income
- It is not sufficient if a liability is contingent. It must be a presently existing liability to pay a pecuniary sum

Expense of an earlier income year

Placer Pacific Management Pty Ltd v FCT (1995)
- An expense is deductible in a later year when the event that gave rise to the expense occurred in an earlier year
- 'Sold defective conveyor belt in 1981, sold business in 1982, settled defective conveyor belt lawsuit in 1989 and claimed the expense as a deduction' – This was allowed.

Incurred after business ceases to operate

FCT v Jones (2002)
- Likely to be deductible providing expense relates to time when business was operating (e.g. at the time interest was incurred for gaining or producing assessable income)
- Did not matter that the loan was refinanced (did not break nexus between expense and business operations)

Relevant to reduction of future expenses

W Nevill and Co Ltd v FCT (1937)
- Expense is deductible in current financial year even though it relates to a reduction in expenses in future years
- 'Firing managing director results in a reduction of future expenses'

When no income is being generated

Steele v DCT (1999)
- Expense may be deductible even though no income is derived at the time the expense is incurred but where, as a result of the expense, the TP may generate income in future.
- There is no requirement to match the expense to the gaining of the assessable income to deduct pursuant to s 8-1 ITAA1997.

Prepaid expenses

Apportionment of a deductible outgoing is generally required when it relates to advance expenditure greater than one tax year (ss 82KZL to 82KZMG ITAA36):
    - Eligible service period: Beginning to end of expenditure s 82KZL(1)
- The eligible service period is … (s 82KZL(1))
- Expenditure * No. of days of eligible service period in the income year/total days of eligible service period s 82KZMF
- *Amounts specifically excluded*
    - S 82KZL(1)
        - Amounts of less than $1,000
        - Amounts required by law or court order (e.g. car registration)
        - Payments of salary or wages under a contract of service
        - Amounts that are capital, private or domestic in nature
        - General insurance company
- *SBE & non-business taxpayers – it will be clear if this applies*
    - Immediate deduction available where an expense relates to a service up to 12 months S 82KZM

Long service & annual leave

Two points (law & statutory provision)
Leave (and expense) provisions not deductible, as there is no actual liability until the employee takes his or her leave.
- The provision is not "incurred".
- "Incurred" does not require payment but does require a fixed liability not subject to contingencies, as seen in:

  - **Nilsen Development Laboratories Pty Ltd v FCT (1981);**
  - **FCT v James Flood Pty Ltd (1953).**

A deduction for leave (annual, sick, long service) is only claimed in the year paid: s 26-10

Bad debts

Provisions for bad debts are not allowable deductions as no loss or outgoing has been "incurred".

- You need to write-off the debt after previously including in assessable income: s 25-35.

Company cannot deduct dividends it pays s 26-26

TRADING STOCK

Ordinary Course of Business
If you lease houses, selling those houses is not selling trading stock (not ordinary course) – **Determine what purpose it is held for**

Definition

xxx is trading stock as it is held for the purpose of **sale/manufacture/exchange** in the ordinary course of his business **s 70-10(a)**

- Livestock is considered trading stock s 70-10(B)
- **Raw materials and partly finished goods** constitute trading stock of a manufacturer under s 70-10, as confirmed by **FCT v St Hubert's Island (1978)**
- **Spare parts** held for the purpose of exchange in the ordinary course of business constitute trading stock.
    - However, spare parts used to repair items used by the TP in their business are not trading stock.
        - **TR 93/20:** If less than 20% of parts are used for personal use, TP can treat a whole pool of spare parts as trading stock.
- Items held for **hire** are not trading stock: **Cyclone Scaffolding (1987); TR 98/8**
- **Intangibles** (e.g. shares) may constitute trading stock if held with the relevant purpose: **Patcorp Investments Ltd (1976).**
    - Share trading vs. passive investing.

S 995 – **Livestock** does not include animals used as beasts of burden or working beasts in a business other than a primary production business.

S 995 – **primary production** business (including natural increase means offspring)

Unbilled work in progress of a professional services firm is generally not trading stock: **Henderson v FCT (1970).**

Consumables used by a service provider in the course of providing services may constitute trading stock:

- Items must be separately identifiable things before and after the services are provided
- Ownership of items must pass to the customer.

Packaging materials held by a taxpayer may be trading stock where they are disposed of, and closely associated with "core goods": Ruling TR 98/7

- Need to be so closely associated that they are necessary to bring the core goods into the form or condition in which they are sold.

Acquisitions and disposals

The acquisition of **the trading stock (…)** is a deduction under s 8-1 as it is necessarily incurred in carrying on a business to produce AI, and is included at the earlier of the TS being "on hand" or when an amount is included in AI in relation to its disposal (s 70-15)

- Note, though acquiring a business asset, the expense is not treated as a capital expense: s 70-25.

The disposal of **the trading stock (…)** is in the ordinary course of business and assessable as ordinary business income s 6-5, and is included when the TS ceases to be "on hand" (s 70-5(2)(b))

- Note with regards to non-arm's length transactions, the market value will be included in the assessable income of the purchaser due to s 70-20

Non-arm's length transactions
Under s 70-20, the amount of deduction is equal to the market value of the trading stock where the

- Buyer and seller did not deal at "arms length"; and
- The expense is greater than the "market value".

Non-arm's length is not defined and dependent on circumstances but requires the outcome to be a result of dealings that can be considered real bargaining: **Granby (1995).**

- *End of year adjustment* should use the market value as the value of the trading stock where s 70-20 applies on acquisition.
- Non-arm's length **disposals** may be treated as a transaction outside of the ordinary course of business.

"Market Value" is not defined but would be the price agreed to in an open and unrestricted market by willing but not anxious purchaser and seller who are aware of current market conditions: **Spencer v Commonwealth (1907).**

Disposals outside the ordinary course of business (gifts, donations)
Taxpayer disposing the trading stock includes **the market value** in assessable income: s 70-90.
Purchaser is deemed to acquire the trading stock for the same value: s 70-95.

- Any amount received is NANE income under s 70-90(2)

Year-end adjustments

Taxpayers are required under s 70-35 to perform a year-end adjustment

Value at year-end	>	Value at start of the year	=	Difference included in AI
Value at year-end	<	Value at start of the year	=	Difference is a deduction

Value of trading stock at start of year:

- Equals value of trading stock at the end of the previous income year (s 70-40) as confirmed by **Hua Wang Bank Berhad (2015).**

Value of trading stock at end of year:

- Taxpayer has three choices to determine the value of trading stock on hand at end of the year: **s 70-45**:
- **Cost**
  - Determined in accordance with accounting principles: **Phillip Morris Ltd v FCT (1979)**
  - Manufacturers, retailers and wholesalers should use the accounting "absorption cost method".
  - The first-in-first-out method should be used where it is not possible to track individual items: Australasian Jam v FCT (1953); IT 2289
- **Market selling value**
  - The amount the taxpayer could sell the stock in the ordinary course of business in its ordinary market.
  - This amount is to be determined under normal sale arrangements **(not sale conditions)**
- **Replacement value**
  - The amount the taxpayer would have to spend to replace the stock.
  - Requires readily available substitutes and identical items: Determination TD 92/198.

Note, if s 70-20 applies and the transaction is deemed **non-arm's length**, then the value of the trading stock at the year end is also taken to be its market value: s 70-20, Note 1.

For obsolete stock TP may value trading stock at a value lower than the 3 methods if it is obsolete and the value used by the taxpayer is reasonable: s 70-50

"On hand"

"On hand" requires the TP having dispositive power: Farnsworth v FCT (1949), however this is dependent on the facts of the case

- Dispositive power may not include legal ownership: **FCT v Sutton Motors (Chullora) Wholesale Pty Ltd (1985)**
- Dispositive power does not require physical possession of the goods: **All States Frozen Foods v FCT (1990).**

If contract says the TP has control, risk and ownership, they have dispositive power: **All States Frozen Foods v FCT (1990).**

Goods sold under a lay-by arrangement, which are still in the seller's possession, is trading stock on hand of the seller: Ruling TR 95/7.

Special rules

An asset owned by the taxpayer becomes trading stock

- Taxpayer is deemed to have disposed the item; and
- Re-acquired the item (**s 70-30**).
  - The taxpayer has a choice as to whether the deemed disposal and re-acquisition is done at "cost" or at "market value": **s 70- 30(3).**

- Balancing adjustment **if the asset was a depreciating asset**
- CGT event K4 if the asset was a CGT asset and disposal and re-acquisition done at "market value" **s 104-225**
  - If done at "cost", then CGT consequences on the deemed disposal are disregarded: **s 118-25**

Taxpayer ceases to hold an item as trading stock, but continues to own it

- Taxpayer is deemed to have sold (*disposed*) the item and re-acquired it for cost **s 70-110**
  - Although re-acquiring it, it is not deductible as it is for private or domestic use **s 8-1(2)(b)**
- Cease to be TS if purpose in holding the asset changes