

Business Taxation

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1. The Tax 'Formula'

Who must pay income tax?

- Income tax is payable by each individual and company, and by some other entities: **ITAA 1997 s 4-1**

How to work out how much income tax you must pay

- Your income tax is worked out by reference to your taxable income for the income year: **ITAA 1997 s 4-10(2)**
- Income tax = (Taxable income × Rate) – Tax offsets: ITAA 1997 s 4-10(3)**
 - List of tax offsets: **ITAA 1997 s 13-1**

How to work out your taxable income

- Taxable income = Assessable income – Deductions: ITAA 1997 s 4-15(1)**
 - If the deductions equal or exceed the assessable income, you don't have a taxable income.

ASSESSABLE INCOME AND EXEMPT INCOME

Assessable income

- Your assessable income includes income according to ordinary concepts, which is called **ordinary income: ITAA 1997 s 6-5(1)**
- Amounts that are *not* ordinary income, but are included in your assessable income by provisions about assessable income, are called **statutory income: ITAA 1997 s 6-10(2)**

What is not assessable income

- If an amount is not ordinary income, and is not statutory income, it is not assessable income (so you do not have to pay income tax on it): **ITAA 1997 s 6-15(1)**
- If an amount is **exempt income**, it is not assessable income: **ITAA 1997 s 6-15(2)**
- If an amount is **non-assessable non-exempt income**, it is not assessable income: **ITAA s 6-15(3)**

Exempt income

- An amount of ordinary income or statutory income is exempt income if **it is made exempt from income tax by a provision of this Act or another Commonwealth law: ITAA 1997 s 6-20(1)**
 - Ordinary income is also exempt income to the extent that this Act excludes it (expressly or by implication) from being assessable income: **ITAA 1997 s 6-20(2)**
 - By contrast, an amount of statutory income is exempt income only if it is made exempt from income tax by a provision of this Act outside this Division or another Commonwealth law: **ITAA 1997 s 6-20(3)**
- If an amount of ordinary income or statutory income is non-assessable non-exempt income, **it is not exempt income: ITAA 1997 s 6-20(4)**

Non-assessable non-exempt income

- An amount of ordinary income or statutory income is non-assessable non-exempt income if **a provision of this Act or of another Commonwealth law states that it is not assessable income and is not exempt income: ITAA 1997 s 6-23**

Relationships among various rules about ordinary income

- No double taxation rule:** Sometimes more than one rule includes an amount in your assessable income: the same amount may be ordinary income and may also be included in your assessable income by one or more provisions about assessable income; or the same amount may be included in your assessable income by more than one provision about assessable income.
 - However, the **amount is included only once in your assessable income for an income year**, and is then not included in your assessable income for any other income year: **ITAA 1997 s 6-25(1)**
- Unless the contrary intention appears, the **provisions of this Act prevail over the rules about ordinary income: ITAA 1997 s 6-25(2) [statutory income prevails over ordinary income]**

- A **mere realisation** of an asset does not produce an income by ordinary concepts: **FCT v Myer Emporium Ltd**
 - Profits made on a realisation or change of investments may constitute income if the investments were initially acquired as part of a business with the **intention or purpose that they be realised subsequently in order to capture the profit** arising from their expected increase in value: **FCT v Myer Emporium Ltd**
- When a **recipient of money provides consideration for the payment**, the consideration will ordinarily be considered in ascertaining whether the receipt is on revenue account or on capital account: **Federal Coke Co Pty Ltd v FCT**
 - The character of an asset which is sold for a price will ordinarily determine the character of the receipt of the price or payment: **Federal Coke Co Pty Ltd v FCT**
 - When money is received in consideration of surrendering a benefit to which the recipient is entitled under a contract, it is relevant to enquire **whether that benefit was a capital asset**: **Federal Coke Co Pty Ltd v FCT**
- Receipts from transactions that are made in the ordinary course of business are on revenue account and receipts arising from the mere realisation of an investment are on capital account: **Federal Coke Co Pty Ltd v FCT**
 - The sale of fixed capital assets will generate a capital receipt: **Federal Coke Co Pty Ltd v FCT**
- Whether an item of **circulating capital** is a capital or revenue asset depends on the **nature and scope of a particular business**: **Memorex Pty Ltd v FCT**
 - In **Memorex Pty Ltd v FCT**, the profits from the sale price in excess of the acquisition cost were assessable because they were derived in the ordinary course of the taxpayer's business which was selling and leasing computer equipment.
- The court has held that an amount is ordinary income where the amount received by the taxpayer upon the termination of their employment was deferred compensation for services rendered as an employee: **Blank v FCT**
- **Knowledge** itself is not property, unless it can be attached to an item of property such as a patent or copyright: **Brent v FCT**
 - Where knowledge attaches to a patent or copyright and the owner sells the exclusive rights, the proceeds will normally be capital rather than income: **Brent v FCT**
- It is possible to divide licences into three categories: **Murray v ICI Ltd**
 - 1) The receipts from an ordinary (non-exclusive) licence, where the grantor grants permission for the grantee to do something which it could not lawfully do otherwise, are income.
 - 2) The consideration for an exclusive licence, where the grantor excludes itself from exploiting the property the subject of the licence, is capital.
 - 3) For a sole licence, where the grantor grants permission to a single grantee but leaves the grantor at liberty to exploit the knowledge also, it is normally an ordinary licence unless the grant sufficiently restricts the grantor's right to earn income.
- **Issue: 'Sale of property'**
 - In **Brent v FCT**, it was secret information rather than copyright being sold. There was no copyright. Thus, she was not selling a capital asset.
- **Issue: Payments for giving up rights – Restrictive covenants**
 - For contracts that restrict earning capacity, where the payments are not a normal or natural incident of carrying on the business, **the payments are on capital account**: **Dickenson v FCT**
 - ❖ In **Dickenson v FCT**, the HC held to be capital amounts paid to a petrol station proprietor to sell only Shell products for the next 10 years from that site and, for the next five years, to sell only Shell within a five-mile radius of his premises.
 - The **restriction should be substantial but may be something less than permanent**: **Higgs v Olivier**
 - ❖ In **Higgs v Olivier**, a payment made to Laurence Olivier to refrain from acting in films for a period of 18 months was held to be capital.

Exceptions

- A capital gain or capital loss you make is disregarded if: **ITAA97 s 104-25(5)**
 - (a) you acquired the asset before **20 September 1985**; or
 - (b) for a lease that you granted: (i) it was granted before that day; or (ii) if it has been renewed or extended, the start of the last renewal or extension occurred before that day.
- There are other exceptions if:
 - your lease expires and you did not use it mainly to produce assessable income: **s 118-40**; or
 - you exercise rights to acquire shares or units: **s 130-40**; or
 - you acquire shares or units by converting a convertible interest: **s 130-60**; or
 - you exercise an option: **s 134-1**

CGT event D1 – Creating contractual or other rights

- CGT event D1 happens if you create a contractual right or other legal or equitable right in another entity: **ITAA97 s 104-35(1)**
 - Example: You enter into a contract with the purchaser of your business not to operate a similar business in the same town. The contract states that \$20,000 was paid for this.
- The time of the event is when you enter into the contract or create the other right: **s 104-35(2)**
- You make a capital gain if the capital proceeds from creating the right are *more* than the incidental costs you incurred that relate to the event. You make a capital loss if those capital proceeds are *less*: **ITAA97 s 104-35(3)**
 - To continue the example: If you paid your lawyer \$1,500 to draw up the contract, you make a capital gain of: \$20,000 - \$1,500 = \$18,500
- The costs can include giving property: see section 103-5: **ITAA97 s 104-35(4)**
 - However, they do not include an amount you have received as recoupment of them and that is not included in your assessable income, or an amount to the extent that you have deducted or can deduct it: **ITAA97 s 104-35(4)**

Exceptions

- CGT event D1 does not happen if: **ITAA97 s 104-35(5)**
 - (a) you created the right by borrowing money or obtaining credit from another entity; or
 - (b) the right requires you to do something that is another CGT event that happens to you; or
 - (c) a company issues or allots equity interests or non-equity shares in the company; or
 - (d) the trustee of a unit trust issues units in the trust; or
 - (e) a company grants an option to acquire equity interests, non-equity shares or debentures in the company; or
 - (f) the trustee of a unit trust grants an option to acquire units or debentures in the trust; or
 - (g) you created the right by creating in another entity a right to receive an exploration benefit under a farm-in farm-out arrangement.
- Example: You agree to sell land. You have created a contractual right in the buyer to enforce completion of the transaction. The sale results in you disposing of the land, an example of CGT event A1. This means that CGT event D1 does not happen.

CGT Assets**What is a CGT asset?**

- A CGT asset is: **ITAA97 s 108-5(1)**
 - (a) any kind of property; or
 - (b) a legal or equitable right that is not property.
- To avoid doubt, these are CGT assets: **ITAA97 s 108-5(2)**
 - (a) part of, or an interest in, an asset referred to in subsection (1);
 - (b) goodwill or an interest in it;
 - (c) an interest in an asset of a partnership;
 - (d) an interest in a partnership that is not covered by paragraph (c).
- The term 'assets' is frequently used to identify that which may be turned to account in order to discharge liabilities: **Hepples v FCT (Gummow J)**

7. Deductions – Specific

Specific Deductions

Specific Deductions: ITAA 1997 s 8-5(3)

- You can also deduct from your assessable income an amount that a provision of this Act (outside this Division) allows you to deduct: ITAA 1997 s 8-5(1)
- Some provisions of this Act prevent you from deducting an amount that you could otherwise deduct, or limit the amount you can deduct: **ITAA 1997 s 8-5(2)**

No Double Deductions

- If 2 or more provisions of this Act allow you deductions in respect of the same amount (whether for the same income year or different income years), you can deduct only under the provision that is most appropriate: **ITAA 1997 s 8-10**

Division 25 Repairs

- You can deduct expenditure you incur for repairs to premises (or part of premises) or a depreciating asset that you held or used solely for the purpose of producing assessable income: **ITAA 1997 s 25-10(1)**
 - If you held or used the property only partly for that purpose, you can deduct so much of the expenditure as is reasonable in the circumstances: **ITAA 1997 s 25-10(2)**

Meaning of Repair

Repairs vs Improvements

- Repairs occur with a restoration of efficiency in function rather than the exact repetition of form and materials: **W Thomas**
- A thing is always 'improved' after 'repaired': **W Thomas**
 - A minor improvement to efficiency is no barrier to deductibility because all repairs improve the condition of an item relative to its condition before the repair: **W Thomas**
- Improvement is seen as adding advantages including lasting qualities: **Western Suburbs Cinemas**
- A replacement with a modern equivalent is deemed to be a repair: **Morcom v Campbell-Johnson**

Repairs v Reconstruction – Entirety and subsidiary parts

- The relevant entirety is not an economic unit but the physical thing which satisfies a particular notion: **Lindsay v FCT**
 - In **Lindsay**, the taxpayer reconstructed a slipway which was a part of the premises on which a ship-repairing business was carried out. The slipway was held to be an entirety in itself.
- Expenditure that goes beyond restoration by renewal or replace of subsidiary parts will not be a deductible repair: **Lindsay v FCT**

Initial repairs

- The non-deductibility of initial repairs stem from the fact that: **W Thomas; Law Shipping Co**
 - A state of disrepair will usually be reflected in the purchase price of an asset;
 - An initial repair is an improvement in the sense that it adds a functional capacity to an asset that it did not possess when it first came into the taxpayer's ownership;
 - Initial repairs are not maintenance costs in that they do not remedy defects that arose from the use of the asset by the present taxpayer (i.e. the defects relate to use by the previous owner).
- In **Law Shipping Co**, the court gave explanations for denying deduction such as state of disrepair factored into purchase price of ship, state of disrepair related to predecessor's trade and repair gave a functional capacity the ship did not have at the time of purchase.
- In **Odeon Associated Theatres**, the taxpayer acquired a number of theatres after WWII. War-time regulations had prohibited all but essential maintenance and the theatres were in poor condition.
 - Distinguished from **Law Shipping Co** – state of disrepair did not affect purchase price and state of disrepair did not prevent use as income-producing asset.

Same business test

- Alternatively, the company must satisfy the same business test if it fails the continuity of ownership test: **ITAA97 s 165-13(1)**
 - The company must satisfy the same business test for the income year (the same business test period): **ITAA97 s 165-13(2)**
- A company satisfies the same business test **if throughout the same business test period it carries on the same business as it carried on immediately before the test time: ITAA97 s 165-120(1)**
- However, the company does not satisfy the same business test if, at any time during the same business test period, it derives assessable income from: **ITAA97 s 165-120(2)**
 - (a) a **business** of a kind that it did not carry on before the test time; or
 - (b) a **transaction** of a kind that it had not entered into in the course of its business operations before the test time.
- In **Avondale Motors**, the positive 'same business' test was strictly interpreted where the same business imports identity in **the sense of an identical business** and not merely similarity.
 - However, this does not mean identical in all respects: what is required is the **continuation of the actual business carried on immediately before the change-over: TR 99/19**
- The new transactions test includes all transactions entered into in the course of the company's business operations and not merely those that are 'isolated' or 'independent': **TR 99/19**
- In **Lilyvale Hotel**, the same business test had been satisfied because the taxpayer had conducted a business of owning and operating a hotel at all times. In this case, the taxpayer managed the hotel by using a hotel management company and, at another time, managed the hotel itself. However, a person does not cease to carry out an activity because they carry out the activity through an agent.

Dividend imputation – Franking a dividend***Who may frank***

- A credit arises in the franking account of an entity and the amount of the credit, when the company is a resident at the time of distribution: **ITAA97 s 205-15(1)**
- An entity satisfies the residency requirement for an income year in which, or in relation to which, an event specified in a relevant table occurs if: **ITAA97 s 205-25(1)**
 - (a) the entity is a company, or a corporate limited partnership, to which at least one of the following subparagraphs applies:
 - i. the entity is an Australian resident for more than one half of the 12 months immediately preceding the event if the event occurs before the end of the income year;
 - ii. the entity is an Australian resident at all times during the income year when the entity exists if the event occurs at or after the end of the income year;
 - iii. the entity is an Australian resident for more than one half of the income year (whether or not the event occurs before the end of the income year); or
 - (b) the entity is a public trading trust for the income year.

What may be franked

- A distribution is a frankable distribution, to the extent that it is not unfrankable under section 202-45: **ITAA97 s 202-40(1)**

Maximum credit for a distribution

- The amount of the franking credit on a distribution is that stated in the distribution statement for the distribution, **unless that amount exceeds the maximum franking credit for the distribution: ITAA97 s 202-60(1)**
 - If the amount of a franking credit stated in a distribution statement for a distribution exceeds the maximum franking credit for the distribution, **the amount of the franking credit on the distribution is taken to be the amount of the maximum franking credit for the distribution, and not the amount stated in the distribution statement: ITAA97 s 202-65**

- A company that makes a frankable distribution is obliged to give the recipient holder a distribution statement: **ITAA97 s 202-75(1)**
- The maximum franking credit for a distribution is worked out using the formula: **ITAA97 s 202-60(2)**

$$\text{Maximum franking credit} = \text{Amount of distribution} \times \frac{c}{1 - c}$$

- Where **c** is 0.3 (30%)

$$\text{Maximum franking credit} = \text{Amount of distribution} \times \frac{30}{70}$$

- **Membership fees and subscriptions** – an expense payment benefit or a property benefit from an eligible membership or subscription, either a subscription to a trade or a professional journal, an entitlement to use a corporate credit card or an entitlement to use an airport lounge membership: **FBTAA s 58Y**
- **Taxi travel** – any benefit arising from taxi travel if the travel is a single taxi trip beginning or ending at the employee's place of work: **FBTAA s 58Z**

Specific types of fringe benefits

13 categories

1. Car benefits: **Div 2**
2. Debt waiver benefits: **Div 3**
3. Loan benefits: **Div 4**
4. Expense payment benefits: **Div 5**
5. Housing benefits: **Div 6**
6. Living away from home allowance (LAFHAs): **Div 7**
7. Airline Transport Benefits: **Div 8**
8. Board Benefits: **Div 9**
9. Meal Entertainment Benefits: **Div 9A**
10. Tax exempt body entertainment fringe benefits: **Div 10**
11. Car Parking Benefits: **Div 10A**
12. Property Benefits: **Div 11**
13. Residual Benefits: **Div 12**

Determining the taxable value of fringe benefits

Valuation of car fringe benefits

- TWO methods:
 - Statutory formula: **FBTAA s 9**
 - Operating costs: **FBTAA s 10**
- Even if the employer elects to use operating cost method, the statutory formula method will apply if it produces a lower taxable value: **FBTAA s 10(5)**

1) Statutory formula: FBTAA s 9(1)

$$\text{Taxable value} = \frac{ABC}{D} - E$$

- **A**: base value of the car (generally cost price of the car and includes leased cars)
 - Where the car has been held 4+ years at the commencement of the FBT year, the base value is 2/3 of the cost price of the car: **FBTAA s 9(2)(a)(i)**
- **B**: the statutory fraction (**0.2**)
- **C**: number of days during FBT year in which benefit was provided
- **D**: number of days in FBT year (365 or 366)
- **E**: amount of recipient's payment (if employee contributed to cost of car)

2) Operating costs: FBTAA s 10(2)

$$\text{Taxable value} = [C \times (100\% - BP)] - R$$

- **C**: operating cost of car during the holding period (use GST inclusive costs)
- **BP**: Business use percentage
- **R**: amount of recipient's payment
- **Operating cost** is the sum of: **FBTAA s 10(3)**
 - Registration, insurance and other expenses; and
 - If car owned by provider: depreciation and deemed interest
 - If car leased by provider: include lease expenses but not depreciation or interest
 - If car neither leased nor owned by provider: include deemed depreciation and deemed interest
- Where deemed depreciation rate: 25%
- Where deemed interest rate: 5.25% for FBT year ending 31 March 2018: **TD 2017/3**