CLAW3202 Comprehensive Study Notes

Exam Focused

Contents

Week 1 – Overview

- Statute law: legislation
- Case law: common law
- ATO rulings

INCOME TAX ASSESSMENT ACT 1997 - SECT 8.1

General deductions

(1) You can deduct from your assessable income any loss or outgoing to the extent that:

(a) it is incurred in gaining or producing your assessable income; or

(b) it is necessarily incurred in carrying on a * business for the purpose of gaining or producing your assessable income.

(2) However, you cannot deduct a loss or outgoing under this section to the extent that:

(a) it is a loss or outgoing of capital, or of a capital nature; or

(b) it is a loss or outgoing of a private or domestic nature; or

(c) it is incurred in relation to gaining or producing your * exempt income or your * non-assessable non-exempt income; or

(d) a provision of this Act prevents you from deducting it.

(3) A loss or outgoing that you can deduct under this section is called a general deduction.

INCOME TAX ASSESSMENT ACT 1997 - SECT 6.5

Income according to ordinary concepts (ordinary income)

(1) Your assessable income includes income according to ordinary concepts, which is called ordinary income.

(2) If you are an Australian resident, your assessable income includes the * ordinary income you * derived directly or indirectly from all sources, whether in or out of Australia, during the income year.

(3) If you are a foreign resident, your assessable income includes:

(a) the * ordinary income you * derived directly or indirectly from all * Australian sources during the income year; and

(b) other * ordinary income that a provision includes in your assessable income for the income year on some basis other than having an * Australian source.

(4) In working out whether you have derived an amount of * ordinary income, and (if so) when you derived it, you are taken to have received the amount as soon as it is applied or dealt with in any way on your behalf or as you direct.

- **Federal Commissioner of Taxation v Stone [2005] HCA 21** (HC of Australia)

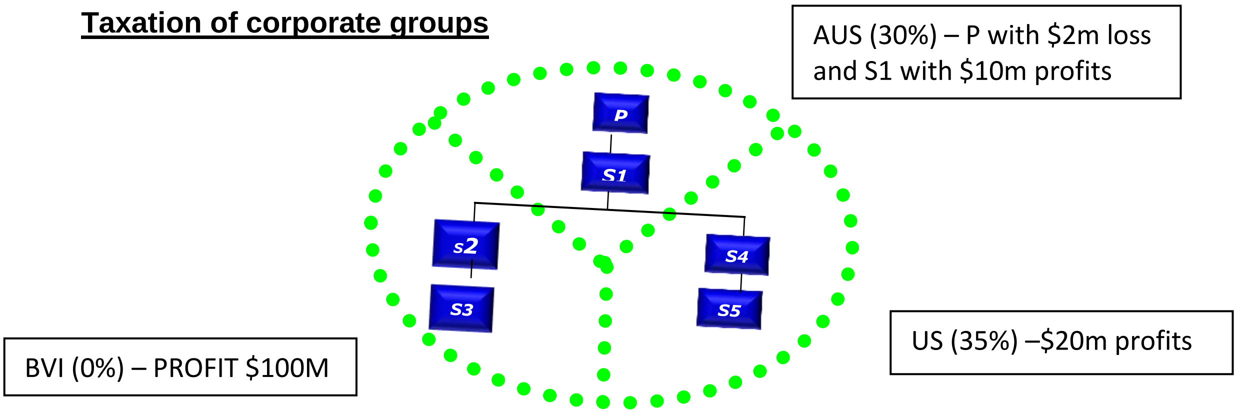
During the 1999 financial year the taxpayer received sums **as prize money,** as **grants** by the Australian Olympic Committee (the AOC) and Queensland Academy of Sport (the

QAS), as **fees for some appearances** she made, and as **payments in cash or kind by sponsors**. The appellant Commissioner contended that all of these sums formed part of her assessable income and assessed her to taxation accordingly.

A good tax system:

- Simplicity
- Fairness (neutral, should not affect the taxpayers' behaviors)
- Efficiency

Taxation of corporate groups

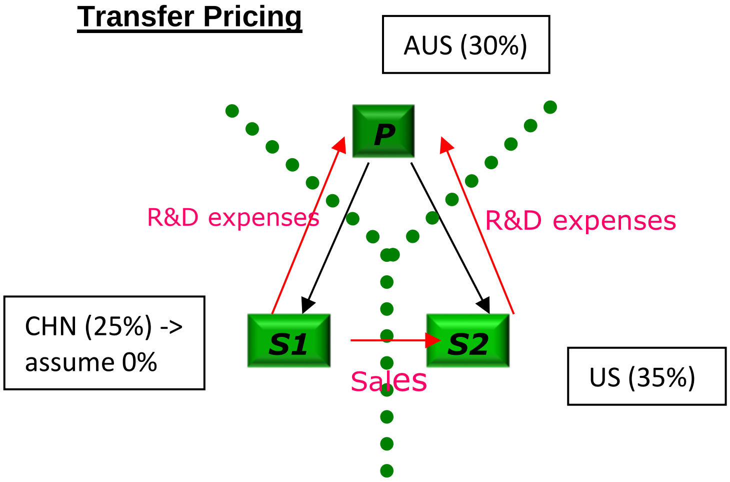


- Domestically, groups would like to be taxed as one – to offset the profit against losses
- Globally, they should pay tax in Australia (location of the parent company) - groups **don't want to be taxed as one entity** – as the tax rate in one country may be higher. If most profits are in BVI (0% tax rate) and the group is being taxed as one, it means that they need to pay more tax on the overall profits of the group in Australia.

Tax Treaties

Bilateral agreements between two countries to avoid double-taxing the residents (Fidler's example – income sourced in Aus. and resident of Switzerland) and avoid tax avoidance.

Transfer Pricing



Sales for group = $100M

Total cost for group = $80M

Group profit = $20M

Parent: CMC, R&D

S1: manufacture

S2: sales & marketing

- Would try to book as much profits in China (country with lowest tax rate) through internal sales (e.g. China sells for $99m to US, and US would be left with $1m profit)

- Transfer pricing – arm's length price (price between independent parties)
- S1 only sells to S2 -> no comparable prices -> difficult to determine arm's length price

Interest Limitation Regimes

- 2 Objectives: Anti-tax avoidance & Competitiveness
- Regimes designed to limit the amount of interest deductions
- Set a cap to limit the interest deductions that companies can get
- Parent can fund a subsidiary through debt (interests) or equity (dividends), parent would prefer debt as interest is tax deductible and dividend is not.

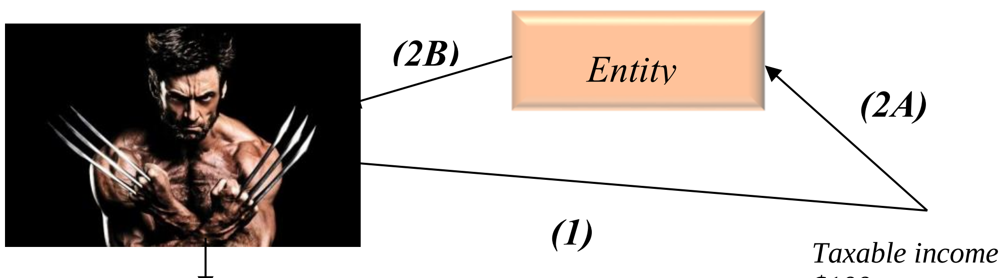
Week 2 - Taxation of Partnerships and Trusts

Revision

- The taxation of **partnerships** in general adopts the Attribution system which has two **main advantages**: (1) distribute loss amongst partners and offset their profits immediately and (2) Preserve character of income and expense.
- A partnership has to compute its net income/partnership loss which is then allocated to its partners as their assessable income/eligible for offset individual taxable income.
- Capital gains and losses on disposals of CGT assets of a partnership are taken into account in the tax returns of partners.
- Salaries paid by a partnership to a partner are not deductible to the partnership, and are treated as another form of profit distribution to the partner.
- A beneficiary presently entitled to a share of the trust income is in general taxed under **section 97 of ITAA 1936.**
- A beneficiary is taxed under **section 98 ITAA1936** if he is under legal disability, which includes (1) minor; (2) insane and (3) bankrupt.
- The prevailing approach to allocate the net income of a trust to its beneficiaries is the proportionate approach, instead of the quantum approach.
- A trust follows the trust law definition of income and derived rental income $200 and capital gain $100 in the current income year. Its **trust income** is $200 and its **net income** is $ 300.
- Accumulated income in a trust in general is taxed in the hands of the trustee at top marginal rate pursuant to **section 99A ITAA 1936.**
- A minor receiving passive income in general is taxed at top marginal rate pursuant to **Division 6AA ITAA 1936**.

Taxation of entities

- If we tax Wolverine directly = Taxable Income $100* Marginal rate 47% = $47
- If we tax an entity (company/trust/partnership) and the person, it needs to be $47 too.



Attribution system (归因)

- "full integration" or "look through"
- ignore the entity completely
- When the entity received the income in 2A, that amount is attributed, or accrual or deemed to be received by the individual immediately. Subject to the individual marginal tax rate. (So there is no tax on 2B, it is neutral and simple and the nature of income will not be changed, if capital income, there is still discount)
- We will tax 2A, no more tax implication on 2B as the income has been fully taxed.
- tax on 'accrual' basis
- Possible problem:
- Distribution from entity: no more tax implication
- Fair and efficient as it retain character of income
- Examples:
    - **Partnership**
    - closely controlled entities:
        - e.g. CFC, consolidated groups
        - economic perspective vs legal perspective
- **Trust** when beneficiary is presently entitled to trust income

- **Problems with the system, especially if applying to companies?**
    - unrealized income
    - cash flow
    - valuation
    - problematic for widely-held (e.g. listed) companies
- May not work for most companies
- For most other entities, 2 levels of taxation: ***(2A)*** + ***(2B)***

- Imagine there are thousands of shareholders, no single one can control the entity or the distribution system. Pay tax base on each person, it going to take longer time
- owner made loss, amount be attributed to the owner and used to offset other income

Classical system

- Tax on both company income and the dividend contribute to shareholders.
  E.g. A Company earning $100 income would pay $30 in tax. The remaining $70 is paid as dividend to a shareholder with a marginal rate of 47%. Then another $33 tax is paid by shareholder. The total tax would be **$63**.
- problems:
    - not neutral - double taxation

- bias towards retention

Double taxation system can cause corporation to prefer debt over equity, makes companies more likely to retain their earnings, and drag down the economic growth.

Imputation system

- Through the use of tax credit called 'franking credits' or 'imputed tax credit', the tax authorities are notified that a company has already paid the required income tax on the income it distributed as dividends. The shareholder then does not have to pay tax on the dividend income.
- This would prevent double taxation on the same income.
  E.g. A Company earning $100 income would pay $30 in tax. Shareholders were allowed a **rebate** for the tax paid by the company on the profits it had distributed to
- The taxpayer as dividend but only to the extent that they had assessable income to offset. (Assessable income is fully taxable). The franked dividend is $70 and imputation credit $30 makes taxable income $100 to shareholder. With a marginal rate of 47%, shareholder pay total **$47** tax with $30 credit for company tax and $17 tax payable. (Neutral result)
- Only Australia and New Zealand still implement Imputation System
- Domestic companies loves this system for the franking credits
- Problems:
  - Claw back of tax preference
    (Tax paid for non-resident, who are not eligible for tax offset pay double tax)
  - Bias against foreign shareholders and foreign sourced income (Behaves like Classical system - $63, penalized foreign investors)

Half inclusion system

- for both residents and non-residents, only half of dividend income is taxable
  - Problem: no more incentive to pay company tax (no pressure for company to pay franking credit, as tax paid by company is irrelevant to tax paid by taxpayer in terms of franking credit)
  - Only half of the dividend is taxable: $35 x 47% = $46.5 (still not $47)

Proxy system

- tax levied at entity level at a 'proxy' rate
- no more tax on distribution
  - Problem: But what are the tax rate?

Current system in Australia		
Partnership (except limited partnership)	**Trust** (except trust taxed like companies)	**Company**
Attribution	Patchwork of attribution, proxy, plus special rules on distribution	*Imputation*

Partnerships

- Definition: **s.6(1)** ITAA 1936: an association of person carrying on business as partner or in receipt of income jointly
- wider definition includes 'passive joint ownership'
  (If husband and wife have joint account, strictly say a partner)

Advantage of partnership

- Partnership is the only one who can distribute loss amongst partners and offset their profits immediately.
- Preserve character of income and expense

CGT issues (not going into details of calculations)

(1) Capital gain/loss in relation to a partnership or its assets, made by the partners individually: s106-5(1) ITAA 1997
e.g. Each partner's gain or loss (%) is calculated by reference to the partnership agreement, or partnership law if there is no contract

(2) Each partner has separate cost bases and reduced cost base for his interest in the assets

(3) If partner leaves partnership
Remaining partners deemed to acquire a share of departing partner's interest in partnership assets: s106-5(3) ITAA 1997
E.g. If one partner contributes a pre-CGT asset to the partnership of 3, it is deemed that he dispose 2/3 of his interest in the asset. His remaining 1/3 shares in the building remains a pre-CGT asset while other partner remain post- CGT

(4) If new partner is admitted
New partner deemed to acquire a share of partnership assets
Existing partners deemed to dispose of part of their interest in each partnership assets:
S106-5(4)
A and B form a partnership, each contribute $15,000 to its capital. The land then increases in value to $300,000. C pays A and B $50,000 each to acquire 1/3 share in the land. His cost base is 100,000.
A and B each dispose 1/3 of their interest in the land. Therefore, capital gain = 50,000
– 5,000 = 45000
If the land is sold now, C would have no capital gain. A and B each have capital gain: 100000 – 10000 = 90000

Limited partnership

- At least one of the partners has limited liability
- Usually one general partner with limited partners (liability limited to contribution)
  - Limited liability
  - Separate management from owner
  - Interest transferable like shares in company
- Div. 5A ITAA 1936 (since 1992)
  - Taxed as company: s94A

Issues on Interest

- Interest expense on partner's capital: **not deductible,** *Beville*
- Interest income on partner's advance: **not taxable**, *Beville*
- Interest expense on loans from partner: deductible, *Leonard*
- Interest on external borrowing by partnership to repay partners' contributions employed in the business: deductible: *Roberts, Smiths*
  - Refinancing takes the same character as the original borrowing
  - ATO position: TR 95/25
- Salaries to partners:
  - **Not deductible:** *Re Scott*
  - What happens if salary > partner's share of net income? TR 2005/7:

Partnership – Attribution system:

Steps:

1. calculate '**net income**' or 'partnership loss' at partnership level s90 ITAA 1936 (as if the partnership were a taxpayer)
2. allocate NI or PL to partners according to **individual interest** of the partner in the amount: s92 ITAA1936
3. partnership return, but not liable to pay tax: s91 ITAA1936

Example 1: Anna and Robert formed a partnership, they agreed to share profit and loss equally, Anna draw a salary of $20,000 for managing the business while the **net profit** after paying Anna salary was $35,000.

Partnership net profit	35,000
Plus salary	20,000
Net income	55,000
Anna	
Salary	20,000
Plus interest in the partnership	35,000/2 = 17,500
Distribution	**37,500**
Robert	
Interest in the balance of net income	17,500
Distribution	**17,500**
Total distribution	**55,000**

If there is surplus after salary, distribute the remaining equally

Example 2: Anna and Robert formed a partnership, they agreed to share profit and loss equally, Anna draw a salary of $20,000 for managing the business while the **net loss** after paying Anna salary was 10,000

Partnership net loss	(10,000)
Plus salary	20,000
Net income	10,000

Anna	
Salary	10,000
Plus interest in the partnership	0
Distribution	**10,000**
Robert	
Interest in the balance of net income	0
Distribution	**0**
Total distribution	**10,000**

If there is loss after salary, salary will be diminished. The whole amount is attributed to Anna. With the other $10k, ATO did not ask her to pay tax on (no immediate tax implication).

Example 3: Anna entitled under the agreement draw a salary of $20,000 for managing the business. The agreement regarding the sharing of profits or loss to be constructed as an agreement to **share equally in profits remaining after the salary is taken into account, if any, equally in losses**. While the net loss after paying Anna salary was 30,000.

Partnership net loss	(30,000)
Plus salary	20,000
Net income	(10,000)
Anna	
interest in the partnership	(5000)
Distribution	**(5000)**
Robert	
Interest in the balance of net income	(5000)
Distribution	**(5000)**
Total distribution	**(10,000)**

With the $20k, treated as tax advance, no immediate tax implication.

Taxation of trust

- Types of trust
  - **Express** (created by document) **vs constructive** (created by action)
  - **Inter vivo** (set up between different persons) **vs testamentary** (set up in the will)
  - **Fixed** (e.g. unit trust, knowing the %) **vs discretionary** (amount distributed is unknown)

  - Legal vs beneficial ownership (separation of ownership in trust)
  - So who should be the taxpayers?

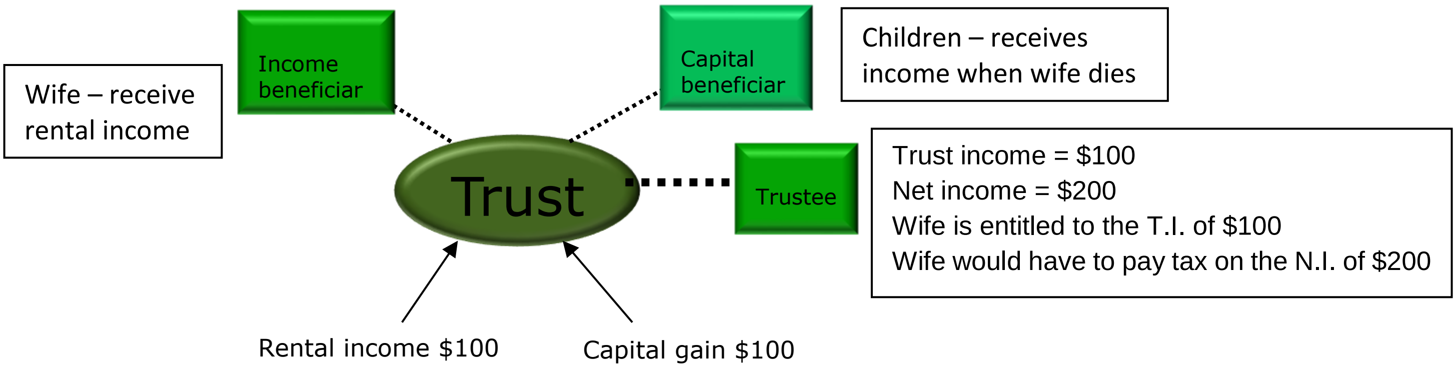
General rule:

- 'Net income' of trust: calculated at trust level "as if the trustee were a taxpayer … and were a resident": **s95 (1) ITAA 1936.**
- **Under trust law, anything that is capital is not trust income**.

- **s97 (1) ITAA1936**

Where a **beneficiary** is presently entitled to a share of the income of the trust estate…the beneficiary is immediately taxable. The assessable income of the beneficiary shall include so much of **that share of the net income of that trust estate**.

- **Trust income** = income (except capital gain)
- **Net income** = income + capital income



Problem: use proportionate or quantum approach on 'that share of net income' *Banford [2010]*
(Even though it may tax on the wrong taxpayer, but all tax is collected)

Trust Attribution

- **S98 (1) ITAA1936**

- If beneficiary who is presently entitled to the trust income is under **legal disability** (E.g. Minor, insane, bankrupt)
- **Trustee will pay tax on behalf of the beneficiary: S98 (1)**
- Similar rule for non-resident beneficiary: **s98 (2A)**

(2) Proxy

- **s99 A**

- (Force all Australian Trust to distribute every last dollar out to beneficiary)
- If no beneficiary is presently entitled to any of the trust income
- **Trustee pay tax at penalty rate = top marginal rate: s99 A**
- Exception: **s99A (2)** trust set up under will (hold the income when someone dies) and the commissioner agrees that 'it would be unreasonable' to apply

Trust – Distribution (CGT event E4)

- **S104-70(1) & 104-71 (1) (c) ITAA 1997**

- CGT event E4: made in respect of your unit or your interest in the trust, not assessable/taxable in the hands of trustee or beneficiary
- Effect of E4:
- cost base/reduced cost base reduced by non-assessable distribution: ***s.104-70(6)***
- may result in capital gain: ***s.104-70(4)***
- *clawback of tax preference* for non-discretionary trusts
    - corresponding event for shares: G1

Anti-Avoidance Provision on Income Splitting

S102 ITAA 1936 applies if

A person has created a trust, and

(a) He has power to revoke or alter the trust so as to acquire a beneficial interest in the income derived by the trustee, or the property producing that income, or

(b) Income is, under that trust, payable to or accumulated for the benefit of a child or children of that person who is or are under the age of 18 years

Tax income in hands of trustee at the person's marginal tax rate

However, s102 proved to be ineffective as proved in *Truesdale (Dummy Settlor)*

Government took 10 years to come up with a response: Child Tax

Division 6AA ITAA 1936 Child tax

- Income diverted to children
    - Subject to top marginal rate
        - Except a small tax-free threshold of $416
        - Full claw back if income ≥ 1,307
    - Persons captured: 'Person under 18': **s102 AC**
    - Income captured: e.g. Passive income, income from trusts (except deceased trust): **s102 AE & s102 AG**