Taxation Australia (TAXAU) 120

Candidate Study Guide

January 2020

Contents

Introduction

Welcome to the *Taxation Australia* (TAXAU) module. This module will provide you with the opportunity to understand key concepts and to practise applying your understanding to a variety of practical scenarios.

Learning model

The Chartered Accountants Program (the Program) material has been constructed applying the learning principles of 'tell, show, do' to learning outcomes devised for each unit. Each unit is made up, primarily, of core content, worked examples, activities and a unit quiz.

TELL		SHOW		DO
Tell me the relevant theory	+	Show me how to do the task	+	Can I do the task unassisted?

How the material is constructed

The material is delivered in two modes:

1. The Candidate study guide (CSG) – this print pack.
2. myLearning – our online environment.

Where do I start?

- The module outline (included in this pack).
- The module plan (included in the module outline), to help structure your studies.
- The other module orientation materials (available in myLearning), to introduce you to the TAXAU module and myLearning.
- Past papers (available in myLearning), to understand how topics are addressed in exams.

It is best to work through the CSG units in order. The CSG provides the 'Tell' part of your learning, giving core principles and basic examples. The CSG also directs you to required readings and online learning materials, which are an essential part of your studies in TAXAU.

Good luck!

The Chartered Accountants Program is challenging. It is designed to be the best educational product it can be for you, the future practitioners in this profession. As it constantly evolves, Chartered Accountants Australia and New Zealand will continue to seek your feedback to ensure the Program meets the learner's needs now and for future development.

We hope you find your journey through the Program a rewarding and enjoyable experience, and encourage you to work steadily through the material. If you require further assistance, post your questions on the discussion forum.

Finally, best of luck with your studies. We look forward to conversing with you online on the discussion forum.

Ming Wong-Too-Yuen, Katherine Koukoulas and Gaye Proberts-Camp
TAXAU module leaders

Legislative references

The following is a list of the legislation referred to throughout the learning materials and the acronyms used:

- Income tax
  - *Income Tax Assessment Act 1997* (ITAA 1997).
  - *Income Tax Assessment Act 1936* (ITAA 1936).
  - *Income Tax (Transitional Provisions) Act* (IT(TP)A 1997).
  - Income Tax Assessment (1936 Act) Regulations 2015 (ITAR 2015).
  - Income Tax Assessment Regulations 1997 (ITAR 1997).
  - *Taxation Administration Act 1953* (TAA 1953).
  - Taxation Administration Regulations 2017 (TAR 2017).
  - *Income Tax Rates Act 1986* (ITRA 1986).
  - *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974.*
  - *International Tax Agreements Act 1953* (ITA Act 1953).
  - *Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and on Capital Gains* (UK Agreement).
  - *Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting* (Multilateral Convention).
- GST
  - *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).
  - A New Tax System (Goods and Services Tax) *Regulations 2019* (GST Regulations).
- FBT
  - *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986).
- Other
  - *Corporations Act 2001* (Corporations Act).
  - *Crimes (Taxation Offences) Act 1980.*
  - *Crimes Act 1914* and *Criminal Code* (contained in the *Criminal Code Act 1995*).
  - *Customs Tariff Act 1995*.
  - *Customs Act 1901* (Customs Act).
  - *Family Law Act 1975.*
  - *Migration Act 1958.*
  - Payroll Tax legislation (for each state and territory).
  - *Social Security Act 1991.*
  - *Superannuation (Excess Concessional Contributions Tax) Act 2007.*
  - *Superannuation (Excess Non-concessional Contributions Tax) Act 2007.*
  - *Superannuation Industry (Supervision) Act 1993* (SISA 1993).
  - *Superannuation Industry (Supervision) Regulations 1994* (SISR 1994).
  - *Superannuation Guarantee (Administration) Act 1992* (SGAA 1992).
  - Superannuation *Guarantee Charge Act 1992* (SGCA 1992).
  - *Tax Agent Services Act 2009* (TASA).
  - Tax Agent Services Regulations 2009 (TASR).

Full citations for cases, legislation, rulings and publications referred to in this CSG can be found on myLearning.

Module outline (including module plan)

Overview

The Taxation Australia (TAXAU) module examines and applies relevant Australian taxation law to various tax entities. It is practical in nature with candidates required to explain and calculate the taxation consequences applicable to a range of real-life simulated scenarios, including a comprehensive tax reconciliation which integrates the various units.

The TAXAU module is one of the five (5) compulsory modules in the Chartered Accountants Program.

How is the TAXAU module taught?

The TAXAU module is 12 weeks in duration plus a one-week study break. It offers flexible learning options with the delivery of materials online through myLearning, which is accessible after candidates enrol in the module by logging into myAccount and selecting myLearning.

Assumed knowledge

It is assumed that candidates would have a good understanding of basic taxation principles from their undergraduate studies. Detailed below is a summary of the assumed knowledge of the TAXAU module:

- Undertake research on taxation-related issues, which includes identifying sources of tax law and key cases.
- Define the principles of assessable income and identify the differences between revenue and capital receipts and between ordinary, statutory and exempt income, and demonstrate an awareness of timing issues.
- Define the principles of allowable deductions, and identify the differences between revenue and capital outgoings and between general and specific deductions with an awareness of timing issues.
- Understand the taxation implications of individuals, companies, trusts, partnerships and superannuation funds.
- Describe the administration of taxation in Australia, which includes issues regarding determining the residency of taxpayers and the consequences of tax avoidance or tax evasion.
- Explain the nature and incidence of fringe benefits tax (FBT).
- Explain the nature and incidence of capital gains tax (CGT).
- Explain the nature and incidence of the goods and services tax (GST).

Candidates can check their assumed knowledge for the module by taking the Assumed Knowledge Quiz in myLearning and, if necessary, using the recommended resources to refresh their learning.

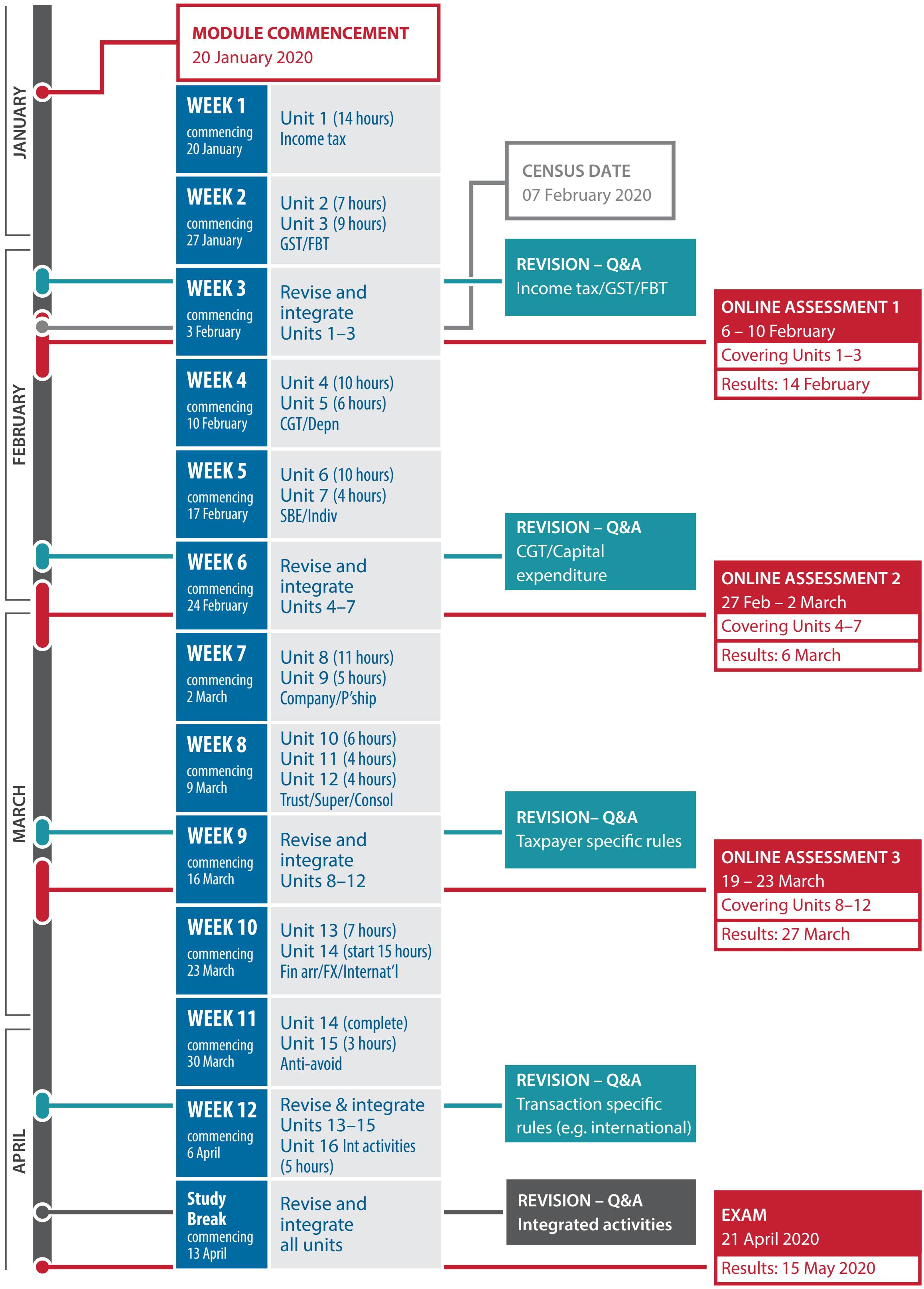
Suggested module plan and time allocation

The expected workload to complete the required content of the TAXAU module is a minimum of 10 hours per week over 12 weeks, or 120 hours in total. In addition, candidates will need to allow time for:

- module orientation
- optional video resources
- optional discussion forums
- revision for and completion of the three (3) online assessments, and
- revision for and completion of the final exam.

Candidates are advised to plan their enrolment carefully around work and other commitments, to ensure they are able to devote the time required to their studies.

The suggested module plan with key dates for Term 1 of 2020 (i.e. TAXAU120) is provided below. It is also available on myLearning.



Unit topics and learning outcomes

The following table outlines the learning outcomes for each unit.

TAXAU module	
Unit topic	**Learning outcomes**
Unit 1: Australian tax fundamentals	Calculate the tax payable of a tax entity by applying the method statement Explain and calculate the assessable income of a tax entity Explain and calculate the deductions available to a tax entity Explain and apply the trading stock definition Explain and calculate the effect of trading stock expenditure on taxable income Explain and calculate the taxation consequences of a disposal of trading stock Explain and calculate the taxation consequences of property either becoming or ceasing to be trading stock Outline the application of land tax, stamp duty provisions and payroll tax Explain the pay as you go (PAYG) system of taxation collection Explain the provisions relating to the self-assessment framework Explain and apply the provisions relating to the uniform administrative penalty regime and the interest regime
Unit 2: Goods and service tax (GST)	Explain and calculate the net GST payable/refundable Outline the GST provisions that apply to second-hand goods Outline the GST anti-avoidance provisions Describe the administrative and compliance arrangements relating to the GST
Unit 3: Fringe benefits tax (FBT) and employment remuneration	Determine when FBT applies Explain and calculate an employer's FBT liability Explain the interaction between income tax, GST and FBT Explain and calculate the effect on an individual's assessable income on deriving termination payments Explain the taxation treatment of employee share schemes
Unit 4: Capital gains tax (CGT)	Outline the background to the CGT regime Explain, calculate and advise on a taxpayer's capital gain or capital loss Analyse and apply the provisions relating to CGT exemptions and the rollover relief provisions Explain and apply the CGT rules related to death Explain and apply the CGT integrity measures
Unit 5: Capital expenditure	Explain, calculate and recommend the most appropriate decline in value for depreciating assets Explain and calculate balancing adjustments Explain the taxation consequences of a change in ownership or interest in a depreciating asset Explain the interactions between the CGT provisions, the trading stock provisions and the capital allowance provisions Explain and calculate the deduction available for capital works Explain and apply the provisions in relation to the interaction between the capital works allowance and the CGT regimes Explain and calculate deductible capital expenditure
Unit 6: Small business entities (SBEs)	Explain and apply the definition of an SBE taxpayer Explain and apply the SBE concessions in calculating an SBE's taxable income Analyse and apply the small business CGT relief provisions

TAXAU module	
Unit topic	**Learning outcomes**
Unit 7: Individuals	Explain the general tax principles that apply to individuals Examine and apply the non-commercial loss provisions Examine and apply the personal services income provisions
Unit 8: Companies	Explain what is a company and the general tax principles Explain and calculate the tax payable by a company Explain and apply the franking account provisions Explain the trans-Tasman tax arrangements Explain and calculate the taxation consequences of company distributions Explain and apply the general and specific anti-avoidance provisions in relation to company distributions Explain and apply the company loss provisions
Unit 9: Partnerships	Explain what is a partnership and the general tax principles for partnerships Explain and calculate the net income or loss of a partnership Explain and calculate a partner's taxable income Analyse and calculate the taxation consequences relating to changes in partnership interests Analyse and apply the partnership CGT rollover relief provisions
Unit 10: Trusts	Explain what is a trust and the general tax principles that apply to trusts Explain and calculate the net income or loss of a trust estate Explain how net income of a trust estate is taxed Explain the main CGT events that relate to trusts Explain the specific trust anti-avoidance provisions
Unit 11: Superannuation funds	Explain what is a complying and non-complying superannuation fund Explain and calculate the tax concessions for superannuation contributions Explain and calculate the taxable income and tax payable of complying superannuation funds Identify the tax payable on the payment of superannuation benefits
Unit 12: Consolidated entities	Explain and apply the eligibility requirements for forming a tax consolidated group Explain and apply the tax consolidation core rules Outline the tax sharing arrangements available to tax consolidated groups Explain and calculate the income tax effect of the tax cost setting rules at consolidation and when an entity leaves a tax consolidated group Explain and calculate the income tax consequences associated with tax losses within a tax consolidated group Explain the treatment of franking accounts when tax consolidated groups are formed and exited
Unit 13: Financial transactions	Identify the taxation of financial arrangements (TOFA) provisions Explain the tax consequences of financing asset acquisitions by lease or as a hire purchase agreement Determine the appropriate Australian dollar tax base for transactions in foreign currency applying the foreign currency translation rules Explain and calculate foreign exchange gains and losses Analyse and apply the tax debt–equity rules

TAXAU module	
Unit topic	**Learning outcomes**
Unit 14: International transactions	Explain and calculate the tax payable of taxpayers in receipt of foreign income Explain and calculate a taxpayer's liability to interest, dividend and royalty withholding tax Explain and apply double taxation treaties Explain and apply the attribution rules in non-complex international transactions Outline the transferor trust provisions Explain and apply the thin capitalisation provisions Discuss the transfer pricing provisions
Unit 15: Tax planning, control and anti-avoidance	Examine what constitutes ethical tax advice by explaining the difference between tax planning, avoidance and evasion Explain the statutory and professional requirements applicable to a tax agent Outline the operative provisions of recent developments Explain and apply the anti-avoidance provisions
Unit 16: Integrated activities	Prepare a tax reconciliation to calculate taxable income by making tax adjustments to accounting profit

Learning resources and supports

The TAXAU module has a range of resources and supports available for candidates, which includes the following.

Hard copy learning material

- Candidate Study Guide (CSG) – after enrolment in the TAXAU module, candidates will receive a hard copy of the core content for the module in the CSG.

Online learning material

- Announcements – to alert candidates to important matters.
- Module orientation and unit introductions – to help get candidates started.
- Core content – to 'tell' candidates the relevant theory (as contained in hard copy CSG).
- Worked examples – to 'show' candidates how to do the task.
- Activities – for candidates to 'do' the task unassisted.
- Quick reference guides and mind maps – to assist candidates in summarising topics.
- Technical videos – to help candidates understand and integrate topics.
- Unit quizzes – to help candidates check their understanding of certain key concepts.
- Practice online assessments and revision questions – to help candidates prepare for each assessment.
- Past exam papers – to help candidates prepare for the final exam.
- Assessment results and feedback – to help candidates understand knowledge gaps and prepare for the final exam.

Additional online support

- Discussion forums
  - Unit forums – where candidates can ask specific technical questions related to unit content.
  - Peer-to-peer forum – where candidates can form study groups or discuss issues in groups with other candidates.
  - Other forums – where module leaders can post additional guidance for candidates.

Date convention

The TAXAU module uses actual dates.

Required readings

The required readings for the TAXAU module include the core content and additional sections of the tax legislation as detailed in the CSG. All required readings are examinable.

Prescribed textbook

Barkoczy, S, 2019, *Core Tax Legislation and Study Guide 2019*, 22nd edn, Oxford University Press, South Melbourne, Victoria.

Note: The relevant tax legislation, which is part of required readings, can be accessed by either referring to:

(i) *Core Tax Legislation and Study Guide 2019* (prescribed textbook), or

(ii) Online at:

- Australian Taxation Office legal database: **www.ato.gov.au** → **Legal database**
- Australian Legal Information Institute (AustLII): **www.austlii.edu.au**.

When accessing the relevant tax legislation online, candidates will need to refer to the law that is applicable to the income tax year ended 30 June 2019 and the fringe benefits tax year ended 31 March 2019, as these are the years covered in the current offering of the module (i.e. TAXAU120).

Six-month rule

Legislation changes constantly. In the Chartered Accountants Program modules, candidates are expected to be up to date with the relevant legislation, Standards, cases, rulings, determinations and other guidance as they stand six months before the exam date, unless otherwise stated.

Candidates are always encouraged to be aware of current developments in all areas.

The relevant date for legislation is the date the legislation receives royal assent. The relevant date for cases is the date the case decision was handed down.

Assessment

The assessment components are outlined below:

Assessment component	**Contribution to final marks**	**Details**
Online assessment	20 marks	Three (3) online assessments Each assessment will consist of 10 single response, multiple-choice questions It is important candidates attempt all online assessments Candidate results and detailed feedback are accessible on My Grades
Exam	80 marks	**Format:** Four (4) compulsory multi-part written questions based on the learning outcomes **Time:** Three (3) hours, plus 15 minutes reading time **Resources:** The exam is open book – candidates can bring in any printed or handwritten resources they require MUST PASS
	100 marks	Candidates must achieve 50 marks or more overall, **AND** 40 marks out of 80 in the exam to pass the module

To pass the module, candidates must:

1. pass the exam (achieving 40 out of 80 marks or more), and
2. pass the module overall (achieving 50 out of 100 marks or more).

It is therefore critical for candidates to practise exam technique and make the most of their exam time.

Task words

Task words are the verbs used in the TAXAU module learning outcomes, worked examples, activities and assessments. Understanding the meaning of task words helps candidates to know exactly what is being asked. Task words direct and tell candidates how to go about answering a question. The following is a list of task words as they apply to the Chartered Accountants Program.

Word	Meaning
Account for	Demonstrate the accounting treatment by using a set of accounts
Advise	Communicate appropriately the recommended course of action based on an analysis of specific circumstances
Analyse	Examine closely; examine something in terms of its parts and show how they are related to each other
Apply	Use established methods/tools/procedures to resolve relatively straightforward scenario or problem
Appraise	Assess the value or quality of something; or assess its performance
Assess	Decide the value of something in a particular context
Calculate	Ascertain or determine by mathematical processes, usually by the ordinary rules of arithmetic
Classify	Place objects/concepts into appropriate categories using an established tool/ methodology or framework
Compare	Critically consider two or more things, emphasising their similarities
Consider	Think carefully about something before making a decision, to look closely or attentively at something
Construct	Build or make something, to form an idea, a process or procedure by bringing together various theoretical and conceptual elements
Contrast	Critically consider two or more things, emphasising their differences
Critique	Give a judgement about the value of something and support that judgement with evidence
Define	Make clear what is meant by something; or use a definition or definitions to explore a concept
Demonstrate	A practical explanation of how something works or is performed
Describe	Present a detailed account of something focusing on depth of knowledge
Design	Develop a procedure/process or course of action based on a selection of the optimum combination from a range of available options
Determine	Establish the most appropriate or most correct answer or course of action from a range of available options
Develop	Bring something into existence that has not previously existed, or to reshape something from its initial position into something more refined
Discuss	Present a detailed account offering an interpretation of something or focusing on breadth of knowledge
Distinguish	Separate one from the other by distinct difference
Evaluate	Determine the value of something, normally with reference to specific criteria
Examine	Inspect something in detail and investigate the implications
Explain	Make clear the details of something; or show the reason for or underlying cause of something; or the means by which something occurs
Identify	Point to the essential part or parts. You might also have to explain clearly what is involved

Word	Meaning
Illustrate	Offer an example or examples, to show how something happens, or that something happens, or to make concrete a concept by giving examples
Integrate	Combine one aspect of their learning with another to form a holistic understanding of a process, procedure or course of action
Interpret	Make clear the meaning of something and its implications
Justify	Provide reasons why certain decisions should be made, conclusions reached and/or courses of action taken
List	Note or itemise in point form
Outline	Go through and identify briefly the main features of something
Plan	Prepare a detailed proposal for doing or achieving something
Prepare	Follow established procedures/methods to create a report of financial information or commentary (e.g. Using a pro forma spreadsheet)
Prioritise	Designate or treat something as being very or more important; or determine the order for dealing with (a series of items or tasks) according to their relative importance
Produce	Without using a pro forma spreadsheet, or without any guidance, create a report of financial information with commentary
Recommend	Advocate a particular outcome or course of action based on an analysis of a range of available options
Review	Report the main facts about something
Select	Carefully choose as being the best or most suitable
Solve	Resolve; or work out to a result or conclusion
State	Accurately articulate established principles, concepts, terms, etc.
Summarise	Describe something concisely

Policies and code of conduct

Candidates are bound by the Chartered Accountants Program's Candidate Code of Conduct. This is available in myLearning.

The policies governing the Chartered Accountants Program are available on our website.

Candidate support and special consideration

Policies around special consideration are available on our website. Candidates will find links to the special consideration forms in myLearning.

Should candidates require additional support during the TAXAU module, they can get in touch with the TAXAU module team via email on TAXAUmodule@charteredaccountantsanz.com, or contact Candidate Support on CandidateSupportProgram@charteredaccountantsanz.com.

Frequently asked questions (FAQs)

Candidates will find answers to many frequently asked questions on myLearning.

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Unit 1: Australian tax fundamentals

Contents

Learning outcomes

At the end of this unit, you will be able to:

1. Calculate the tax payable of a tax entity by applying the method statement.
2. Explain and calculate the assessable income of a tax entity.
3. Explain and calculate the deductions available to a tax entity.
4. Explain and apply the trading stock definition.
5. Explain and calculate the effect of trading stock expenditure on taxable income.
6. Explain and calculate the taxation consequences of a disposal of trading stock.
7. Explain and calculate the taxation consequences of property either becoming or ceasing to be trading stock.
8. Outline the application of land tax, stamp duty provisions and payroll tax.
9. Explain the pay as you go (PAYG) system of taxation collection.
10. Explain the provisions relating to the self-assessment framework.
11. Explain and apply the provisions relating to the uniform administrative penalty regime and the interest regime.

Introduction

The Australian taxation system includes (but is not limited to) the following separate taxes:

- Income tax – applied to taxable income and capital gains.
- Goods and services tax (GST) – applied to transactions.
- Fringe benefits tax (FBT) – applied to non-cash benefits provided to employees.

This offering of the *Taxation Australia* (TAXAU) module considers the:

- Income tax year ended 30 June 2019.
- GST tax periods in the year ended 30 June 2019.
- FBT year ended 31 March 2019.

Amendments to the legislation that are applicable from 1 July 2019 for income tax and GST purposes, and from 1 April 2019 for FBT purposes, are outside the scope of the module.

In this unit, we will cover some of the fundamental features of **income tax** law, in particular, the income tax concepts of assessable income, allowable deductions and trading stock. The fundamentals of GST are covered in Unit 2 and the fundamentals of FBT are covered in Unit 3.

In addition to income tax, GST and FBT, Australia imposes various other taxes at both the federal and state levels. This unit provides an awareness of three of the most important of these taxes: payroll tax, stamp duty and land tax. This unit also provides an awareness of Australia's tax collection mechanisms and self-assessment system.

An understanding of the topics in this unit provides the necessary foundation to successfully complete the TAXAU module. In later units, you will apply these fundamentals to different types of taxpayers and cover more complex income tax issues.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, leap years would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Income tax framework

Design of income tax legislation

Income tax legislation in Australia can be found in two main Acts (the Acts):

- ITAA 1997.
- ITAA 1936.

The reason there are two Acts is because a project was begun, but not completed, to rewrite the earlier Act, ITAA 1936, and replace the alphanumeric numbering system in that Act. The income tax law that was not rewritten remains in ITAA 1936. The re-written income tax law (e.g. assessable income and allowable deduction provisions) and most subsequent new or amended income tax law (e.g. thin capitalisation and transfer pricing provisions) are in ITAA 1997.

In progressing through the TAXAU module, you will be required to read specific sections from both Acts (and other related Acts) to assist your understanding of how income tax law is applied.

Many terms used in the Acts are defined. To correctly interpret income tax law, you must read related sections from both Acts (including general, specific and defined term sections) together. The starting point for defined terms is:

- Section 6(1) ITAA 1936
- Section 995-1 ITAA 1997.

These definition sections may then direct you to other sections or parts in either Act.

The most defined terms in ITAA 1997 are identified by an asterisk appearing at the start of the term. Basic terms for key participants in the income tax system (e.g. individual, person) and core concepts (e.g. assessable income, deduction) are not identified with an asterisk. However, specific definitions for these terms exist within ITAA 1997.

Defined terms in ITAA 1936 are not identified by any markers. Therefore, when reading a particular section of income tax law, you should check the definition sections in both Acts for defined terms.

Where a term is not specifically defined in either Act, it generally takes its common meaning (e.g. under case law and/or the dictionary).

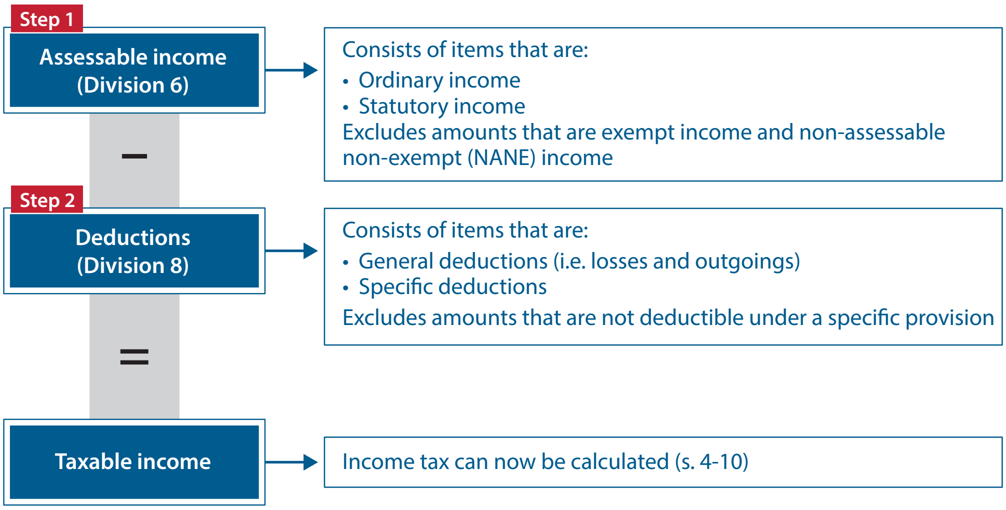
Note: The income tax legislation can be accessed and printed from the Australian Taxation Office (ATO) legal database: www.ato.gov.au – Legal Database.

Calculation methodology

A fundamental feature of Australian income tax law is the framework for calculating an entity's taxable income and tax payable (or refundable). An entity's taxable income must first be ascertained before its income tax liability can be calculated. Income tax law also recognises that some taxpayers may make a tax loss. A separate calculation framework applies for tax losses.

Taxable income (s. 4-15)

To calculate an entity's taxable income, the following formula is used.



Important points to note at this stage in respect of the calculation of taxable income are:

- All amounts of assessable income must be included in taxable income.
- Technically, a taxpayer cannot choose not to claim a deduction to which they are entitled (unless there is a specific rule to the contrary in a particular provision – e.g. Division 36 gives corporate taxpayers a choice in relation to claiming prior year tax losses). This is because, under s. 4-15, allowable deductions are subtracted from assessable income to arrive at taxable income. There is no choice principle embedded in this provision. Therefore, the words 'can deduct' a loss or outgoing in the provisions (such as in s. 8-1), when read in conjunction with s. 4-15, mean that a taxpayer 'must deduct' that expenditure.
- Section 4-15(2) lists a number of situations where the general formula for the calculation of taxable income may differ for different taxpayers. Specific variations are then made to the treatment of either income or deductions for the different entities.
- Deductions may include prior year tax losses (but exclude carry forward net capital losses which can only be offset against capital gains).
- The method most businesses use to calculate taxable income is to prepare a reconciliation from their accounting profit to taxable income (see discussion later in this unit).
- Where the deductions of a taxpayer equal or exceed their assessable income, the taxpayer does not have any taxable income. The excess deductions (subject to certain reductions) may be carried forward by the taxpayer as a tax loss and used as a deduction in a later income year.

Assessable income and allowable deductions (including carry forward tax losses) are analysed further later in this unit.

Required reading

Section 4-15 ITAA 1997.

Income tax payable (or refundable) (s. 4-10)

To calculate an entity's income tax payable (or refundable), the following formula is used.

Taxable income	Result of calculation in s. 4-15
×	
Tax rate (*Income Tax Rates Act 1986*)	The tax rate depends on the type of taxpayer: • Individuals – a progressive tax rate scale plus Medicare levy applies (the higher the taxable income, the higher the rate) • Companies – a flat rate of 27.5% for base rate entities and 30% for all others • Superannuation funds that comply with prudential requirements – generally, a flat rate of 15% (although a higher rate applies to certain types of income – see Unit 11)
–	
Tax offsets	Tax offsets (sometimes referred to as 'tax rebates' in ITAA 1936) reduce income tax payable Specified tax offsets ('refundable tax offsets' in Division 67) can give rise to a tax refund
=	
Income tax payable (or refundable)	In calculating income tax payable (or refundable), the Australian Taxation Office (ATO) credits tax paid in advance because of PAYG: • withholding, or • instalments

Important points to note in the calculation of tax payable (or refundable) are:

- The tax rates vary depending on the type of taxpayer. Generally, a flat rate of tax applies. However, for individual taxpayers, marginal tax rates (i.e. progressive tax rates) mean that the rate increases progressively depending on the amount of taxable income.
- Under s. 90-1 TAA 1953, income tax includes the Medicare levy and the Medicare levy surcharge (where applicable for individual taxpayers). However, it does not include withholding tax (s. 995-1 and s. 128A ITAA 1936).
- The treatment of tax offsets may vary depending on the type of taxpayer. Tax offsets may be refundable (e.g. excess franking tax offsets for individuals and superannuation funds), converted into a tax loss (e.g. excess franking tax offsets for companies) or be lost (e.g. excess foreign income tax offsets). Tax offsets are discussed further below.

Required reading

Section 4-10(3) ITAA 1997.

Tax offsets

A tax offset reduces the amount of income tax an individual or entity has to pay. Tax offsets result in a benefit to the taxpayer that is equal to the amount of the credit or offset. A tax offset should never be confused with a tax deduction, which is subtracted from assessable income to arrive at taxable income. The benefit resulting from a deduction will depend on the marginal tax rate applicable to the taxpayer.

The term 'tax offset' is used in ITAA 1997, while 'rebate' and 'tax credits' are used in ITAA 1936. However, the terms all have the same impact (i.e. they reduce tax payable).

Tax offsets have been introduced for the following reasons:

- To provide a tax benefit to a specific group within the community (e.g. those on low incomes or carers).
- To recognise the tax that has already been paid on assessable items (e.g. the foreign income tax offset recognises income tax levied by a foreign jurisdiction).
- To encourage activities that the Government considers desirable (e.g. the research and development (R&D) tax incentive provides a tax offset to eligible companies).
- To reflect a resident company's tax that is imputed, or attributed, to Australian shareholders, under what is commonly called the 'dividend imputation' system (i.e. franking tax offsets).

Some tax offsets are 'refundable' if they exceed the amount of income tax that is otherwise payable (Division 67).

The order in which tax offsets must be applied is set out in s. 63-10. Broadly, tax offsets that are non-refundable to the taxpayer are applied before tax offsets that are refundable. For example, an individual taxpayer would apply a non-refundable foreign income tax offset before they apply a refundable franking offset.

A full list of tax offsets is provided in s. 13-1. A detailed understanding of all tax offsets is outside the scope of the TAXAU module. However, this list of the types of tax offsets should be reviewed. The tax offsets that you are required to know in detail are covered in later units (e.g. franking tax offsets in Unit 8 and foreign income tax offsets in Unit 14).

Required reading

Section 13-1 ITAA 1997.

Example – Income tax payable

Doner Pty Ltd (Doner) is an Australian resident company that derived a taxable income of $500 million for the year ended 30 June 2019. This amount included some foreign income for which Doner is entitled to claim a foreign income tax offset of $20 million. During the year, the company paid pay as you go (PAYG) instalments of $120 million.

The balance of Doner's company tax payable for the year ended 30 June 2019 (assuming Doner is not a small business entity or a base rate entity) is as follows:

Item	Calculation	$ '000
Tax on taxable income at 30%	$500 million × 30%	150,000
Less: Foreign income tax offset		(20,000)
Less: PAYG instalments paid		(120,000)
Net company tax payable		10,000

Note: The offset is claimed before the PAYG instalments and forms part of the assessment process.

Tax loss (s. 36-10)

Income tax law recognises that some taxpayers may make a tax loss. A tax loss is calculated using the following formula from s. 36-10:

Deductions – Assessable income – Net exempt income = Tax loss

Important points to note at this stage are:

- **A tax loss is not the same as a net capital loss for capital gains tax (CGT) purposes.** A tax loss is on revenue account (and is sometimes referred to as a 'revenue' loss). A net capital loss, on the other hand, arises under the CGT provisions (discussed in Unit 4) and is not a deduction when calculating taxable income or a tax loss.
- **Net exempt income means exempt income net of any expenses and foreign taxes relating to that exempt income.** Although it is not assessable, exempt income (discussed later in this unit) reduces the tax loss that would otherwise be available.

  Note: Non-assessable, non-exempt (NANE) income (also discussed later) is different to exempt income as it does not reduce tax losses.
- **An unused tax loss carries forward indefinitely to the next income year** and is a deduction when calculating the taxable income for that next income year. For certain taxpayers, the ability to use (i.e. claim a tax deduction for) a carry forward tax loss is subject to anti-avoidance tests that are designed to counter trafficking of loss-making entities (e.g. continuity of ownership and business continuity tests).
- **A net capital loss also carries forward indefinitely to the next income year** (subject to anti-avoidance tests for certain types of taxpayers) and is taken into account in calculating the net capital gain (if any) in that next year. If the capital loss cannot be used in the next income year, it is carried forward to the following year, and so on.

Carry forward tax losses are analysed further later in this unit.

Required reading

Section 36-10 ITAA 1997.

Reconciliation from accounting profit to taxable income

Practically, most businesses do not use the formula specified in s. 4-15 to calculate taxable income. The method they use to calculate taxable income is to prepare a reconciliation from their accounting profit to taxable income (sometimes called a statement of taxable income). To do this, they analyse their financial statements (e.g. profit and loss statement, statement of other comprehensive income, and balance sheet) to identify any differences between what is recognised for accounting purposes in accounting profit and what is assessable income or an allowable deduction for tax purposes in a particular income year. All identified differences are added to, or subtracted from, accounting profit to determine taxable income. Candidates should be familiar with this approach and have the basic accounting skills to analyse financial information from their prior studies. A comprehensive case study utilising this approach is included in the final unit of the TAXAU module.

The following table provides an overview of how a business calculates taxable income. Further guidance is provided in the quick reference guides (located online in myLearning).

Reconciliation of accounting profit to taxable income	
Item	**$**
Accounting profit/(loss) (P/L)	xx
Add/(less): Adjustments	
Add: Expenses in P/L but not tax deductible	xx
Less: Expense not in P/L but tax deductible	(xx)
Less: Income/gains in P/L but not assessable	(xx)
Add: Income/gains not in P/L but assessable	xx
Equals: Taxable income	xxx

Assessable income

Overview

Assessable income is defined in Division 6, and includes:

- ordinary income when it is derived (s. 6-5), and
- statutory income (s. 6-10).

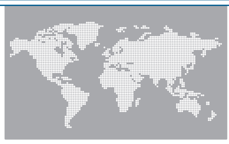
However, assessable income excludes exempt income and non-assessable, non-exempt (NANE) income.

To be able to calculate the assessable income of a taxpayer, it is necessary to have an understanding of two key concepts:

- residence, and
- source of income.

These concepts are important because Australian tax residents are generally taxed on income from all (i.e. worldwide) sources, whereas non-residents are only taxed on Australian-sourced income.

Australian resident taxpayer

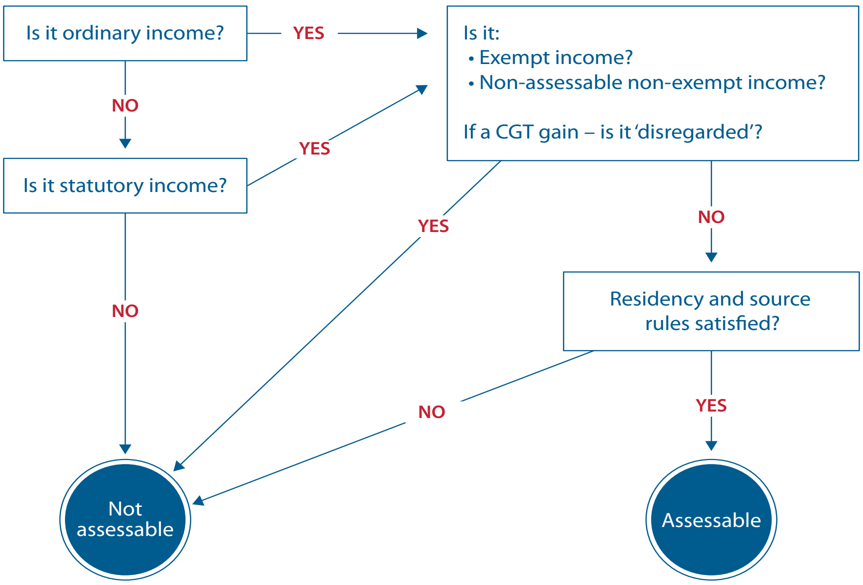


Assessable income includes ordinary income and statutory income from all sources (ss 6-5(2), 6-10(4))

Foreign resident taxpayer

Assessable income includes ordinary income and statutory income from Australian sources (ss 6-5(3), 6-10(5))

The following flow chart sets out an approach for determining whether an amount should be categorised as assessable income, linking the concepts of residency and source.



Residence

Section 6-5 on ordinary income and s. 6-10 on statutory income both use the term 'Australian resident'. It is defined in s. 995-1 by reference to the definition of 'resident' in s. 6(1) ITAA 1936.

Similarly, the references in ss 6-5 and 6-10 to 'foreign resident' relate to a person who does not satisfy the definition of 'resident' in s. 6(1) ITAA 1936.

Taxation differences

Aside from ss 6-5 and 6-10, the following table highlights other important differences between the taxation of a resident and non-resident.

Income tax differences between residents and non-residents	
Residents	**Non-residents**
Individuals (see Unit 7): • Pay income tax in the progressive income tax rate scale that includes a tax-free threshold (apportioned if a part-year resident) • Tax offsets are often available (e.g. the means-tested private health insurance rebate and franking tax offsets) • Pay the Medicare levy once their taxable income exceeds a threshold amount, as well as the Medicare levy surcharge if they do not have private health insurance	Individuals (see Unit 7): • Pay income tax at special rates without the benefit of a tax-free threshold • Tax offsets are usually not available • Do not pay the Medicare levy and may not be entitled to claim Medicare benefits
Under the CGT provisions (see Unit 4): • Residents are taxed on net capital gains, calculated on a worldwide basis • Resident individuals and complying superannuation funds can claim the CGT discount for assets held for at least 12 months	Under the CGT provisions (see Unit 4): • CGT applies only if a CGT event happens to an asset that is 'taxable Australian property'; for example, Australian land (this concession also extends to 'temporary residents') • Non-residents are ineligible for the CGT discount on gains accruing after 8 May 2012
Residents typically need to lodge a return with the ATO and pay tax by assessment, with credit given for any tax paid in advance under: • PAYG withholding, and • PAYG instalments	• PAYG withholding tax may apply to Australian-sourced income (e.g. interest, unfranked dividends and royalties; payments to entertainers, sportspersons, and those working on building and infrastructure projects; proceeds on disposal of taxable Australian property) • PAYG withholding tax rate is typically much lower than the tax rates applicable to residents (e.g. 10% on interest) • No need to lodge an Australian tax return if withholding tax has been deducted from certain types of Australian-sourced income (e.g. tax withheld on interest, unfranked dividends and royalties is a 'final' tax) and no other income is derived from Australian sources
Companies benefit from a range of concessions, for example: • The ability to pay franked dividends and claim the franking tax offset on franked dividends received (see Unit 8) • They are eligible to be members of / form a consolidated tax group (see Unit 12) • R&D incentives	Non-resident entities located in countries that have a tax treaty with Australia will typically pay tax on business profits sourced in Australia only if the entity has a permanent establishment (sometimes called a 'PE' or 'branch') in Australia (see Unit 14)

Change of residency

Due to the differing treatment of residents and non-residents, Australian income tax law caters for individuals and entities who cease to be resident, or who become resident. These change of residency rules generally provide a clear transition from one status to another in the year of change.

For example, if an individual resident taxpayer moves overseas in circumstances that result in the cessation of their residency status for Australian tax purposes, the individual will only be entitled to a portion of the tax-free threshold for the income year in which their departure occurs. This portion of the threshold will be calculated by reference to the number of months that they were resident in that year.

The consequences of changing residency status are particularly important for CGT purposes (see Unit 4). One notable deficiency in relation to changing residency is the treatment of trading stock. There is no tax provision that deals with this situation (see trading stock later in this unit).

Resident individual

Four tests in s. 6(1) ITAA 1936 are used to determine whether an individual is a 'resident' on a year-by-year basis, as outlined in the table below. Residency is a question of fact. A person who satisfies any of the four tests will be categorised as a resident. If all four tests are not satisfied, the person will be a non-resident.

Residency tests for individuals	
Test	**Explanation**
'Resides' test	The primary residency test is whether an individual resides in Australia. As there is no definition of 'resides' in the Australian income tax law, the ordinary meaning of the word applies. TR 98/17 contains relevant factors to assist in determining if an individual resides in Australia and examples that illustrate how the ATO applies this test. The relevant factors include: • Intention or purpose of presence • Family and business or employment ties • Maintenance and location of assets • Social and living arrangements • Physical presence in Australia If an individual is a resident under this test, the other tests (below in this table) do not need to be considered (*FCT v. Applegate*)
'Domicile' test	A person is an Australian resident if their domicile is in Australia, unless it can be shown that their permanent place of abode is outside Australia There are three basic types of domicile: • Domicile of origin (at birth, a child adopts the domicile of the father, or for an ex-nuptial child, the domicile of the mother) • Domicile of choice (inferred by law – for example, where a migrant decides to live permanently or at least indefinitely in another country) • Domicile by operation of law (imposed by law – for example, an infant's domicile is that of their parents and changes when the parents' domicile changes) Determining a person's 'permanent place of abode' involves weighing up factors that are similar to those outlined above under the 'resides' test (IT 2650). The word 'permanent' does not have the meaning of 'everlasting' or 'forever', but is used in the sense of being contrasted with 'temporary' or 'transitory' (*FCT v. Applegate).* Also it should not be interpreted by reference to a person's specific house or dwelling, but rather it should be interpreted more widely to consider whether a person is living permanently in a particular country or state (*Harding v. COT*) A person retains their domicile of origin unless and until they acquire a domicile of choice in another country (the person's intention has to be to make their home indefinitely in that other country – see s. 10 of the *Domicile Act)*

Residency tests for individuals	
Test	**Explanation**
'More than 183 days' test	A person who is physically present in Australia for more than half the income year, whether continuously or intermittently, is said to have a constructive residence in Australia unless it can be established that: • Their usual place of abode is outside Australia • They do not intend to take up residence in Australia The 183-day test generally only applies to people coming to Australia, rather than people leaving Australia
Membership of a Commonwealth Government superannuation scheme	A person is a resident if they are a member of a Commonwealth Government superannuation scheme

Required reading

Section 6(1) ITAA 1936 – definition of a 'resident individual'.

Resident company

Under the definition of 'resident' in s. 6(1) ITAA 1936, a company is resident in Australia if it meets the requirements of either of the tests outlined in the following table.

Tests of company residency	
Test	**Explanation**
First statutory test – A company incorporated in Australia	Place of incorporation is a question of fact, ascertained by searching the company register maintained by the Australian Securities and Investments Commission (ASIC)
Second statutory test – A company not incorporated in Australia but which carries on business in Australia **and either (a) or (b) below applies**	Place of carrying on business is a question of fact, ascertained by looking at the relevant facts and circumstances. 'Business' can include both active operations (e.g. selling goods or services, manufacturing or mining operations) and passive operations (e.g. investments in property or shares) A passive investment business tends to be carrying on business where the central management and control is undertaken (*Malayan Shipping Co Limited v. FCT*). The same position may also apply for an active trading business (see below for the ATO's view)
(a) Central management and control are in Australia	This requirement focuses on the who, when and where of a company's strategic decision-making (i.e. where management and control decisions at the highest level are made (*Koitaki Para Rubber Estates Limited v. FCT*)). Where effective control and decision-making is in Australia, and the offshore board is a mere 'rubber stamp', central management and control will be in Australia (see *Bywater Investments Ltd v. FCT,* which distinguished the decision in *Esquire Nominees Ltd v. FCT* in the context of an offshore company that was 'having its strings' pulled by the de facto controller in Australia) This area of law is evolving. Because of the advances in technology and e-commerce, many of the old cases are now outdated. Physical location is becoming less relevant. Many board meetings are now held by phone or via email exchange The ATO has released its view on central management and control and whether a company carries on business in Australia in TR 2018/5. In the ATO's view, if the central management and control of a company is in Australia, then the company will carry on business in Australia, and thus be a resident Previously, the ATO's view was that the location of central management and control of a company and where that company carries on business could be different (e.g. central management and control could be in Australia without the company carrying on business in Australia) – see withdrawn taxation ruling TR 2004/15W The ATO has also released additional guidance on where a company's central management and control is located in PCG 2018/9

Tests of company residency	
Test	**Explanation**
(b) Voting power is controlled by shareholders who are Australian residents	The residence of the shareholders who control the voting power is a question of fact. A change of shareholder residence may trigger a change of residence for the companies they control

Required reading

Section 6(1) ITAA 1936 – definition of a 'resident company'.

Other resident entities

The residency of a **trust** (ss 95(2) and (3) ITAA 1936) depends on the:

- residence of the trustee, or
- central management and control of the trust.

A separate definition of 'resident trust for CGT purposes' applies (s. 995-1(1)).

The definition of an 'Australian superannuation fund' (s. 295-95(2)) is relevant in determining whether a fund is a 'complying superannuation fund'.

Residency is not relevant to partnerships – it is the status of each partner that is relevant.

Role of double tax agreements

Where a double tax agreement exists between Australia and another country, the agreement will usually contain 'tie breaker' rules that help to decide scenarios in which a taxpayer might otherwise be resident in both jurisdictions. However, even if a double taxation agreement deems a taxpayer to be a resident of a particular country, this is only for the purposes of applying the double taxation agreement. The taxpayer will still be a resident of their home country for domestic tax law purposes.

Source of income

The source of income refers to the place where the income is earned. It is relevant when determining whether income is taxable in Australia because a resident is taxed on income from all sources, while a non-resident is only taxed on income from Australian sources. Determining the source of income is also relevant for 'temporary residents', who are generally only assessed on their Australian-sourced income.

Common types of income

Determining the source of income is a **matter of fact** and different source rules are applied to different types of income.

The following table sets out the sources of common types of income.

Sources of common types of income	
Type of income	**Source**
Sale of goods	The place where the contract of sale was entered into or where value was added (*CoT (NSW) v. Kirk*)
Sale of shares	The place where the sales contract was entered into, although the place where the company conducts its operations is also relevant (*Australian Machinery & Investment Co. v. DFCT*) In TD 2011/24, the ATO states that determining the source of profits on share sales is not dependent solely on where the sales contracts are executed, but on the whole factual matrix, including those facts occurring before and during the investment
Sale of other property	The place where the property is located The CGT provisions seek to tax non-residents on the direct or indirect disposal of 'taxable Australian property' (e.g. Australian land) (see Unit 4)
Lease contracts	For leased real estate, the place where the property is located (*Rhodesia Metals Limited (in liq.) v. CoT*). For others, the place where the lease contract is entered into
Services	Normally, the place where the work is performed (*FCT v. Efstathakis* and *FCT v. French*) – however, where the services are particularly specialised or can be performed anywhere: • the place where the service contract was entered into (*FCT v. Mitchum*), or • the place where payment for the service was made (*Evans v. FCT*)
Interest	The place where the loan contract was entered into or where the funds were advanced (*FCT v. Spotless Services Limited*)
Dividends	The place where the profits that gave rise to the dividend were made (*Esquire Nominees v. FCT*)
Royalties	If related to the right to use property, the place where the property is located. If related to the right to use intellectual property, the place where the contract is entered into (*FCT v. United Aircraft Corporation*) However, where an Australian business pays a royalty to a non-resident, it is deemed to be sourced in Australia under s. 6C ITAA 1936

Note: Because of the increasing globalisation of business and developments in e-commerce and cloud computing, this area of tax law is evolving. Therefore, the table above should be regarded as a guide only. The courts will look at the whole factual matrix and work out which jurisdiction actually 'drives' the generation of the income.

Role of double tax agreements

Where a double tax agreement exists between Australia and another country, the agreement may allocate the source of particular types of income or gains to Australia or the treaty partner country. This overcomes scenarios where a taxpayer might otherwise have income or gains sourced in both jurisdictions.

Worked example 1.1: Residency and source of income – individual
[Available online in myLearning]

Activity 1.1: Residency of a company
[Available online in myLearning]

Activity 1.2: Source of personal services income – self-employed individual
[Available online in myLearning]

Ordinary income

Scope

Section 6-5(1) defines ordinary income as 'income according to ordinary concepts'.

This wording reflects an often-quoted statement in *Scott v. CoT* (1935), where the court said that the question of whether an amount is income 'must be determined in accordance with the ordinary concepts and usages of mankind' (at SR (NSW) 219).

Courts have traditionally categorised ordinary income as income from:

- personal exertion
- business
- isolated transactions, including income from profit-making undertakings or schemes
- property.

Numerous **judicial tests** that consider various factors have been developed to help determine whether an amount is **ordinary income**, as follows.

Factors that indicate an amount is ordinary income	
Income factor	**Explanation**
Arising from employment or services	Amounts that are incidental to employment or services rendered are income (e.g. tips for a waiter: *Kelly v. FCT*; *Scott v. FCT* (1966))
Arising from carrying on a business	Amounts that are an ordinary incident of the taxpayer's business (e.g. proceeds from selling trading stock) will be income Courts are often called on to address the threshold question: Is the taxpayer carrying on a business? And, if so, is the amount generated in the course of that business activity? (*FCT v. Stone*; *FCT v. Myer Emporium*)
Periodic, recurrent or regular	Income is typically periodic, recurrent or regular (*FCT v. Dixon*; *GP International Pipecoaters Pty Ltd v. FCT*). An isolated transaction is more likely to be capital in nature unless it is entered into for a profit-making purpose (see below)
Not a capital amount	Amounts of a capital nature are not income according to ordinary concepts. However, amounts received from the use of property (e.g. rents, royalties, interest and dividends) are assessable income (*Eisner v. Macomber*, which provides the helpful metaphor of a tree, being capital, and the fruit, being the income) Much depends on the nature of the particular business and the assets realised. For example, the sale of income-generating assets owned by banks and insurance companies is received on revenue, not capital, account (*Australasian Catholic Assurance Co. Limited v. FCT*; *London Australia Investment Co. Limited v. FCT*) The income and capital distinction is discussed in detail below
Not a personal gift or windfall gain	Personal gifts are not income (*Scott v. FCT* (1966)). For all cases, courts look at the quality of the receipt in the hands of the recipient (*Hayes v. FCT*). However, where the gift is provided in the context of an employment or service type arrangement, the gift will be income (*Brown v. FCT*). The motive must be personal benefaction, not gratitude for employment or services rendered Windfall gains typically lack a connection to any income-producing activity, although the Commissioner occasionally assesses taxpayers who are considered 'professional' gamblers (unless they make losses, in which case the Australian Taxation Office (ATO) would typically assume that the activity is a mere hobby)
Non-convertible benefits	An amount that is not convertible to cash is not ordinary income (*FCT v. Cooke & Sherden*). However, this decision does not apply to non-cash benefits received in: • An employment context – fringe benefits tax (FBT) provisions contain statutory rules for valuing the benefit and levying tax on employers (discussed in Unit 3) • A business context – s. 21A ITAA 1936 treats the benefit as if it were convertible to cash, thus removing convertibility as a factor to be considered in determining whether the benefit is ordinary income (discussed in more detail later in this unit)

Factors that indicate an amount is ordinary income	
Income factor	**Explanation**
Compensation for loss of trading stock	A receipt compensating for the loss of an asset (e.g. trading stock) that would have otherwise given rise to income is itself treated as income (*FCT v. Wade*)
Replacement income	An amount received as replacement for income takes on the character of income (*Liftronic Pty Ltd v. FCT*)
Isolated transaction	A gain from an isolated transaction that was entered into with the intention of making a profit **and** in the course of a commercial transaction or in carrying on a business may be income (*FCT v. Myer Emporium*) The taxpayer's intention of making a profit is not of significance in determining the existence of a business (*Greig v. FCT*) (see characteristics of a capital receipt later in this unit). The question of whether a business is being carried on is a matter of fact (see allowable deductions later in this unit) It is uncertain whether the principle in *FCT v. Myer Emporium* applies to non-business situations. Thus, the acquisition of an asset by a person carrying on a business might be treated differently to the acquisition of the same asset by a person not carrying on a business

Note: These tests are indicators and not determinative in themselves. The same principles do **not** apply to statutory income.

> **Required reading**
>
> Section 6-5 ITAA 1997.

When is income 'derived'?

Ordinary income is assessable in the year in which it is derived (s. 6-5(1)). Therefore, it is critical to establish when income has been derived. The appropriate method used to determine when income is derived is one that is 'calculated to give a substantially correct reflex of the taxpayer's true income' (*Carden's case* at CLR 154). This is determined on a case-by-case basis based on ordinary business and commercial principles. While tax considerations are generally independent of the accounting treatment of transactions, in the matter of derivation the courts have looked to Accounting Standards to assist in determining the appropriate tax treatment (*Arthur Murray (NSW) Pty Ltd v. FCT*).

Note: Income included under a statutory provision may, but does not always, have a specified time of derivation. However, the concept of derivation does not apply to taxpayers who make a gain on a Division 230 financial arrangement (discussed in Unit 13).

The two primary methods of determining when income is derived are the cash basis method and the accruals basis method (sometimes called the 'earnings' basis method).

The most appropriate method for **non-business income** (e.g. interest and dividends from passive investment) is the **cash basis method**.

Generally, the most appropriate method for **business income** is the **accruals basis method**. However, the test from *Carden's case* still applies (TR 93/11). For business income, using the accruals basis method is usually appropriate in the following circumstances:

- The accounting practice is to adopt an accruals approach.
- The business is incorporated (a company structure generally implies a more sophisticated arrangement).
- Income is generated from the use of equipment and employees' talents (i.e. the business infrastructure drives the income, not the personal exertion of the individual).

A business selling **trading stock must use the accruals method** for that income (*J Rowe and Son Pty Ltd v. FCT).*

The timing of when income is derived is not clear for some types of income (see discussion below on income from services and other common types of ordinary income).

Cash basis method (receipts basis)

The cash basis method is based on the '**receipt**' of income.

Where a person gives instructions on how income is to be dealt with on their behalf, a constructive receipt approach applies. In these circumstances, the person is deemed to have received that income when it is dealt with as directed by that person (ss 6-5(4) and 6-10(3)). In *Brent v. FCT*, Gibbs J indicated that income is not 'dealt with' in the required manner if a person requests that a creditor defers payment. Note: If this is done to avoid tax in a particular year, Part IVA ITAA 1936 may need to be considered (refer to Unit 15 on tax planning and anti-avoidance).

An example of a constructive receipt is a term deposit that renews (or rolls over) on a default basis during the income year. Although the interest it earns is automatically added to the principal and reinvested for a new term, it has nonetheless been derived in that year by the account holder. Another example is a builder that says to a customer, 'don't pay me, pay this bill on my behalf'. The payment of the bill is constructive payment.

Note how this differs from a salary sacrifice arrangement that is entered into on a **prospective** basis. For example, an employer and employee can agree to reduce the employee's wages to be paid in the future so that extra 'pre-tax' employer contributions can be paid into a superannuation fund on the employee's behalf. The employee has not yet earned or become entitled to receive the future wages (*Constable v. FCT*; TR 2001/10). In contrast, when the services have already been performed and the salary is then sacrificed, the income will be derived because the salary sacrifice is too late (i.e. you cannot salary sacrifice income that already has been earned).

Accruals basis method (earnings basis)

The accruals basis method is based on income 'earned'. Income is generally 'earned' when a taxpayer **issues an invoice** (e.g. recognises the sales income and a trade debtor for accounting purposes) or a customer has an **obligation to make a payment** (i.e. there is a recoverable debt) such that the rendering of the invoice is mere procedure. However, an invoiced amount may **not** be earned where it is:

- subject to a later discount
- refundable (see discussion below on income received in advance)
- contingent on the future provision of goods or services
- subject to a genuine dispute (*BHP Billiton Petroleum (Bass Straight) Pty Ltd v. FCT*).

A full discussion of the cash and accruals basis methods is found in TR 98/1.

Changing methods

When a taxpayer changes from the cash basis method to an accruals basis method of determining when income is derived, some income will not be taxed as ordinary income (*Henderson v. FCT*). In the cash basis year (Year 1), the taxpayer derives only what was received. In the accruals basis year (Year 2), the taxpayer derives what was earned, evidenced by fee notes or invoices issued. The fee notes or invoices that are outstanding at the end of Year 1 are not derived in Year 1 (because no cash is received during the year) or in Year 2 (because the fee notes or invoices were not issued during the year).

However, a capital gain may arise because the debts have no cost base (i.e. the provision of services does not constitute the giving of money or property – see TD 2) and the capital proceeds will be the amount received. Section 118-20 would not reduce this capital gain because no amount would be included in assessable income (see ATO ID 2014/1).

Therefore, taxpayers should be careful not to get too fixed on old cases which were relevant at the time. Many old cases on income now need to be 're-evaluated' in light of the introduction of capital gains tax (see Unit 4) and the taxation of financial arrangement provisions (see Unit 13). When a taxpayer changes from cash to accruals, the old income tax cases may say that some amounts are tax-free. However, the capital gains tax rules would supersede this.

On the other hand, where a taxpayer changes from the accruals basis method to the cash basis method, some income may be taxed twice. However, it is arguable that s. 6-25 operates to prevent double taxation.

The cash and accruals basis methods are illustrated by the following simple example.

Example – Derivation of sales and trade debtors

The taxpayer had the following sales and trade debtor transactions. The calculation of assessable income for the income year ended 30 June 2019 under the cash basis and accruals basis is:

	Transactions $	Cash basis $	Accruals basis $
Cash received	180,000	180,000	180,000
Debtors (opening balance)	(12,000)		(12,000)
Debtors (closing balance)	15,000		15,000
Assessable income		180,000	183,000

Where the taxpayer uses the accruals basis for tax purposes, the opening debtors balance would have been included in assessable income in the preceding year. Alternatively, where it is appropriate for the taxpayer to use the cash basis for tax purposes (e.g. where the taxpayer is not a company and the taxpayer also uses a cash basis for accounting purposes), the opening and closing debtor balances have no impact on assessable income.

Note: When an accruals taxpayer prepares its reconciliation of accounting profit to taxable income (i.e. the method commonly used by business taxpayers to calculate taxable income), there is **no** adjustment needed for trade debtors (as the accounting treatment and the tax treatment are the same). However, an adjustment is needed for any provision for doubtful debts, which is not deductible for tax purposes until the debts are actually written off as bad (see later in this unit under 'Accounting provisions and reserves' and 'Bad debts').

Common rules for 'derived'

The following table summarises when particular types of ordinary income are derived, based on the legal and accounting principles governing the earning of that income and taking into account the relevant statutory provisions, case law and ATO practices.

Time of derivation of types of ordinary income

Income type	When derived
Salary and wages	On receipt, in accordance with the employment contract or award (*Brent v. FCT*)
Interest (on passive investments)	On receipt. The constructive receipt approach may apply if interest is reinvested (s. 6-5(4))
Interest (on overdue customer accounts)	On an accruals basis (consistent with the trade debtor to which it relates) (TR 98/1)
Interest (financial institutions and other taxpayers with Division 230 financial arrangements)	Under the taxation of financial arrangements (TOFA) rules in Division 230, the accruals basis method is the default mechanism for including interest and other gains on financial arrangements in assessable income. The accruals basis method applies where it is sufficiently certain that there will be a gain over the duration of the arrangement. If this sufficiently certain test is not met, the gain is included in assessable income when the arrangement ends, or the investment is realised. (TOFA is considered in Unit 13)
Rent	On receipt, unless the taxpayer is carrying on a rental business, in which case the accruals basis method may be appropriate. Note that most rental contracts using the accruals basis method require rent to be paid in advance. Where rent is paid in advance and is refundable, the rent would generally only be derived on an accruals basis (refer TR 2002/14)
Dividends	When paid or credited (s. 44 ITAA 1936). A dividend reinvestment plan is treated as a constructive payment by a company of a dividend to a shareholder, followed by an application by the shareholder receiving the dividend to acquire the new shares
Trading income	At the time that a debt becomes due. Where goods are supplied, this income is generally determined on the sale or delivery of the goods even if the goods themselves are paid for by instalments (*J Rowe and Son Pty Ltd v. FCT*). Where goods are sold on lay-by, the income (excluding any non-refundable deposit) is derived when the final instalment is paid and the goods are delivered (TR 95/7). Where there is a dispute over whether an amount is owing, the amount is not considered to have been derived until the dispute is resolved (*BHP Billiton Petroleum (Bass Strait) Pty Ltd v. FCT*)
Professional services	When income is derived depends on whether the services are provided on a cash or accruals basis. This depends on the nature of the services, scale of the business and contractual terms under which the service is provided (TR 93/11). See below for further detail
Agent's commission	When the commission matures into a recoverable debt and the agent is not obliged to take any further steps before becoming entitled to the commission
Long-term construction contract payments (i.e. construction work that extends beyond a year of income)	Two methodologies are accepted by the ATO (TR 2018/3, which is consistent with IT 2450 (withdrawn)): • Basic approach – all progress and final payments received in a year are included in assessable income • Estimated profits basis – allows the taxpayer to spread the ultimate profit or loss on the project over the years taken to complete the contract, provided that the basis is reasonable and is in accordance with accepted accountancy practices

Special rules for 'derived'

Professional services

The appropriate method to use to determine when income from professional services is derived and therefore assessable, has been the subject of a number of cases.

Where a **sole practitioner** is providing services that are dependent on the practitioner's own skill and expertise (e.g. a barrister), it has been held that the cash basis provides an appropriate reflection of when the income is earned (*FCT v. Firstenberg*; *FCT v. Dunn).*

However, in *Henderson v. FCT,* the court held that where the taxpayer is a member of a **large professional practice**, the income is earned by the business structure and business infrastructure rather than by the partner's personal skills and exertion, and therefore that the accruals basis provides a more appropriate reflection of the income derived.

Work-in-progress (WIP)

Work-in-progress (WIP) is the value of services performed where circumstances do not yet allow demand for payment. For example, where work has been carried out by an accounting firm but not yet invoiced to the client, recorded billable hours against the client code are referred to commonly as the practice's WIP. The accounting entry is debit WIP (balance sheet) and credit income (profit and loss).

Where WIP balances are not billed, they are generally not earned and therefore not included in assessable income (i.e. there is no recoverable debt – see *Henderson v. FCT* and TR 93/11). However, where the WIP balances are billable (e.g. where interim bills could have been issued for the work but are held back in breach of the governing contract – note that this would be very rare in practice), the WIP may be earned and therefore included in assessable income.

Example – Derivation of work-in-progress

XYZ, a large accounting practice, has recorded the following services income in its profit and loss for the income year ended 30 June 2019. The WIP balances are unbilled at year end.

Income	**$**
Cash received	180,000
WIP (opening balance)	(12,000)
WIP (closing balance)	15,000
	183,000

The WIP balances generally are not recoverable until invoices are rendered. Therefore, the WIP balances are not included in assessable income in the current income year (i.e. they are included in assessable income in a future income year). Accordingly, XYZ's assessable income for the income year ended 30 June 2019 would only be $180,000.

When XYZ prepares its reconciliation of accounting profit to taxable income, it will need to make the following adjustments for WIP balances:

Reconciliation of accounting profit to taxable income	
	$
Accounting profit	183,000
Less: WIP (closing balance)	(15,000)
Add: WIP (opening balance)	12,000
Taxable income	180,000

Note: There are specific taxation rules that apply where WIP balances are sold or acquired by a taxpayer. These specific provisions are discussed further later in this unit.

Income received in advance (unearned income)

Where a taxpayer using the **accruals basis** receives income in advance (e.g. for services that have not yet been delivered), the income **may not** be considered to have been **derived** until such time as the **services have been rendered** (*Arthur Murray (NSW) Pty Ltd v. FCT*; *Country Magazine Pty Ltd v. FCT*). The time of derivation will depend, however, on the terms of the particular contract under which the amount is received **and** how the amount is recognised for accounting purposes.

- Where the unearned fees have been recognised on the balance sheet for accounting purposes **and** the fees are refundable either in cash or by way of damages, the income will **not** be derived (see TR 2014/1).
- Where the unearned fees have been recognised as part of accounting profit for accounting purposes (i.e. the accounting standards record the income as earned), the principle in *Arthur Murray (NSW) Pty Ltd v. FCT* is not applicable. Thus, the income will generally be derived.

Example – Derivation of income received in advance (unearned income)

XYZ provides music lessons and has recorded the following income in its profit and loss for the income year ended 30 June 2019. The unearned income balances are for music lessons that have been paid for in advance (i.e. have not yet been provided) and are refundable.

Income for accounting purposes	**$**
Cash received	180,000
Unearned income (closing balance)	(15,000)
Unearned income (opening balance)	12,000
	177,000

The income from music lessons is not earned (and therefore not derived) until the music lessons are provided. The opening unearned income balance would have been excluded from assessable income in the prior year (as it relates to lessons provided in the current income year). The closing unearned income balance should be excluded from assessable income in the current year (as it relates to lessons being provided in the next income year). Accordingly, XYZ's assessable income for the income year ended 30 June 2019 is $177,000.

When XYZ prepares its reconciliation of accounting profit to taxable income (i.e. the method commonly used by business taxpayers to calculate taxable income), it will have **no** adjustment for unearned income balances (i.e. as the tax and accounting treatment are the same).

Reconciliation of accounting profit to taxable income	
	$
Accounting profit	177,000
Add/less: Unearned income adjustment	0
Taxable income	177,000

Worked example 1.2: Derivation of income

[Available online in myLearning]

Capital receipts

As noted earlier, capital is not income according to ordinary concepts. The courts have made a key distinction between income and capital (also referred to as the distinction between amounts received on 'revenue' and 'capital' account). This distinction was particularly important prior to the introduction of CGT in 1985. However, the inclusion of a net capital gain as an amount of statutory income (see later in this unit) did not reduce the importance of this distinction.

Key differences in tax treatment for income and capital receipts

Why it remains important to distinguish income from capital is outlined in the table below.

Key differences in tax treatment for income and capital	
Income	**Capital**
Usually taxed when income is derived. Income is taxed on an accruals basis when: • the taxpayer is in business and uses the accruals basis method, or • the accruals basis method applies to a Division 230 financial arrangement	Capital gains only arise when a CGT event happens (usually only realised gains are taxed)
No discounting for gains of an income (revenue) nature	Capital gains on assets held for more than 12 months attract a CGT discount when made by: • Resident individuals • Complying superannuation funds • Trusts • Non-resident individuals and trusts on or before 8 May 2012
A limited range of income is treated as exempt income, or NANE income	Capital gains on certain assets are: • reduced (e.g. a gain on the sale of shares in an active offshore subsidiary may be reduced by up to 100%), or • disregarded (e.g. the family home of a resident individual, collectables acquired for $500 or less, personal use assets acquired for $10,000 or less etc.)
Limited scope for deferring recognition of income	Recognition of a capital gain may be deferred where CGT rollover relief is available (e.g. the incorporation of a business, a scrip-for-scrip takeover, a demerger, the transfer of assets due to a marriage or relationship breakdown)
A tax loss carries forward and can be claimed as a deduction against both net capital gains and other types of assessable income made in future years	Only a net capital gain is included in assessable income A net capital loss is carried forward and can only be used to reduce capital gains made in future years. It cannot be claimed as a deduction against other types of assessable income made in future years

Characteristics of a capital receipt

The characteristics of a capital receipt (as opposed to an income receipt) are set out below, together with examples taken from leading tax cases. No one factor will be determinative and much depends on the circumstances of each case.

Characteristics of a capital receipt	
Characteristic	**Leading case example**
Gain relating to a one-off or non-recurring event (e.g. the transfer or surrender of **part of the profit-earning structure**)	*Californian Oil Products Limited (in liq.) v. FCT* By mutual consent, the taxpayer's exclusive agency agreement with a supplier was cancelled and the taxpayer received £70,000, which was payable in 10 equal half-yearly instalments. The payments related to the complete cessation of the taxpayer's business and were held by the High Court to be a capital amount (**Note:** If the instalments had included an interest component, that portion would have been assessable)
Amount received for a **restrictive covenant or sterilisation of an asset**	*Dickenson v. FCT* The taxpayer owned a petrol station. He was approached by Shell Oil Company to become a tied distribution outlet, selling only Shell products. Dickenson received two payments of £2,000 for entering into a restrictive covenant (i.e. he agreed not to trade at any non-Shell site within a five-mile radius for the following five years). The High Court held that the payments were not assessable. The taxpayer's 'business constituted a profit yielding organisation of a definite structure under his control and he received the money as part of an inducement to change a feature of it'
Gain resulting from **merely realising** an investment in the most advantageous way	*Scottish Australian Mining Co Limited v. FCT* The taxpayer was formed for the purpose of mining coal and purchased land in 1863 to carry on that business. After mining operations ceased in 1924, the taxpayer subdivided the land; built roads and a railway station; made sites available for schools, churches and parks; and sold the subdivided parcels at a considerable profit. The court held that the profits should not be included in assessable income. The taxpayer had not acquired the land for the purpose of profit-making by sale, nor was it engaged in the business of selling land. It had merely taken 'the necessary steps to realise the [value of the] land to the best advantage' Contrast with: *FCT v. Whitfords Beach Pty Ltd* The taxpayer was formed in 1954 by a group of fishermen and acquired land next to shacks owned by the fishermen to provide beach access. In 1967, three land development companies purchased all the shares in the taxpayer with the intention of developing, subdividing and selling the land (the company's constitution was changed accordingly). The land was re-zoned and substantial profits were made from the sale of subdivided blocks. The court held that the profits were assessable. The taxpayer's acquisition by land developers transformed it from a company that held land for domestic purposes to a company whose purpose was to engage in a commercial venture with a view to making a profit. The sale of the land went beyond merely realising a capital asset: its activities constituted the carrying on of a land development business
Amount received as lump-sum compensation in relation to an asset	*McLaurin v. FCT* The court held that damages paid by way of an undissected lump sum (which may include income items and capital items) will be treated as capital in the hands of the recipient
Isolated transaction and not carrying on a business	*Westfield Limited v. FCT* Westfield Limited (Westfield) built, owned and operated shopping centres. It acquired land for this purpose, but later sold it at a profit to AMP Limited (AMP) on the basis that AMP would engage the taxpayer to design and construct the shopping centre. The court held that the profit was not assessable as ordinary income. At the time it acquired the land, Westfield intended to develop the land, not realise a profit from selling it Contrast with: *FCT v. Myer Emporium* The court found ample evidence that the taxpayer entered into the transaction with a profit-making purpose. Thus, despite being an isolated transaction the gain was held to be income (see earlier in this unit under ordinary income)

Characteristics of a capital receipt	
Characteristic	**Leading case example**
Isolated transaction and not carrying on a business (cont.)	*Greig v. FCT* Mr Greig acquired shares with the intention of making a profit on their disposal, however subsequently sold those shares at a substantial loss. The court held that the taxpayer's intention to make a profit was not of significance in determining the existence of a business. That hope or expectation did not make the purchase of shares a business operation or commercial transaction. He did not conduct his affairs in the required manner. The taxpayer's portfolio of shares was managed by his advisers who treated them on capital account. It could not be concluded that the taxpayer had the subjective intention of himself dealing in the shares as opposed to investment. Therefore, his loss on disposal was a capital loss and not an allowable deduction under s. 8-1

Example – Profit-making intention

Peter Smith is an individual taxpayer. Peter sells shares he acquired with the intention of making a short-term gain. He did not acquire his shares as part of a business or commercial transaction. On selling the shares he actually makes a loss. Following the principle in *Greig v. FCT* it is unlikely that the shares are held on revenue account. Rather they are held on capital account and the loss is a capital loss.

In contrast, assume the same facts as above, however the taxpayer acquired his shares as part of a business or commercial transaction. Following the principle in *FCT v. Myer Emporium*, as the shares were acquired with the intention of making a short-term profit on sale they are held on revenue account (and not capital). Therefore, the loss is deductible under s. 8-1.

Worked example 1.3: Income versus capital receipts
[Available online in myLearning]

Statutory income

The second element of assessable income under s. 6-10 is statutory income. Statutory income includes amounts that are specifically included under the Acts.

Where an amount could be included as either statutory income or ordinary income, the more specific statutory income provision prevails (see s. 6-25). This is particularly relevant where there is a difference in the method of calculation of the amount that would be included in assessable income.

The most common example of statutory income is a **net capital gain** under s. 102-5. This is discussed in detail in Unit 4.

The following types of statutory income are considered later in this unit under particular types of income:

- A gain resulting from a profit-making undertaking.
- The disposal of a leased car for a profit.
- Sale of work-in-progress amounts.

Section 6-10 also provides a list of other types of statutory income.

Required reading
Section 6-10 ITAA 1997.

Non-assessable income

There are two types of income that are not assessable when determining the assessable income of an entity. These are exempt income and non-assessable, non-exempt (NANE) income. These two terms have different meanings and are mutually exclusive (s. 6-20(4)).

Exempt income

Exempt income is an amount that is classified as either ordinary income or statutory income, but is exempt from income tax under tax or other legislation (s. 6-20).

Therefore, exempt income is excluded from assessable income. However, net exempt income is taken into account in specific circumstances – for example, when calculating:

- a current year tax loss (s. 36-10)
- a prior year tax loss that can be claimed in the current year (ss 36-15 to 36-20).

ITAA 1997 contains two classes of exempt income:

Entity is exempt; therefore, type of income is irrelevant (s. 11-5)	**Ordinary or statutory income that is exempt (s. 11-15)**
These are organisations endorsed as tax-exempt by the: • ATO • Australian Charities and Not-for-Profits Commission (ACNC) Examples: • Charities (e.g. Australian Red Cross) • Public educational institutions (e.g. The University of Sydney)	Examples: • Interest on a judgement debt involving damages awarded for a personal injury claim (s. 51-57) • Benefits exempt under the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986) (s. 23L(1A) ITAA 1936) • Non-cash business benefits under s. 21A ITAA 1936 that are valued (in total) at $300 or less (s. 23L(2) ITAA 1936) (discussed later in this unit) • Pay and allowances to members of the Australian Army, Naval or Air Force Reserves (s. 51-5 Item 1.4) • Periodic maintenance payments made to a former spouse or a child (s. 51-50(2)) • Specified types of government pensions, benefits and allowances (Division 52)

A detailed understanding of all the listed items in s. 11-15 is outside the scope of the TAXAU module. However, this list of exempt ordinary and statutory income should be reviewed.

Required reading

Section 11-15 ITAA 1997.

Section 23L(1A) ITAA 1936.

NANE income

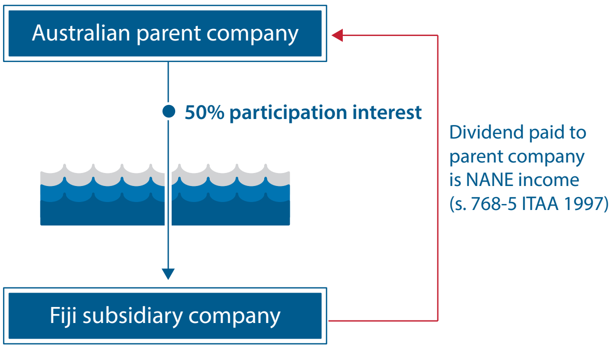
The expression 'non-assessable non-exempt income' has been carefully crafted so that where a taxpayer derives NANE, the income is:

- not assessable (i.e. not taxed), and
- not exempt, which means it is not taken into account – for example, when calculating a tax loss or claiming prior year tax losses.

Some examples of NANE income that you should be familiar with are:

- A fringe benefit under the FBTAA 1986 (s. 23L(1) ITAA 1936). Fringe benefits tax is analysed in detail in Unit 3.
- A 'non-portfolio' return (e.g. dividend) paid by a foreign company to an Australian resident company – that is, where the recipient company holds a participation interest of at least 10%

in the foreign company and the return relates to an instrument that is treated as an equity interest under the debt–equity rules (s. 768-5 ITAA 1997). This exemption is illustrated by the following diagram.



The treatment of non-portfolio dividends is analysed in detail in Unit 14 and the debt–equity rules in Unit 13.

- GST payable on a taxable supply (s. 17-5(a) ITAA 1997) – as discussed below.

Section 11-55 lists provisions from ITAA 1997 and ITAA 1936 that categorise certain amounts as NANE. A detailed understanding of all the listed items is outside the scope of the TAXAU module. However, the list of NANE income items should be reviewed.

Required reading

Section 11-55 ITAA 1997.

Section 23L(1) ITAA 1936.

Interaction between GST and assessable income

Taxpayers who supply goods and services to which GST applies receive payments that include a GST component. The GST component is collected on behalf of the government and is therefore treated as NANE income in the hands of the taxpayer (s. 17-5(a)).

Example – Assessable income and GST interaction

Big Time Inc. (BT Inc.) is a non-resident company operating a business in Australia that is registered for GST. BT Inc. receives the following amounts during the year ended 30 June 2019:

- Income from sales and other transactions from wholly overseas sources: $560,000.
- Income from sales in Australia: $165,000, of which the GST component is $15,000.

As BT Inc. is a non-resident, it is only taxable in Australia on its Australian-sourced income. The income from overseas sources is exempt under ss 6-5(3) and 6-10(5).

The sale of goods in Australia includes a GST amount of $15,000. This amount is NANE under s. 17-15.

BT Inc.'s assessable income for Australian taxation purposes is $150,000 for the year ended 30 June 2019.

Required reading

Section 17-5(a) ITAA 1997.

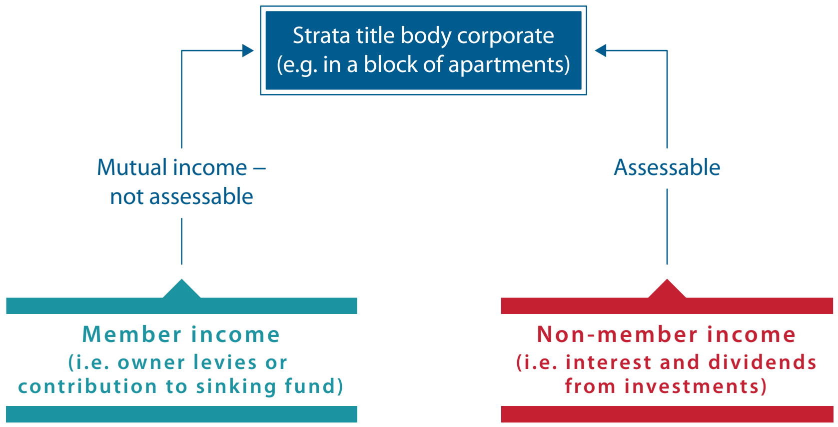
Mutuality principle

The mutuality principle recognises that a person cannot make a profit when dealing with themselves. In the same way that transferring funds from a business bank account to a personal bank account that is held by the same individual does not result in income, where a group of individuals has contributed to a common fund for a common purpose and the monies are returned to the contributors when such a fund is wound up, any transactions between those individuals (or members) and the fund does not create income (*Bohemians Club v. Acting FCT*).

There must be a clear 'identity' as a class between the members who contributed to the fund and those who are entitled to a distribution when it is wound up (*Coleambally Irrigation Mutual Cooperative Ltd v. FCT*).

Note that the mutuality principle does not apply where members are trading with the organisation with a view to it making a profit (*FCT v. Australian Music Traders Association*). The principle also does not apply to non-member or investment income.

A strata title body corporate – which is comprised of the owners of units in, for example, an apartment block – provides a practical example of how the mutuality principle applies.



Specific provisions in the tax legislation may override the application of the mutuality principle, including:

- Part III Division 9 ITAA 1936, which sets out a statutory regime that applies to cooperative companies and mutual insurance companies.
- Division 50, which provides that the income of a range of various organisations, including mutual organisations that are established for certain purposes, is exempt from income tax.

Particular types of assessable income

Non-cash business benefits

Scope

Section 21A ITAA 1936 was enacted to counter the decision in *FCT v. Cooke & Sherden* which held that amounts that are not convertible to cash are not ordinary income. Assuming the benefit would otherwise be of an income nature, s. 21A(1) ITAA 1936 treats any non-cash business benefit that is not convertible to cash as if it was convertible to cash.

There are a number of points to note about this section:

- Section 21A(1) ITAA 1936 **only applies to 'non-cash business benefits'**. This is defined as 'property or services provided … wholly or partly in respect of a business relationship' (s. 21A(5) ITAA 1936), which means that s. 21A ITAA 1936 is not applicable in every situation. For example, a benefit provided by a non-business landlord to a residential tenant would not attract s. 21A. This is further illustrated by the following examples.

Examples – Non-cash benefit rules

The following rules apply to non-cash benefits that are not convertible to cash.

Example	Type of relationship	Rule
A television company sends the managing director of one of its clients, a leading advertising agency, to Hollywood for the launch of the new season's television programs	Business	Business-to-business non-cash benefit – consider whether s. 21A ITAA 1936 applies (subject to the 'otherwise deductible rule' – see below)
A television company sends its marketing director to Hollywood for the launch of the new season's television programs	Employee	Employer-to-employee non-cash benefit – s. 21A ITAA 1936 does not apply. Consider whether FBT applies
A television company sends the top student at the National Institute of Dramatic Art (NIDA) to Hollywood for the launch of the new season's television programs	Neither business nor employee	No business or employee relationship – consider whether the prize is ordinary income under s. 6-5 (if it is not convertible to cash, the prize cannot be treated as ordinary income)

- Subsection 21A(1) ITAA 1936 ensures that the non-cash business benefits **that would otherwise be income**, that were held in *FCT v. Cooke & Sherden* not to be ordinary income because they were not convertible to cash, will now be **treated as if they were convertible**. Section 21A does not deem a non-cash benefit to be income, it just makes it convertible to cash.
- The value of the non-cash business benefit is the **arm's-length value less any contribution** by the recipient towards the benefit (s. 21A(2) ITAA 1936).
- The amount deemed to be convertible to cash under s. 21A(1) ITAA 1936 is **reduced by** any portion of the benefit:
  - For which the recipient, had they paid for the benefit, would be entitled to a **one-off deduction** (i.e. 100% immediate deduction) (s. 21A(3) ITAA 1936). For example, depreciating assets costing less than the immediate deduction threshold (see Units 5 and 6) and other operating expenses deductible under s. 8-1. Note: TR 2013/6 considers the one-off deduction but in the context of the fringe benefits tax provisions (see Unit 3).
  - That the provider treats as '**non-deductible entertainment expenditure**', as defined in s. 21A(5) ITAA 1936 (see s. 21A(4) ITAA 1936). This definition relates back to s. 32-5 (see discussion later on in this unit).

Exclusions

If the total amount of benefits received during a year under s. 21A(1) ITAA 1936 (i.e. net of the above reductions) does not exceed $300, the benefit will be exempt from tax (s. 23L(2) ITAA 1936). However, if it does exceed $300, none of the amount is exempt.

Calculation method

The following example illustrates how to calculate the amount included in a taxpayer's assessable income.

Example – Non-cash business benefits

Gordon Jones is a medical practitioner who is not a small business entity. Gordon has been approached by the representative of a drug company to prescribe its drugs. During the year ended 30 June 2019, the drug company has provided the following incentives to Gordon:

- Ten thermometers and tongue depressors printed with the company logo (value: $200).
- Sample packs of prescription medication, which Gordon distributes to patients who cannot afford to purchase the medication (value: $3,000).
- A $250 gift voucher to a local bookshop, which Gordon used to purchase a medical reference book ($100) that is updated annually, as well as books on gardening ($150).

Gordon also moved into new business premises during the year ended 30 June 2019. To encourage Gordon to sign the new lease, the landlord provided the following business-related incentives to Gordon:

- Two months free rent (value: $5,000 per month).
- A photocopier (value: $2,000). Gordon has included the photocopier in his fixed asset register.
- Premium tickets to a major sporting event (value: $1,000). The tickets cannot be transferred to anyone else and are solely for the benefit of Gordon and his family.

A number of non-cash business benefits have been provided to Gordon by the drug company and his lessor. Because these are in relation to a business relationship, s. 21A ITAA 1936 potentially applies.

The amount included in Gordon's assessable income for the year ended 30 June 2019 is calculated as follows:

Item	**$**
Total value of non-cash business benefits	16,450
Less: Section 21A(3) – a once-only deduction would be available if the taxpayer had purchased these benefits	
• Thermometers < $100[1]	(200)
• Medicines	(3,000)
• Medical book	(100)
• Rent	(10,000)
Less: Section 21A(5) – non-deductible entertainment to the provider	
• Sporting tickets	(1,000)
Subject to s. 21A	2,150

Note

1. The ATO allows small items that have a GST-inclusive value of $100 to be claimed as an outright tax deduction (see PS LA 2003/8).

The amount deemed to be convertible to cash is not reduced for the following items:

- Gardening books – as they are private expenditure.
- Photocopier – Gordon would be entitled to a depreciation (decline in value) deduction had he paid for the benefit. However, as depreciation is not a once-only deduction, the reduction under s. 21A(3) does not apply.

As the balance in this case is not less than $300 (note that the total benefits need to be aggregated), the amount is not exempt from tax under s. 23L(2) and would be included in Gordon's assessable income under s. 6-5.

Required reading

Sections 21A and 23L(2) ITAA 1936.

Reimbursement of deductible expenditure

There is no general principle that the reimbursement of a previously deductible amount is assessable (*FCT v. Rowe*).

However, consideration should be given to whether such a payment is:

- ordinary income, or
- statutory income, either under:
  - a specific provision, or
  - the statutory recoupment rules in Subdivision 20-A.

The approach that should be adopted for the reimbursement of deductible expenditure is best illustrated by the following examples:

Reimbursement of deductible expenditure	
Treatment	**Example**
Ordinary income (s. 6-5)	ABC Accountants (ABC) pays an annual premium for professional indemnity insurance. This is clearly a business-related expense and is deductible. Based on ABC's claims history, the insurance company later pays a premium rebate to ABC. The transaction giving rise to the rebate is itself a part of ABC's day-to-day business, giving the rebate the character of ordinary income
Statutory income (specific provision)	Peter works for ABC and is reimbursed on a cents-per-kilometre basis because he sometimes drives his own car to a client's premises to undertake audit work. Section 15-70 includes the reimbursement in Peter's assessable income (Note: FBT does not apply to cents-per-kilometre reimbursements – see s. 22 FBTAA 1986) Peter can claim a deduction for work-related car expenses (which will be covered later in the unit)
Statutory recoupment rules (Subdivision 20-A) Under s. 20-20(1), these rules only apply if the amount is not: • Ordinary income • Statutory income under a specific provision	ABC successfully contests an FBT dispute with the ATO and receives a refund for overpaid tax. The earlier FBT payment would have given rise to a tax deduction for ABC under s. 8-1. The ATO refund is an assessable recoupment (s. 20-20(3), read together with item 1.2 of the table in s. 20-30(1) and with s. 20-35(1)) Instead of paying the FBT refund, if the ATO applied it against ABC's other tax liabilities, the refund would be derived under the constructive receipt approach (s. 6-10(3))

Disposal of a leased car for a profit

Scope

Where a taxpayer makes a profit on the disposal of a leased car that was used for income-producing purposes, an amount will be included in assessable income under s. 20-110. The aim of the provision is to claw back previous deductions for car lease payments where the lessee acquires the car from the lessor and subsequently sells it at a profit.

A car is defined in s. 995-1(1) as a motor vehicle, other than a motorcycle, designed to carry less than a one-tonne load and fewer than nine passengers.

The profit is the consideration receivable on the car's disposal less the cost of the car and any capital expenditure incurred on it after it was acquired (s. 20-115).

Calculation method

The amount that is included in assessable income is the lower of the:

- Actual profit.
- Total lease payments that were deducted over the term of the lease (s. 20-110(2)(a)).
- Notional depreciation for the lease period (s. 20-110(2)(b)), which is calculated under s. 20-120 as:

$$\left[\text{Lessor's original cost} - \text{Lessor's termination value}\right] \times \frac{\text{Number of days in the lease period}}{\text{Number of days the lessor owned the car}}$$

Example – Sale of a previously leased motor vehicle

Colin Anderson (Colin) leases a new car for a period of 48 months. The lease charges are $500 per month. Colin uses the car 60% for business purposes and 40% for private purposes. After four years, on termination of the lease, Colin acquires the car from the lessor for $11,000 and immediately sells it for $25,000. The cost of the car to the lessor at the commencement of the lease was $22,000.

As the car was previously leased, Colin needs to calculate the assessable amount (if any) resulting from the disposal under s. 20-110. The assessable amount is the lesser of the following:

- the amount of the notional depreciation deemed to have been allowed = $11,000, calculated as follows (s. 20-120):

Per s. 20-120 method statement	**$**
Deemed cost of car to Colin (actual cost to lessor)	22,000
Less: Lessor's termination value	(11,000)
Excess	11,000
Multiplied by	× 1,460 days ÷ 1,460 days
Notional depreciation	11,000

- the deductible lease charges: $500 × 48 × 60% business use = $14,400
- the actual profit made: $25,000 – $11,000 = $14,000

As the amount of notional depreciation of $11,000 is the lowest of the three calculations above, it is this amount that is assessable under s. 20-110.

Gain or loss resulting from a profit-making undertaking

Assessable income specifically includes the profit arising from carrying out a profit-making undertaking or plan (s. 15-15). Conversely, a loss in such circumstances is deductible (s. 25-40).

However, s. 15-15 does not apply:

- to property acquired on or after 20 September 1985 (i.e. assets subject to CGT), and
- where the profit is ordinary income (i.e. assessable under s. 6-5).

Section 15-15 may apply if an entity entered into a profit-making undertaking or plan for property acquired pre-CGT.

Similarly, losses on sales of post-CGT property would be deductible under s. 8-1 where there was a profit-making undertaking or plan. Section 25-40 only applies to a sale of pre-CGT property.

Required reading

Sections 15-15 and 25-40 ITAA 1997.

Sale of work-in-progress (WIP) amounts

Scope

Under s. 15-50, an amount that is received from the sale of WIP to another entity will be included in the assessable income of the recipient (i.e. the seller) in the income year in which it is received.

WIP is the value of **services performed** where circumstances do not yet allow demand for payment. For example, where work has been carried out by an accounting firm but not yet invoiced for, recorded billable hours against a client code are commonly referred to as the firm's WIP. WIP does **not include goods** that are in the process of being manufactured.

See later in this unit for discussion on the deductibility of amounts paid for the acquisition of WIP, and Unit 9 for the application of the WIP provisions to changes in partnership interests.

Calculation method

The following example illustrates the calculation of the amount included in assessable income.

Example – Sale of work-in-progress amount

Camp Pty Ltd, an Australian resident company, operates a number of repair businesses and sells spare parts. During the current income year, it sold a small repair business. As part of the sale, it sold unbilled WIP of $30,000.

Under s. 15-50, Camp Pty Ltd's assessable income includes the $30,000. Assuming the $30,000 has been included in Camp Pty Ltd's accounting profit, no adjustment will be required when it prepares its reconciliation of accounting profit to taxable income for the current income year.

Note, if the sale occurred on 30 June 2019, the gain would be assessable in the 2019 year. However, if the sale occurred on 1 July 2019, the gain would be assessable in the following year.

Required reading

Section 15-50 ITAA 1997.

Other types of statutory income

Section 10-5 provides a summary list of the legislative provisions that require certain income amounts to be included in the assessable income. A detailed understanding of all the listed items is outside the scope of the TAXAU module. However, this list should be reviewed.

A range of other statutory income provisions that you should be familiar with are discussed in various units in the TAXAU module, including the following.

Signpost to statutory income provisions in the TAXAU module			
Act	**Provision**	**Details**	**TAXAU unit**
ITAA 1997	s. 15-2	Allowances and other things provided in respect of employment and services • Includes gratuities, compensation, bonuses, etc. • Excludes amounts assessable under another statutory income provision or ordinary income under s. 6-5	Later in this unit and Unit 3
	s. 15-10	Bounties and subsidies included in assessable income when received in carrying on a business	Unit 16
	s. 15-20	Royalties included in assessable income when received	Unit 14
	s. 15-35	Interest on overpayments and early payments of tax	Later in this unit
	s. 15-70	Reimbursed car expenses	Unit 3
	s. 40-285	Gain on disposal of a depreciating asset	Unit 5
	s. 70-35(2)	Trading stock – assessable income arises if the value of opening stock is less than the value of closing stock	Later in this unit
	Division 82/s. 82-130	Employment termination payments	Unit 3
	Division 83A	Employee share schemes	Unit 3
	s. 102-5	Net capital gain	Unit 4
	s. 230-15	Gain on a Division 230 financial arrangement	Unit 13
	Divisions 301–307	Superannuation benefits	Unit 11
	s. 775-15	Foreign exchange gains	Unit 13
ITAA 1936	s. 44	Dividends	Unit 8
	s. 47	Distributions by liquidator	Unit 4/Unit 8
	Division 5/s. 92	Partnership income, and treatment of partners	Unit 9
	Division 6/s. 97	Trust income, and treatment of beneficiaries	Unit 10
	s. 109	Deemed dividends – excessive payments by a private company to shareholders or associates	Unit 8
	Division 7A	Deemed dividends – disguised profit distributions by a private company to shareholders or associates	Unit 8
ITAA 1997 and ITAA 1936	Various	Foreign-sourced income and gains made by Australian resident taxpayers	Unit 14

Required reading

Section 10-5 ITAA 1997.

Allowable deductions

Overview

Deductions can arise in one of two ways:

- General deductions (s. 8-1).
- Specific deductions (s. 8-5) – provisions that allow specific deductions are listed in s. 12-5.

Certain amounts are not allowed as deductions even though they may otherwise fall within the allowable deduction rules (s. 8-5(2)).

Where an amount could be deductible under two different provisions, the most appropriate provision applies and the amount cannot be claimed twice (s. 8-10).

General deductions

Scope

Section 8-1 is often described as having:

- Two **positive limbs**, which allow a deduction (s. 8-1(1)).
- Four **negative limbs**, which deny a deduction (s. 8-1(2)).

Positive limbs – s. 8-1(1)	Explanation
A taxpayer can deduct from their/its assessable income any loss or outgoing to the extent that it is: • incurred in gaining or producing the taxpayer's assessable income (s. 8-1(1)(a)), or • necessarily incurred in carrying on a business for the purpose of gaining or producing the taxpayer's assessable income (s. 8-1(1)(b))	• The first part of this limb is applicable for non-business taxpayers. It requires a 'direct nexus' between the expense incurred and the assessable income derived • The second part of this limb relates to business taxpayers. There is no direct nexus requirement for businesses

Negative limbs – s. 8-1(2)	Explanation
However, a taxpayer cannot deduct a loss or outgoing under s. 8-1 to the extent that it is: • capital, or of a capital nature (s. 8-1(2)(a)) • of a private or domestic nature (s. 8-1(2)(b)) • incurred in relation to exempt income or NANE income (s. 8-1(2)(c)), or • prevented from being claimed as a deduction by a provision in the tax legislation (s. 8-1(2)(d))	• Capital expenditure might need to be considered under another income tax provision. For example: – CGT assets (see Unit 4) – Depreciating assets (see Unit 5) – Capital works – buildings and structural improvements (see Unit 5) – Blackhole expenditure (see Unit 5) • Specific deduction provisions can override the general deduction provision to allow a deduction otherwise prevented, deny a deduction otherwise allowed, impose addition conditions that must be satisfied, or limit the amount that can be claimed. (See discussion later in the unit)

There are a few preliminary points to note about s. 8-1 before exploring these limbs in detail:

- **An expense does not need to be specifically matched to assessable income that is produced in the same year as the expense.** Subject to special rules dealing with prepayments, the question is whether there is a connection (or nexus) between the expenditure and the taxpayer's income-producing activity (*FCT v. Smith*). The following example illustrates this connection.

Example – General deduction under s. 8-1: Salary continuance insurance

In *FCT v. Smith*, the taxpayer was a medical practitioner who was injured in a car accident. At the time of the accident, he was employed at a hospital and his injuries prevented him from working for several months.

Fortunately, he had personal disability insurance cover and under this policy he received payments during the period of his incapacity. The Commissioner assessed him on this payout, but denied a s. 8-1 deduction for the insurance premium for the same income year. One of the Commissioner's arguments was that there was an insufficient nexus between the premium payment and income, because a supervening event (such as an accident or disability) needed to occur before any income was paid under the insurance policy.

The High Court ruled in favour of the taxpayer by holding that:

- Section 8-1

  > … does not require that the purpose of the expenditure shall be the gaining of the income of that particular year, so long as it was made in the given year and is incidental and relevant to the operations or activities regularly carried on for the production of income.

- Although the payment of the premium in an income year did not result in any income being generated in that year, there was 'a sufficient connection between the purchase of the [insurance] cover against the loss of ability to earn and the consequent earning of assessable income to bring the premium within the first limb of s. 8-1'.
- What is 'incidental and relevant' is:

  > … determined not by reference to the certainty or likelihood of the outgoing resulting in the generation of income but to its nature and character and generally to its connection with the operations which more directly gain or produce the assessable income.

- There was a clear connection between the expenditure (i.e. insurance cover purchase) and the medical practitioner's employment.

- **Section 8-1 does not dictate how much expenditure the taxpayer ought to incur.** Rather, the key issue is whether the expenditure directly or indirectly relates to the taxpayer's income-producing activities or business (*Ronpibon Tin NL v. FCT*). However, where expenditure is grossly excessive compared to the income derived, the courts will examine the subjective purpose of the taxpayer in incurring the expenditure to see if there is a non-commercial motive (*Fletcher v. FCT*).
- Section 8-1 applies to a '**loss or outgoing**'. A loss tends to be an amount that is incurred involuntarily (e.g. the theft or destruction of an asset), or that has no reciprocal benefit. A taxpayer has a greater measure of control over an outgoing, which usually results in a reciprocal benefit (e.g. publicity, employee satisfaction, etc.).
- Section 8-1 uses the term '**incurred**' to determine the point in time at which a deduction arises, so that the deduction claim can be allocated to the correct income year. 'Incurred' is not a defined term, but it has been considered by the courts on many occasions. See the analysis provided below on 'incurred'.

Required reading

Section 8-1 ITAA 1997.

When is expenditure 'incurred'?

Expenditure is incurred when the taxpayer is **definitively committed** to the expense, or the liability is **enforceable at law** (*FCT v. James Flood*). The expense does not need to have been paid for, even if the taxpayer determines assessable income on a cash basis. The following is an example:

Example – Incurring business expenses

Fiona is a Chartered Accountant who carries on a business as a sole practitioner with six full-time staff, none of whom is professionally qualified. Fiona takes sole professional responsibility for the practice and signs all statutory certificates. She returns her income on a cash basis of accounting.

In June 2019, she received invoices for a number of the business's expenses, including telephone, stationery and day-to-day motor vehicle costs (e.g. petrol and oil). She paid the invoices in July 2019.

Conclusion: Fiona incurred the outgoings in the income year ended 30 June 2019.

Adapted from: TR 97/7

Note that there are cases in which the courts have referred to the accounting treatment of expenses to determine whether an amount has been incurred, particularly in relation to insurance liabilities (*RACV Insurance v. FCT*; *ANZ Banking Group v. FCT*). In each of these cases, the court found that a legal liability existed even though the liability to pay claims was not yet quantifiable and as such the court was prepared to accept actuarial estimates. This was because the underlying event that triggered the liability occurred and the quantity of the liability was capable of reasonable estimation.

Common rules for 'incurred'

The table below sets out a **summary of criteria** that assist in determining whether an expense has been 'incurred', from key judicial decisions that have considered the meaning of the term.

Criteria to determine whether an expense has been 'incurred' – TR 97/7

Criterion	Explanation
Has the expense been paid?	Actual payment clearly indicates that an expense has been incurred (*FCT v. Lau*). However, the law limits the ability to claim deductions for prepayments in certain circumstances (discussed later in this unit)
If the expense has not been paid, is there a presently existing liability?	To be incurred, there must be a presently existing liability to pay a sum of money (*FCT v. Citylink Melbourne*). For example, a taxpayer who receives a letter from a charity asking for a tax deductible donation has no presently existing liability because payment is made at the taxpayer's sole discretion. Contrast this with, say, an invoice from an electricity supplier: in that case, the electricity has been consumed and a liability does exist There may be a presently existing liability even though it may be defeasible (capable of being annulled or invalidated) by other parties (*Commonwealth Aluminium Corporation Ltd v. FCT*)
Can the liability be reasonably estimated?	Even though the exact amount cannot be precisely determined, as long as it can be reasonably estimated there may be a liability (*ANZ Banking Group v. FCT*)
Is there a genuine dispute over the liability's existence?	Where there is a genuine dispute over a liability's existence, it will generally not be incurred (*Softwood Pulp and Paper Ltd v. FCT*)

Special rules for 'incurred'

Interest expenses

In a loan, the borrowed funds are capital. Interest, however, does not secure an enduring benefit but simply the use of the funds for the term of the loan. Ordinarily, interest is a revenue item (*Steele v. DFCT*).

The following two key tests have been developed by the courts for determining the deductibility of interest under s. 8-1:

- 'Use' test – which considers whether the borrowed funds have been put to an income-producing use (*FCT v. Munro*), although a strict tracing approach is not necessary where one loan replaces another (i.e. refinancing) (*FCT v. Roberts and Smith*).
- 'Purpose' test – which considers the taxpayer's purpose in borrowing the funds, particularly where the interest expense exceeds the income generated (*Fletcher v. FCT*).

Like other outgoings, interest is deductible when incurred (i.e. when a presently existing liability to pay exists), although taxpayers with Division 230 financial arrangements will typically use the default accruals method of accounting for claiming deductions (described below).

Discounts on commercial bills and promissory notes

In *Coles Myer Finance v. FCT,* a case decided before the introduction of Division 230, the High Court considered how deductions should be claimed for the discount on a commercial bill. The court held that discounts on commercial bills and promissory notes were allowed as deductions on a straight-line accruals basis over the term of a financial instrument, being the period to which the discount was 'properly referable' (see example below).

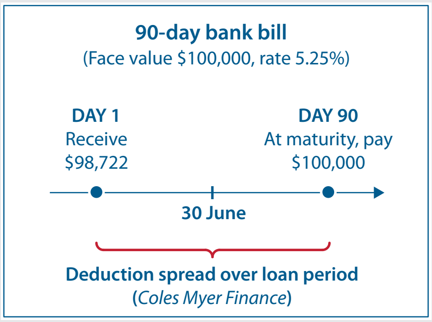
Following this decision, the ATO accepted that the 'properly referable' test applied to all taxpayers (not just financial institutions) claiming deductions for bill discounts (TR 93/21).

Example – Commercial bills

A business taxpayer takes out a bank bill loan on Day 1 with a face value of $100,000 for a period of 90 days. The bank quotes a rate of 5.25%.

Also on Day 1, the taxpayer receives the discounted amount of $98,722. On Day 90, the taxpayer pays the bill holder $100,000.

The total interest charged is $1,278, which is the same as saying that $98,722 has been borrowed for 90 days at 5.25%.



Division 230 financial arrangements

As discussed above in the section on assessable income, the accruals method is the default mechanism for claiming deductions on Division 230 financial arrangements where there is a sufficiently certain obligation that there will be a loss during the period of the arrangement. The taxation of financial arrangements (TOFA) is discussed in Unit 13.

Accounting provisions and reserves

Accounting provisions and reserves are not deductible. Examples include provisions for legal and other expenses, bad debts and leave payments (i.e. annual leave and long service leave in respect of employees).

Although justified by Accounting Standards and prudent business practices, the associated liability cannot be recognised under the tax legislation until the income year in which it satisfies the conditions that give rise to a deduction.

Provisions and reserves – conditions for deductibility of the liability		
Provision	**Condition**	**Reference**
Legal and other expenses	Have these been incurred? If so, are they of a revenue nature?	s. 8-1
Bad debts	Is the debt a **bad** debt? If so, was it written off during the year in which the deduction is being claimed?	s. 25-35 (see later in this unit)
Leave payments	Have these obligations actually been paid?	s. 26-10 (see later in this unit)

In practice, whoever prepares a tax return needs to look carefully at the taxpayer's accounts to identify both the amounts paid or incurred, and the movement in a provision.

'Incurred in gaining or producing assessable income'

Sections 8-1(1)(a) and (b) are the two positive limbs of s. 8-1 that allow deductions.

The courts adopt a pragmatic approach when applying s. 8-1, in order to confine deductions to expenditure that is connected to actual activities that produce assessable income. The phrase 'in gaining or producing' assessable income has been interpreted as meaning 'in the course of gaining or producing' assessable income (*Amalgamated Zinc (De Bavay's) Limited v. FCT*).

Example – Costs incurred in turning up for work

A young accountant spends money on suitable business attire to wear to work. Although dressing to a workplace standard is obviously required, this expenditure is not incurred in the course of doing the work that generates the income.

A similar view is taken on the cost of commuting to and from work, or childcare fees that are paid so that a child is properly cared for while their parents are at work.

These are all expenses that put the taxpayer in a position to earn income, but they are not incurred in the course of earning that income.

Such expenditure may also be private in nature (and excluded under the negative limbs – discussed later in this unit), but they do not satisfy the positive limbs of s. 8-1.

Expenses relating to net capital gains

Although net capital gains are included in assessable income under s. 102-5 ITAA 1997, s. 51AAA ITAA 1936 ensures that expenses incurred in relation to a CGT asset are not, for that reason alone, tax deductible.

Example – Costs relating to a CGT asset

An investor thinks that land on the outskirts of Darwin, an Australian city, will increase in value. She borrows money from a bank and buys several hectares of vacant land, which she does not use to generate any income. Some years later, the land is indeed sold at an increased value and the investor makes a substantial net capital gain. The inclusion of the net capital gain in her assessable income under s. 102-5 does not make the interest paid on the borrowed funds tax deductible (s. 51AAA ITAA 1936). Rather, it forms part of the CGT asset's cost base and is taken into account when calculating the net gain (discussed further in Unit 4).

However, if the land had been used to generate income (e.g. by being rented out to a mining company to store heavy equipment), interest deductions would have been allowed (subject to deduction denial provisions – see later in this unit).

Required reading

Section 51AAA ITAA 1936.

'To the extent'

A deduction is allowed 'to the extent' that it is incurred for a relevant income-producing purpose. This means that dual-purpose expenditure is apportioned (*Ronpibon Tin NL v. FCT*). For example, a journalist's subscription to an internet news service that is used partly for researching articles and partly for private purposes will result in an apportioned deduction that is based on a reasonable estimate of time spent using the service for income-producing purposes (TR 98/14).

It is possible to allow a deduction for a portion of expenditure that is used for mixed purposes (*Ure v. FCT*). Generally, the courts look at the issue of purpose objectively. TR 95/33 discusses how a taxpayer's subjective purpose can be determined where there is more than one purpose for incurring the expenditure (refer *Fletcher v. FCT*). The subjective purpose will be considered when income is less than allowable deductions.

Example – Apportionment of expenditure

In *Ure v. FCT*, Ure borrowed money at a commercial interest rate and on-lent it at a rate of 1% per annum to his wife and a related company. He disclosed the 1% interest as assessable income of $660 and claimed a deduction of $8,736 for the whole of the interest paid to the lenders.

The Federal Court held:

- Ordinarily, 'where the immediate objective achieved by the outgoing is the production of assessable income which is commensurate with the amount of the outgoing', the taxpayer's indirect objectives or motives 'will not prevent the characterisation of the outgoing as having been incurred in earning assessable income'.
- However, if the amount of assessable income produced is not commensurate with the level of expenditure, 'the immediate object or effect' of the expenditure will not be sufficient 'either to explain or to characterise it'. In such cases, the taxpayer's indirect objectives and motives can be decisive in determining whether a deduction should be allowed.

In Ure's case, his indirect objectives and motives were clearly not of an income-producing character, since they involved:

- The provision of accommodation for himself and his family.
- A financial benefit to his wife and a related company.
- A reduction in his personal tax liability.

The court ruled that Ure was only entitled to a deduction of $660 for the interest incurred, this being equal to the amount of interest income he derived from on-lending the borrowed money at a rate of 1% per annum.

'Carrying on a business'

The main difference between the first and the second positive limbs in s. 8-1 is whether the taxpayer is carrying on a business (i.e. s. 8-1(1)(b)).

If the taxpayer is **not carrying on a business**, the deduction is limited to the first positive limb (s. 8-1(1)(a)). That is, there must be a **direct nexus** between earning the income and claiming the deduction. Note that, under the first positive limb, it is accepted that a person does not have to have paid the amount as long as it was actually incurred and there is the relevant connection to earning assessable income (TR 97/7).

If the taxpayer is **carrying on a business**, the requisite nexus between the expenditure and the assessable income is less direct – it is **sufficient** that the expenditure was incurred in the course of carrying on the business. Therefore, whether a person is carrying on a business becomes relevant in determining the deductibility of a loss or outgoing. This is a matter of fact and degree, and the courts will have regard to the specific facts in each case when reaching a decision.

TR 97/11 provides a table of indicators that help identify whether a business is being carried on.

Business indicators (TR 97/11)
Activity has a significant commercial purpose
Taxpayer has more than just an intention to engage in business
Taxpayer has an intention of making a profit and the activity is or will be profitable (*FCT v. Stone*)
Repetition and regularity of the activity (*FCT v. Whitfords Beach Pty Ltd*)
Activity is akin to comparable businesses
Activity is planned, organised and carried on in businesslike manner (*Ferguson v. FCT*)
Size, scale and permanency of the activity (*Thomas v. FCT*; *FCT v. Walker*)
Cannot be described as a hobby, recreation or sporting activity (*Evans v. FCT*)

Note: The ATO has recently released TR 2019/1, which applies similar indicators to help identify whether a business is being carried on.

Non-commercial business loss rules

Even if the taxpayer is carrying on a business, either alone or in partnership, any tax losses arising from that activity may be affected by the non-commercial business loss rules in Division 35.

Division 35 is designed to prevent revenue leakage from individuals who are involved in unprofitable activities. It sets out a series of alternative tests, any one of which must be satisfied in order for the loss from the activity to be claimed as a deduction. If none of the tests are satisfied, the deduction for the loss will be deferred. (Division 35 is discussed in more detail in Unit 7.)

Necessarily incurred in carrying on a business

Under the second positive limb (s. 8-1(1)(b)), an expense has the necessary connection to the business if it is clearly a **part of the usual operations** of the business. That is, the test is one of commercial necessity rather than legal necessity (*FCT v. Snowden & Willson Pty Ltd*). Expenditure that is incurred to reduce future expenses is allowable (*W Nevill & Co. Ltd v. FCT*).

The High Court in *Spriggs and Riddell v. CoT* (a case involving professional footballers) held that a taxpayer can be both an employee and carrying on a business in relation to the same activity.

Pre-commencement and post-cessation expenditure

The indicators of a business activity are particularly relevant in determining whether tax deductions are available in the pre-commencement or winding-up phases of operations.

'The temporal relationship between the incurring of an outgoing and the actual or projected receipt of income may be one of a number of factors relevant' when applying s. 8-1, 'but contemporaneity is not legally essential' (*Steele v. DFCT*). The key issue is whether there is a connection between the expenditure and the income-producing activity. The following examples illustrate two cases where there was no such connection.

Example

In *FCT v. Maddalena*, a professional footballer's costs in securing a job at a new club were incurred too soon to be regarded as incurred in the course of gaining his income

Example

In *FCT v. Riverside Road*, interest on funds borrowed to build a motel ceased to be deductible when the taxpayer sold the motel to a trust, then leased it back

Expenditure **prior** to starting a business or producing income	Expenditure **in the course of** carrying on a business, or from an income-producing activity	Expenditure **after** cessation of a business or income-producing activity

Timeline

The courts have increasingly found in favour of taxpayers who continue to incur expenditure after their business activity has ceased. The following table outlines a selection of these important cases.

Case examples: Expenditure incurred after business activity has ceased – deductions allowed	
Case	**Facts and decision**
Placer Pacific Management Pty Ltd v. FCT	The taxpayer ceased its conveyor belt manufacturing business and claimed a deduction for an out-of-court settlement (and legal costs) relating to claims by a former customer that the taxpayer's conveyor system was defective **Decision:** The 'occasion of the outgoing' to remedy a defective conveyor system was the contract for the supply of the conveyor belt entered into when the business was formerly carried on. The settlement was deductible
FCT v. Brown	The taxpayer took out a loan to acquire a delicatessen, which was later sold at a loss. The sale proceeds were paid to the bank but were insufficient to fully satisfy the liability **Decision:** The 'occasion' of the loss or outgoing (i.e. interest expense) was the bank loan, the purpose of which was to allow the Browns to acquire and carry on the business. The interest was deductible
CoT v. Jones	The taxpayer and her husband took out a loan to fund a trucking business. After her husband's death, Jones sold the business assets to repay the loan but the proceeds were insufficient to repay it and she continued to meet the interest obligations from her salary as a nurse. Later, Jones refinanced the loan with a different lender to obtain a lower interest rate, and claimed a deduction for the interest paid to that lender The Commissioner argued that: • Jones had an opportunity to repay the loan, and her decision not to repay it resulted in the denial of a deduction • Refinancing the loan broke the nexus between the expenditure and the income-producing activity required by s. 8-1 **Decision:** The court rejected both these arguments, and allowed the interest deduction

In TR 2004/4, the ATO accepted that the principle reflected in the *FCT v. Brown* and *CoT v. Jones* decisions extended not just to 'income earning' business activities, but also to passive investments (e.g. interest on a rental property could be deductible if the property is sold for a loss).

Worked example 1.4: Deductibility of interest

[Available online in myLearning]

'Capital, or of a capital nature'

Even if an expense has the necessary connection to assessable income and, prima facie, qualifies as an allowable deduction, it will **not be allowed** as a deduction if it fails any one of the four negative limbs in s. 8-1(2).

A question that arises often in practice is whether a loss or outgoing is capital expenditure or expenditure of a capital nature. The issue is equivalent to the income and capital distinction discussed above. Note, however, that there is no concept of symmetry in Australian tax law: a payment on revenue account may be deductible to the payer, but treated as capital in the hands of the recipient (and vice versa).

The key tests that are applied in determining whether an expense is of a capital nature or revenue were set out in *Sun Newspapers Ltd and Associated Newspapers Ltd v. FCT*. The taxpayer was a newspaper publisher who acquired a rival newspaper from a competitor who also undertook not to compete with Sun Newspapers for a three-year period. The table below outlines these key tests.

Whether capital expenditure or revenue – *Sun Newspapers Ltd and Associated Newspapers Ltd v. FCT*	
Test	**Explanation**
What is the character of the advantage sought?	If the expenditure will result in an enduring benefit to the taxpayer, it is more likely to be of a capital nature
What is the manner in which the advantage is to be used or enjoyed?	If the expenditure was a once-and-for-all benefit as opposed to a short-term benefit, it is more likely to be of a capital nature
What means were adopted to obtain the advantage?	If the advantage was provided by a single lump sum as opposed to a series of recurrent payments, the expenditure is more likely to be of a capital nature. However, if payment for a capital expense is made by instalments, this will not necessarily make it a revenue expense

Leading judicial decisions on the income–capital distinction provide the best guidance on this area of tax law.

Activity 1.3: Revenue versus capital outgoings
[Available online in myLearning]

Treatment of capital expenditure

Once a taxpayer concludes that no general deduction for business expenditure of a capital nature is available, they may consider whether the expenditure relates to:

- A depreciating asset – in which case, it should give rise to a capital allowance deduction under Division 40 (sometimes referred to as tax depreciation) (see Unit 5).
- The construction of an income-producing building or structural improvement – in which case, it should give rise to a capital works deduction under Division 43 (see Unit 5).
- A CGT asset – in which case, the expenditure should form part of the cost base of the asset (see Unit 4).

If none of the above apply, the taxpayer should consider s. 40-880, which provides a deduction for certain types of business 'blackhole' expenditure (see Unit 5).

'Private or domestic nature'

It is important to note the difference between private and domestic expenditure:

- Private expenditure relates to personal expenditure.
- Domestic expenditure relates to a household.

Private or domestic expenditure will rarely satisfy the positive limbs of s. 8-1(1). In this sense, the exclusion of such expenditure in s. 8-1(2)(b) only serves to confirm the **non-deductibility** of expenditure on items such as:

- Childcare to allow a parent to enter the workforce (*Lodge v. FCT*).
- The cost of travel to and from work (*Lunney and Hayley v. FCT*) – although s. 25-100 gives a deduction to a taxpayer who travels between two places where assessable income-earning activities are carried on.

Where a person incurs expenditure of a mixed private and income-producing deductible purpose, the expenditure must be **apportioned** to reflect the private portion of its overall use.

For expenses relating to a **home study** (*Handley v. FCT,* TR 93/30 and PS LA 2001/6), the courts make a distinction between:

- costs that have a direct connection to the home study (e.g. power, heating) – which are deductible on a floor area basis that takes into account the floor area of the study relative to that of the home, and
- occupancy expenses (e.g. mortgage, rent, rates, and home insurance) – which are deductible only if a section of a home is used as a sole place of business (e.g. a doctor's surgery at home). However, claiming occupancy expenses will have CGT implications (see Unit 4).

Some taxpayers have convinced the courts that normally private expenditure is wholly or partly work-related. Examples include:

- Sunscreen, sunglasses and hats for outdoor workers, without which they could not do their jobs effectively in the hot sun (*Morris v. FCT*).
- A larger than normal and more varied wardrobe – In *FCT v. Edwards*, for example, so that the taxpayer could be suitably attired for a broad range of functions in her role as personal secretary to the wife of the Queensland State Governor.

Workers whose occupation requires protective clothing (e.g. builders) or occupation-specific clothing (e.g. chefs) are eligible for s. 8-1 deductions for the cost of their acquisition and cleaning.

Some employers arrange for employees to have access to a range of corporate apparel that carries the employer's name and logo. Provided the uniform design is registered, costs relating to these non-compulsory corporate wardrobes will be deductible under Division 34.

Work-related deductions are discussed further later in this unit.

Treatment of private expenditure – company

As a company typically exists for a business or income-producing purpose, it would be rare for a company's expenditure to be of a private or domestic nature. The main exception occurs where a company is paying a shareholder's personal expenses in circumstances where the company is simply an 'alter ego' of the shareholder. Such expenditure may also give rise to either:

- a deemed dividend (Division 7A ITAA 1936 see Unit 8), or
- a fringe benefit where an employment relationship exists (see Unit 3).

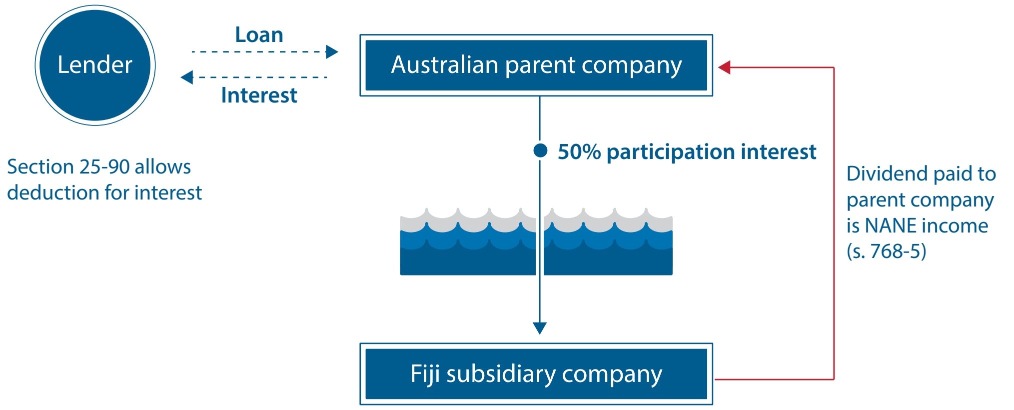
Further, s. 8-1 has a 'built-in' anti-avoidance mechanism in the sense that, where the taxpayer's subjective purpose is to avoid tax rather than derive assessable income, no s. 8-1 deduction is allowed. A company's subjective purpose is ascertained from the views of directors and senior company officers (e.g. as evidenced by minutes of board meetings and other relevant documentation).

'Incurred in relation to gaining or producing exempt or NANE income'

Generally, expenses related to income that is not assessable income are not tax deductible. This applies whether the income is exempt income or NANE income. For example, a member of the Australian Defence Force Reserves will not be eligible for a deduction for uniforms or kit costs because the income they derive is exempt.

In some cases, however, a specific deduction provision allows a deduction notwithstanding that the expenditure relates to income that is not assessable. For example, s. 25-90 allows Australian companies to claim interest deductions in Australia for borrowed funds that are used to establish offshore subsidiaries that yield NANE income under s. 768-5. Note, however, that outbound thin capitalisation rules restrict the level of gearing under s. 25-90.

The way in which s. 25-90 allows Australian companies to claim interest deductions on borrowed funds for offshore subsidiaries is illustrated by the following diagram.



The exemption in s. 768-5 and the thin capitalisation rules are analysed in detail in Unit 14.

Specific deductions

The tax law may allow specific deductions under s. 8-5 for certain types of expenses. A specific deduction provision might reflect a policy decision to:

- Allow a deduction in circumstances where it would otherwise be prevented by the general deduction provision (s. 8-1) (e.g. s. 25-5 allows a tax deduction for tax return preparation expenditure).
- Impose conditions that must be satisfied before a deduction is allowed (e.g. s. 25-35 contains rules for bad debts).
- Limit the amount that can be claimed (e.g. s. 82A ITAA 1936 limits the deduction for self-education expenses).

The following specific deductions, which are often encountered in practice, are considered later in this unit under 'Particular types of deductions':

- Repairs (s. 25-10).
- Borrowing expenses (s. 25-25).
- Bad debts (s. 25-35).
- Leave payments (s. 26-10).
- Tax-related expenses (s. 25-5).
- Entertainment expenses (Subdivisions 32-A and 32-B).
- Prepayments (ss 82KZL–82KZO ITAA 1936).
- Acquisition of work-in-progress (s. 25-95).
- Deduction denial and limitation provisions, which include.
  - Fines and penalties (s. 26-5) and bribes (s. 26-52 and s. 26-53).
  - Interest and royalty payments to non-residents (s. 26-25).
  - Residential rental property expenses – including travel (s. 26-31), etc.
  - Payments to employees and contractors (from 1 July 2019).
  - Superannuation contributions for employees (s. 26-95).
  - Amounts provided as fringe benefits to employees.
  - Vacant land expenses (from 1 July 2019).
- Work, self-education, car and business travel expenses.

It also provides a list of other types of specific deductions and where they are covered in the TAXAU module.

Required reading

Section 8-5 ITAA 1997.

Interaction between GST and deductions

GST-registered taxpayers who buy goods and services to which GST applies can claim an input tax credit for the GST component. This component is effectively recouped from the government, and therefore is not deductible (s. 27-5).

Required reading

Section 27-5 ITAA 1997.

Tax losses (Division 36)

The tax loss rules apply to all taxpayers regardless of whether they are individuals, partnerships, trusts or companies.

Note: There are additional tax loss rules relating to particular entities that are discussed in other units of the TAXAU module.

Calculation method (s. 36-10)

A 'loss' is defined as the excess of deductions over the sum of assessable income and net exempt income for an income tax year (s. 36-10). The steps to calculate a tax loss for an income year contained in s. 36-10 are as follows:

Deductions – Assessable income – Net exempt income = Tax loss

Limit on deductions (s. 26-55)

Certain deductions (which are not otherwise deductible under s. 8-1) cannot increase a tax loss or put the taxpayer in a tax loss position. These deductions include:

- Pensions, gratuities or retiring allowances (s. 25-50).
- Gifts or contributions (Division 30). However, gift deductions can be spread for up to five years if they would otherwise waste a tax loss (Subdivision 30-DB).
- Personal superannuation contributions (s. 290-150).

Where a taxpayer that is carrying on a business makes a donation, the donation is generally deductible under s. 8-1 where the taxpayer receives a reciprocal benefit (e.g. advertising, employee satisfaction, etc.). Therefore, s. 26-55 will not apply to such an expense.

Net exempt income (s. 36-20)

A tax loss is only available to the extent that allowable deductions exceed both assessable income and net exempt income. Net exempt income is defined at s. 36-20 and is summarised in the following table.

Net exempt income	
For a resident	**For a non-resident**
Total exempt income from all sources	Total exempt income Australian sources
Less: Non-capital losses incurred in deriving exempt income	*Plus:* Total s. 26AG ITAA 1936 exempt income (i.e. film proceeds)
Less: Any taxes payable outside Australia (i.e. non-Australian taxes) on exempt income	*Less*: Non-capital losses incurred in deriving exempt income
	Less: Non-Australian taxes on s. 26AG income

For example, assume that a non-resident has a tax loss and derives salary income overseas. Because the offshore salary does not have an Australian source, the tax loss is not offset against the offshore salary even though it is 'exempt income' (refer s. 6-5(3)). The tax loss therefore can be carried forward to future years.

Note that under s. 6-20(4), an amount that is NANE income is not exempt income. Therefore it does not waste tax losses. NANE income is listed in s. 11-55 and includes:

- Foreign branch income (s. 23AH ITAA 1936).
- Distributions from controlled foreign companies (s. 23AI ITAA 1936).
- Foreign equity distributions on participation interests (s. 768-5 ITAA 1997).
- Income subject to withholding tax (s. 128D ITAA 1936).

Utilisation of tax losses

General rules

Section 36-15 sets out how tax losses are carried forward for deduction in subsequent income years for **non-corporate** entities. Broadly, a tax loss may be used to offset the excess, if any, of total assessable income for a subsequent income year over the total deductions for that year (ignoring the tax loss) (s. 36-15(2)). If the excess is not sufficient to absorb the whole of the tax loss, the undeducted part of the tax loss is carried forward to subsequent income years (s. 36-15(7)), subject to anti-avoidance tests.

A tax loss may be carried forward indefinitely until it is fully utilised (subject to anti-avoidance tests).

If the taxpayer has net exempt income in a subsequent income year, the amount of the tax loss is reduced by the amount of that net exempt income. Any remaining tax loss can then be offset against the excess, if any, of the total assessable income over total deductions (s. 36-15(3)). 'Net exempt income' is defined in s. 36-20.

If a taxpayer incurs a tax loss in more than one year, the losses are utilised in the order in which they were incurred – the oldest is utilised first (s. 36-15(5)).

The following key tax loss rules apply to all taxpayers:

- A capital loss can only reduce a capital gain.
- A revenue loss can reduce a net capital gain (as well as assessable income generally).

Specific rules

Specific tax loss utilisation rules apply for different types of taxpayers. In particular, utilisation by a company is subject to satisfying various tests (see Unit 8).

Required reading

Sections 36-10, 36-15, and 36-20 ITAA 1997.

Particular types of deductions

Repairs

Scope

Section 25-10 allows a deduction for repairs on assets that are held or used to produce assessable income. However, capital repairs are not deductible. TR 97/23 discusses ‘repairs’ in detail.

A repair is **deductible** if it:

- Simply restores the function of an asset and does not improve it (though minor functional improvements are acceptable) (*W Thomas and Co. Pty Ltd v. FCT*).
- Simply renews or replaces the **parts of an asset** rather than the **entire asset** (*Lindsay v. FCT*).
- Does not add to or change the character of the asset (*W Thomas and Co. Pty Ltd v. FCT*).

An example of a deductible repair is replacing the damaged part of carpet with similar carpet in the living area of a rental property. However, where such expenditure is incurred to prepare a rental property for sale, it would not be a deductible repair.

Exclusions

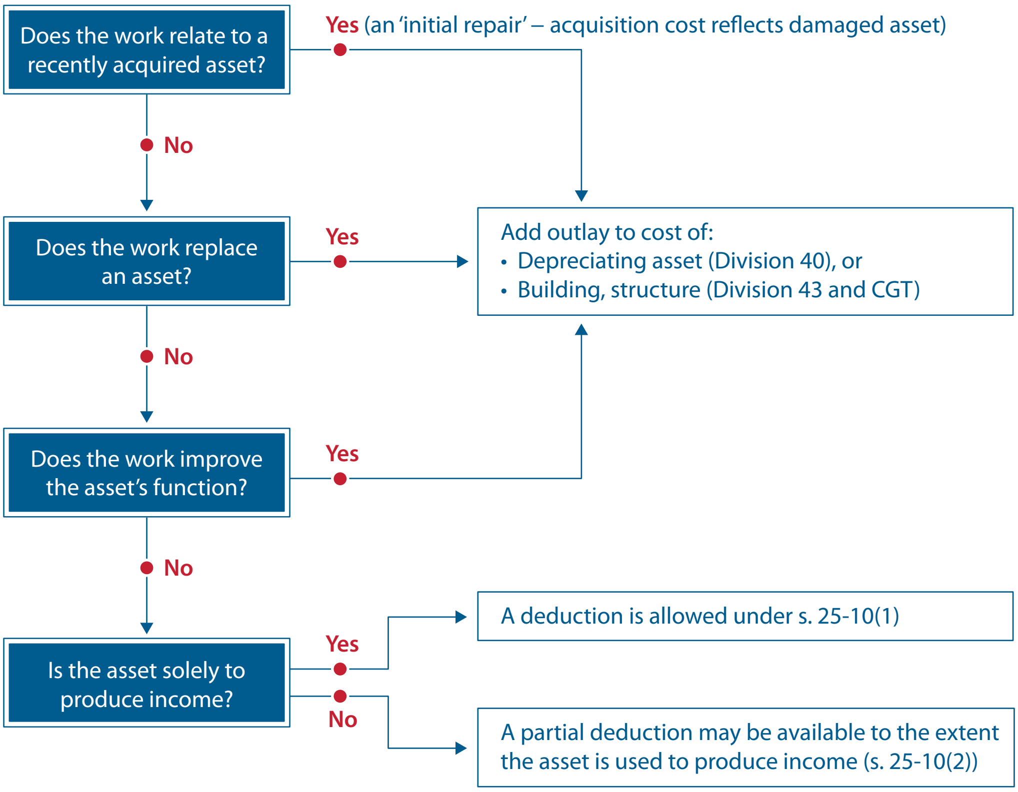
A repair is **not deductible** under s. 25-10 if:

- The work improves the function of the asset significantly (*FCT v. Western Suburbs Cinemas Ltd*).
- The work is maintenance work carried out to prevent future damage to the asset, rather than to restore functionality (*BP Oil Refinery (Bulwer Island) Ltd v. FCT*) – however, these costs may be deductible under s. 8-1.
- It is an ‘initial repair’ – in *W Thomas and Co. Pty Ltd v. FCT*, the initial repairs to the asset were capital in nature because the asset’s run-down nature was reflected in the low price paid to acquire it (*W Thomas and Co. Pty Ltd v. FCT*).

An example of a repair that is not deductible is replacing a damaged aluminium roof in its entirety with a tiled roof on a rental property.

Concluding that a repair is non-deductible is not the final income tax consideration: the outlay may qualify for a capital allowance deduction (Division 40 – see Unit 5), a capital works deduction (Division 43 – see Unit 5) or form part of the CGT cost base of an asset (Division 110 – see Unit 4).

The following diagram illustrates how to approach an asset repair problem.



Calculation method

The following example illustrates how to calculate the amount allowable as a deduction.

Example – Initial repairs

Makeit Pty Ltd, an Australian resident company, acquires a new warehouse. The day after the acquisition it pays $25,000 for repairs.

The repairs are initial repairs (i.e. capital in nature) and are not deductible under s. 25-10.

Assuming Makeit Pty Ltd has included the expenditure in its accounting profit for the current income year, an adjustment adding back $25,000 is required when it prepares its reconciliation from accounting profit to taxable income.

Note: The initial repairs would be included in the capital works deduction under Division 43 (see Unit 5).

Required reading

Section 25-10 ITAA 1997.

Worked example 1.5: Repair expenditure

[Available online in myLearning]

Borrowing expenses

Scope

Under s. 25-25, a deduction is allowed for expenditure incurred in borrowing money (e.g. legal, valuation and survey fees, loan guarantee fees, insurance, etc.) to the extent that the borrowed funds are used to produce assessable income. Such expenses would ordinarily be classified as capital in nature and therefore not deductible under s. 8-1 (*Texas Land and Mortgage Co. v. Holtman*).

Exclusions

Section s. 25-25 deals with the 'cost' of borrowing, as distinct from the 'cost' of money (i.e. interest). The deductibility of interest is therefore determined under s. 8-1, not s. 25-25. This includes penalty interest if a loan is discharged early (*Metals Exploration Ltd v. FCT* and TR 93/7).

The cost of discharging an income-producing borrowing is deductible outright under s. 25-30 (i.e. mortgage discharge costs are not borrowing costs) (see Unit 13).

If the borrowing is a Division 230 financial arrangement, the borrowing expenses will be taken into account under the method used in Division 230 (e.g. if the default accruals method applies, the borrowing expenses will be reflected in the accruals method for calculating deductions over the life of the financial arrangement) (see Unit 13).

Calculation method

If the borrowing (which is not a Division 230 financial arrangement) is:

- For a total expenditure **of $100 or less**, it is totally written off in the year the expenditure is incurred (s. 25-25(6)).
- For a total expenditure of **more than $100**, it is written off over the period of the loan or five years, whichever is the lesser (s. 25-25(4)–(5)). For a loan with a dual purpose, the deduction is apportioned. If the loan period is not specified (e.g. a rolling bank overdraft facility), five years is the default period.

To work out the maximum amount that can be deducted for borrowing expenses in an income year, a method statement is set out in s. 25-25(4) and illustrated in the following example.

Example – Borrowing expenses

Sandy borrows $100,000. Of this, $60,000 is used to provide working capital for a business and the remaining $40,000 for home renovations. The loan was established on 1 April and is to be repaid over a three-year period (which does not include a leap year). The cost of arranging the loan, including the valuation of property used as security for the loan, is $1,500.

Note that Sandy's loan falls outside the scope of Division 230 financial arrangements.

Section 25-25 allows a deduction for the cost of borrowing money to the extent that the money is used for income-producing activities and spreads the cost over the period of the loan, or over five years if the loan period is longer than five years.

Borrowing expenses include all costs associated with establishing a loan – for example, application fees, valuation fees, legal costs and registration of security.

In Sandy's case, the borrowing costs are given as $1,500, and the period of the loan is less than five years. Therefore, the cost is apportioned over the actual term of three years.

Using the method statement set out in s. 25-25(4), Sandy's deductible amount in each income year of the loan period is worked out as follows:

- Step 1 – The daily rate of deduction is = $1,500 ÷ (3 × 365) = $1.37.
- Step 2 – The deductible amount for each year is calculated on the number of days in each financial year that the loan was in place. As 40% of the money is for private use, the cost must be apportioned. This apportionment is annual, as the use of the money may change from year to year.

The deductible amount in each income year will be as follows.

Year	Days	Calculation	$
1	91	91 × $1.37 × 60%*	75
2	365	365 × $1.37 × 60%	300
3	365	365 × $1.37 × 60%	300
4	274	274 × $1.37 × 60%	225
		Total deduction	900

Assuming Sandy has included the borrowing cost expenditure in the accounting profit of her business for the current income year, an adjustment adding back the expenditure and subtracting the deductible amount is required when she prepares her reconciliation from accounting profit to taxable income. In subsequent years, an adjustment subtracting the deductible amount for the particular year will be required.

Note: The impact of leap years are ignored for the purposes of this calculation. In practice, leap years would need to be taken into account.

* Alternate calculation method – Year 1 = $1,500 ÷ 3 years × 91 ÷ 365 days × 60% = $75.

Where a loan is repaid early, the unclaimed tax deduction is claimed in the year of repayment (see the ATO's *Rental properties* publication). Where a loan is aborted before it is entered into, the borrowing costs are not deductible under s. 25-25. However, business taxpayers may be able to claim them under s. 40-880 as blackhole expenditure (see Unit 5).

The reference to five years appears to mean actual years (i.e. 365 days) rather than tax years (s. 25-25(5)). This means that if a taxpayer has a short tax year (e.g. if they move to a substituted accounting period), the deduction for that shorter tax year is reduced accordingly.

Required reading

Section 25-25 ITAA 1997.

Bad debts

Scope

A bad debt can be claimed as a deduction under s. 25-35. To claim the deduction:

- There must be an existing debt. In some cases, a scheme of arrangement will have been entered into which has extinguished the debt (*Point v. FCT*).
- The existing debt must be bad. It is sufficient for the debt to be determined as uneconomic to recover.
- The existing debt must previously have been brought to account as assessable income, or represent monies lent in a money-lending business. (Note that this requires the taxpayer to be returning income on an accruals basis.)
- The existing debt must have been written off as a bad debt during the income year. Therefore, taxpayers should ensure that accounts receivable are reviewed before the end of the financial year to ensure any bad debts are written off.

Exclusions

An allowance (or provision) for doubtful debts for accounting purposes does not meet the s. 25-35 requirements (because it has not yet been written off) and is not deductible as a bad debt.

Where a bad debt relates to a Division 230 financial arrangement, a deduction is, in most cases, only triggered by the bad debt actually being written off in the circumstances described above. Each Division 230 tax timing method has its own mechanism for dealing with bad debts. For example, where a taxpayer uses the default accruals method, upon a bad debt being written off, a deduction is only allowed if the amount was taken into account in determining assessable income, or if it arose in the 'course of [a] business of lending money' (ss 230-195(3)–(6)).

Calculation method

The following examples illustrate how to calculate the deductible amount under s. 25-35.

Examples – Bad debts deductions

The application of the bad debt provisions to particular scenarios is as follows.

Applying bad debt provisions	
Situation	**Outcome**
AusCo Pty Ltd has an opening balance of $7,000 in its provision for doubtful debts and a closing balance of $20,000. No amounts have been written off as bad during the income year	No deduction available under s. 25-35. All that has happened is mere accounting entries to raise a provision. The debtors have not actually been written off. When they are actually written off, a deduction will then be available AusCo has included an expense of $13,000 in its accounting profit. Therefore, an adjustment adding back $13,000 is required when AusCo prepares its reconciliation of accounting profit to taxable income
AusCo Pty Ltd (which is not in the business of money lending) acquired $20,000 of trade debtors. It collected $15,000 and the balance was written off as not collectible during the income year	No deduction available under s. 25-35. When a taxpayer purchases a debtor from another business, the accounting entry made is to debit the trade debtor account and credit the cash account. There is nothing included in the profit and loss as income at the time of purchase. There is also no amount included in assessable income for tax purposes. Therefore, as the trade debtor has not previously been brought to account as assessable income, no deduction is allowed when it is written off. Also, the write-off of the trade debtor is capital in nature, therefore no deduction is available under s. 8-1 AusCo has included an expense of $5,000 in its accounting profit. Therefore, an adjustment adding back $5,000 is required when AusCo prepares its reconciliation of accounting profit to taxable income
Julie operates her business on a cash basis for tax purposes. She writes off a trade debtor of $5,000 as a bad debt during the income year	No deduction available under s. 25-35. Cash basis taxpayers only include sales as assessable income when the cash is received. When a sale is made on credit (i.e. when no cash is received and a trade debtor is recognised), no amount is included in assessable income. Therefore, as the trade debtor has not previously been brought to account as assessable income, no deduction is allowed when it is written off
Julie operates her business on an accruals basis for tax purposes. She writes off a trade debtor of $7,000 as bad during the income year	A deduction is available under s. 25-35. Accruals basis taxpayers include sales as assessable income when made even if no cash is received (i.e. a trade debtor is recognised). Therefore, as the trade debtor has previously been brought to account as assessable income and has actually been written off, a deduction is allowed

Required reading

Section 25-35 ITAA 1997.

Leave payments

Scope

Under s. 26-10 leave payments (i.e. annual leave, long service leave, sick leave and other leave) in respect of employees are not deductible until paid.

Calculation method

The following example illustrates how to calculate the deductible amount under s. 26-10 where a provision or accrued expense has been raised for accounting purposes.

Example – Long service leave provision

Aussie Pty Ltd (Aussie) acquires a new business in Year 1. The initial journal entry for the long service leave (LSL) entitlements of the new employees who have now joined Aussie as a result of the acquisition is Dr Expense (profit and loss (P/L)) $200,000 and Cr LSL provision (liability on (balance sheet (B/S)) $200,000.

Note: This example assumes that LSL was not adjusted against the purchase price of the business (which would normally be the case, i.e. Dr Payable 70%, Dr Deferred tax asset 30%, and Cr LSL provision 100%). Applying IAS 12 *Income Taxes*, a deferred tax asset arises because Aussie will be allowed a deduction in the future, which will decrease its tax liability.

In Year 1, no tax deduction will arise because no LSL is paid (s. 26-10).

In Year 2, Aussie:

- Pays an amount of LSL of $25,000 – that is, Dr LSL provision (liability on B/S) $25,000 and Cr Cash $25,000.
- Increases the LSL provision by $10,000 – that is, Dr Expense (P/L) $10,000 and Cr LSL provision (liability on B/S) $10,000.

Adding to the provision does not generate a deduction. However, paying LSL generates a deduction under s. 26-10 of $25,000.

LSL provision – Year 2 accounts

Opening	Additions	Payments	Closing
$200,000	$10,000 Non-deductible	$25,000 Deductible	$185,000

In practice, Aussie will calculate its taxable income by preparing a reconciliation from its accounting profit to taxable income. This will identify the deductible amount by adjusting for the movement in the LSL provision as follows:

Accounting profit (Year 2)	+	Closing balance: LSL provision	–	Opening balance: LSL provision	=	Taxable income (Year 2)
$X[1]	+	$185,000[2]	–	$200,000[2]	=	$Y

Notes

1. Accounting profit effectively includes an expense of $10,000 for LSL expensed.
2. The movement in the provision effectively includes an additional deduction of $15,000 for LSL.

The combination of 1 and 2 results in a total deduction claimed of $25,000 (i.e. the amount paid).

Required reading

Section 26-10 ITAA 1997.

Tax-related expenses

Scope

Under s. 25-5(1)(a) **tax-related expenses** are deductible if they relate to managing your **income tax affairs**, are paid to a r**ecognised professional tax advisor** (i.e. tax agent), and are **not costs associated with an offence**. This encompasses a broad range of activities, such as preparation and lodgement of income tax returns, obtaining income tax advice, attending to an ATO query or review for income tax, and disputing an income tax assessment or determination. It also includes the cost of travel related to having an income tax return prepared (TD 2017/8).

Under s. 25-5(1)(c), **interest paid** to the ATO for the under/late payment of tax is also deductible; for example, the general interest charge (GIC) paid in respect of a GST or income tax liability.

Exclusions

Tax-related expenses related to managing GST (and other non-income taxes) are not addressed in s. 25-5(1)(a). These expenses would generally be deductible under s. 8-1. However, where they relate to a capital transaction (e.g. the purchase of a building) they would generally be capital.

Income tax payments, PAYG withholding amounts and PAYG instalments are not tax deductible under s. 25-5(2)(a)); nor are they deductible under s. 8-1. They are 'below the profit line' (*Smith's Potato Estates Ltd v. Bolland*).

Interest on money borrowed to pay income tax, PAYG withholding and PAYG instalments is not deductible under s. 25-5(2)(c). However, business taxpayers can claim the interest as a s. 8-1 deduction on the basis that it is a working capital expense (IT 2582). No deduction arises under s. 8-1 for individuals (including partners in a partnership) for such interest. This is because an individual's (or partner's) income tax is a personal obligation and the interest lacks any direct connection with a business or income-producing activity (TD 2000/24).

For other taxes:

- FBT and state payroll tax are deductible under s. 8-1 as a business's labour costs.
- Land tax would be deductible under s. 8-1 if the land produces assessable income. (If the land is not used for an income-producing purpose, land tax is included in its CGT cost base.)
- GST paid by an enterprise that is entitled to a GST input tax credit is not tax deductible under s. 27-15 (see analysis earlier in this unit and Unit 2).
- Stamp duty would generally have the same tax consequences as the underlying transaction (e.g. a purchase of a building would generally be capital).

Calculation method

The following example illustrates how to calculate the deductible amount under s. 25-5.

Example – Tax related expenses

Makeit, an Australian resident company, acquires a new warehouse. It pays $14,000 in tax advisory fees in respect of the tax aspects associated with the acquisition. The tax advisory fees are deductible under s. 25-5.

Note: Where the expenditure is included in the warehouse's cost for accounting purposes, a subtraction item of $14,000 will be required in the reconciliation of accounting profit to taxable income. However, where the expenditure is expensed for accounting, no adjustment is required.

Required reading

Section 25-5 ITAA 1997.

Entertainment expenses

Scope

Section 32-5 **denies a tax deduction** for expenditure in respect of providing entertainment, unless the entertainment falls within one of the exceptions in Subdivision 32-B. The words 'in respect of' are very wide and require a sufficient and material relationship between the expenditure and the entertainment. In other words, but for the entertainment, would the expenditure have been incurred?

Section 32-10 defines 'entertainment' to mean:

- Entertainment involving food, drink or recreation.
- Accommodation or travel in connection with the provision of entertainment.

For example, restaurant meals and taxi travel in relation to a meal with a customer are entertainment. However, sustenance is excluded (e.g. sandwiches provided at an internal staff or client meeting, morning and afternoon teas, meals while travelling on business, etc.).

Entertainment is provided even though business discussions or transactions occur (s. 32-10(2)).

The definition is circular ('entertainment means entertainment …') and begs the question: 'What is entertainment?' In TR 97/17, the ATO has published the 'Why, What, When and Where' test, which is helpful in identifying entertainment scenarios. This test illustrates that entertainment does not occur every time that food, drink or recreation is provided. Rather, it is necessary to form a conclusion whether the food, drink or recreation was provided in an entertainment context.

Example – Entertainment context

Damian is a self-employed salesman who travels frequently and for long periods through regional Australia selling toys on behalf of various wholesalers. He applies the ATO's 'Why, What, When and Where' test in TR 97/17 to assess whether his entertainment expenses are deductible:

Test	Scenario 1	Scenario 2
	Damian spends the evening in his motel room, orders a room service dinner (including wine), and watches television	Damian invites a local toy store retailer out to dinner, hoping to generate business. He pays for dinner and wine at the best restaurant in town
Why?	Travelling on business	Seeking to attract new business
What?	Room service meal with wine	Restaurant-quality meal with wine
When?	After business hours	After business hours
Where?	In a motel room, alone	In an upmarket restaurant, with a client
Conclusion	Not an entertainment context (i.e. mere sustenance). Deductible under s. 8-1	Entertainment context. Section 8-1 deduction denied by s. 32-5

Exclusions

Section 32-5 **will not deny a deduction** for entertainment expenses that meet various exception criteria in Subdivision 32-B.

Entertainment that gives rise to a 'fringe benefit'

The main exception in this subdivision is s. 32-20, which applies where the entertainment provided is a 'fringe benefit', as defined in the FBTAA 1986 (see Unit 3). It is important to note that the FBT law defines 'fringe benefit' in a way that excludes benefits that, under the FBTAA 1986, are **exempt** benefits. In other words, entertainment that gives rise to an **exempt** benefit under the FBT law will be non-deductible.

The s. 32-20 exception gives rise to obvious compliance problems for employers because meal entertainment usually involves both employees and non-employees (e.g. a business lunch at a restaurant). Rather than keep a 'per head' record of the meal entertainment costs attributable to the employees (deductible and subject to FBT) and non-employees (non-deductible and not subject to FBT), employers can choose to claim a deduction using either:

- a 50/50 split method (s. 51AEA ITAA 1936), or
- a 12-week register of expenditure to establish a representative percentage (s. 51AEB ITAA 1936).

Other exceptions that allow deductions

Other exceptions allowing deductions for entertainment include:

- Entertainment that is provided by taxpayers who carry on a business providing entertainment, or where part of their business provides entertainment (e.g. hotels, restaurants and airline companies).
- Promotions that are offered to the public at large.
- Providing food and drink to employees on ordinary working days at an in-house dining facility – excluding a party, reception or social function.
- Providing food and drink to non-employees in an in-house dining facility – excluding a party, reception or social function – if the employer chooses to include a deemed amount of $30 in assessable income for each meal (s. 32-30 item 1.2 and s. 32-70).
- Providing food and drink at an eligible training seminar lasting at least four hours.
- Charitable entertainment (e.g. free entertainment that is provided to the sick or disabled).

Calculation method

The following example illustrates how to calculate the deductible amount for entertainment and its interaction with FBT. Note, this interaction does not exist for other types of benefits.

Example – Entertainment: Interaction between income tax and FBT

ABC Accountants provides two different types of benefits to its staff. It applies a two-step test to assess whether the benefits are deductible or subject to FBT.

Test	Benefit 1	Benefit 2
	A $3,000 holiday package for two awarded to the staff member whose results achieved Merit List status in the Chartered Accountants Program	An employee-only annual Christmas party at a local club. The all-inclusive price works out at $280 per employee
Step 1 – Is this entertainment?	Yes – entertainment includes the provision of food, drink and recreation. Applying the test in TR 97/17, this benefit is provided in an entertainment context	Yes – entertainment includes the provision of food, drink and recreation. Applying the test in TR 97/17, this benefit is provided in an entertainment context
Step 2 – Is this a 'fringe benefit' as defined in the FBTAA 1986?	Yes – this will be either an expense payment or residual fringe benefit (depending on how it is structured). No FBT exemption applies	No – this will be an 'exempt benefit' under s. 58P FBTAA 1986 (a minor, infrequent benefit valued at less than $300 inclusive of GST). An 'exempt benefit' is excluded from the definition of 'fringe benefit'
Conclusion	FBT is payable by the employer The cost of the holiday is deductible under s. 8-1 (s. 32-20 exception applies)	No FBT is payable by the employer The cost of the Christmas party is not deductible under s. 32-5 (s. 32-20 does not apply)

Required reading

Sections 32-5 and 32-20 ITAA 1997.

Prepayments

Scope

Section 82KZMA ITAA 1936 requires deductions for prepaid expenses that would otherwise be deductible when incurred under s. 8-1 ITAA 1997, to be spread over the eligible service period. However, there are a number of exceptions.

Exclusions

The main exclusions from the prepayment rules and examples of when those exclusions apply are set out below. They provide a legitimate tax planning avenue for eligible taxpayers.

Immediate prepayment deductions	
Eligibility	**Example**
Expenditure that is deductible under a provision other than s. 8-1. The prepayment rules only apply to expenditure that would otherwise be claimed as a deduction under s. 8-1. Where a specific provision applies to an item of expenditure, the specific provision overrides the s. 8-1 deduction, and the prepayment rules are not applicable	A business prepays fees for its tax return preparation As this expenditure is deductible under a specific provision (s. 25-5), the prepayment rules do not apply. The timing of the deduction is determined under the specific provision
Individuals who are not carrying on a business, where the period covered by the expenditure is **12 months or less** (s. 82KZM ITAA 1936)	An employed accountant borrows money to acquire dividend-yielding shares and prepays interest for nine months As the taxpayer is an individual and the prepayment is for 12 months or less, the prepayment rules do not apply. The taxpayer can claim an immediate deduction for the full amount under s. 8-1
A 'small business entity' taxpayer where the period covered by the expenditure is **12 months or less** (s. 82KZM ITAA 1936) (see Unit 6)	Small Pty Ltd prepays rent on its business premises for 12 months As the taxpayer is a small business entity and the prepayment is for 12 months or less, the prepayment rules do not apply. Small Pty Ltd can claim an immediate deduction for the full amount under s. 8-1 **Note:** If Small Pty Ltd prepays rent on its business premises for 14 months, where two months relate to the current year and 12 months relate to the next income year, the prepayment rules apply (i.e. the entire period of the expenditure must be 12 months or less)
Expenditure that is less than $1,000 (net of any input tax credits to which a business taxpayer may be entitled)	Large Limited takes out a two-year subscription to a business magazine that costs $995 As the expenditure is for less than $1,000, the prepayment rules do not apply. Large Limited can claim an immediate deduction for the full amount under s. 8-1
Expenditure that is required by law (s. 82KZL ITAA 1936 – definition of 'excluded expenditure')	Large Limited prepays the premium for its workers' compensation cover, compulsory third party insurance, motor vehicle registration, land tax, interest withholding tax, etc. As the expenditure is required by law, it satisfies the definition of excluded expenditure and the prepayment rules do not apply. Large Limited can claim an immediate deduction for the full amount under s. 8-1
Expenditure that is paid under a service (i.e. employment) contract (s. 82KZL ITAA 1936 – definition of 'excluded expenditure')	Large Limited is winding down its business and negotiates a new service contract to retain the services of its chief executive officer (CEO) until the company is liquidated. The contract includes an upfront retention payment to the CEO for the next two years As the expenditure relates to an employee contract, it satisfies the definition of excluded expenditure and the prepayment rules do not apply. Large Limited can claim an immediate deduction for the full amount under s. 8-1

Calculation method

Where the prepayment rules apply, the s. 8-1 deduction is spread over the period to which the expenditure relates (called the ‘eligible service period’) using a daily apportionment basis.

The eligible service period is **capped at 10 years** if the prepayment relates to a longer period.

For business expenditure, the formula in s. 82KZMD ITAA 1936 for calculating the deduction is:

$$\text{Expenditure} \times \frac{\text{Number of days of eligible service period in the year of income}}{\text{Total number of days of eligible service period}}$$

The following example illustrates how to calculate the amount of a prepayment that is deductible.

Example – Prepayments

Big Accounting operates from rented business premises that are owned by Aussie Property Trust. Due to difficult economic times, the banks that lent money to Aussie Property Trust want it to reduce its debt levels.

In order to generate cash to repay its debt, Aussie Property Trust approaches Big Accounting with an offer: if Big Accounting will prepay its rent for one year ($10 million) on 1 May 2019, it will receive a 5% discount (i.e. pay only $9.5 million). Big Accounting accepts the offer.

Assuming that Big Accounting is not a small business entity (see Unit 6), in the income year ended 30 June 2019, the deduction available to Big Accounting will be $1,587,671 (i.e. $9.5 million × 61 days ÷ 365 days). The balance will be deductible in the income year ended 30 June 2020.

Assuming Big Accounting has included the prepaid portion of the expenditure as an asset for accounting purposes (i.e. it is not included in accounting profit), no adjustment is required when it prepares its reconciliation of accounting profit to taxable income for the current income year.

Note: The impact of leap years is ignored for the purposes of this calculation. In practice, leap years would need to be taken into account.

Required reading

Section 82KZL ITAA 1936 – definition of ‘excluded expenditure’.

Sections 82KZMD and 82KZMA ITAA 1936.

Acquisition of work-in-progress (WIP) amounts

Scope

Section 25-95 allows a deduction for the payment of an amount to acquire WIP from another taxpayer. (Note: This section is not relevant when determining the derivation of income from services performed or provided by the taxpayer, as discussed earlier in this unit.)

As noted under the sale of WIP amounts, WIP is the value of services performed where circumstances do not yet allow demand for payment.

An amount is a 'WIP amount' under s. 25-95(3) to the extent that:

(a) an entity agrees to pay the amount to another entity (the recipient), and

(b) the amount can be identified as being in respect of work (but not goods) that has been partially performed by the recipient for a third entity but not yet completed to the stage where a recoverable debt has arisen in respect of the completion or partial completion of the work.

The definition is based on the premise that the entity paying for the WIP will attempt to complete it and invoice for it.

Calculation method

A deduction for the payment of an amount to acquire WIP is available to a taxpayer in the income year in which it was paid, to the extent that, as at the end of that income year:

- a recoverable debt has arisen in respect of the completion or partial completion of the work to which the amount related, or
- the taxpayer reasonably expects a recoverable debt to arise in respect of the completion or partial completion of that work within 12 months after the amount was paid.

To the extent that a recoverable debt for the completion or partial completion of the WIP to which the payment relates cannot reasonably be expected to arise within 12 months of the date of the payment, that amount will be deductible in the following income year (s. 25-95(2)).

If none of the WIP amount is deductible in the income year in which the payment is made, the entire amount is deductible in the following income year. This is the case even if no recoverable debt is expected to arise in the future.

Refer to Unit 9 for the application of the WIP provisions to changes in partnership interests.

Required reading

Section 25-95 ITAA 1997.

Deduction denial and limitation provisions

A range of provisions prevents taxpayers from deducting a loss or outgoing, either in whole or in part. A list of provisions that prevent or modify deductibility is included in s. 12-5. The most common of these are found in Division 26.

Fines, penalties and bribes

Under s. 26-5, fines and penalties payable under an Australian or foreign law are not deductible. This is the case even where they arise out of legitimate income-producing activities. For example, a parking fine incurred by a courier business.

Amounts ordered by a court to be paid on the conviction of an entity for an offence against an Australian or foreign law are also not deductible under s. 26-5. This would also include costs of defending criminal charges (*FCT v. Shane Day*).

Bribes to public officials are not deductible under s. 26-52 and s. 26-53.

Interest and royalty payments

Under s. 26-25, interest or royalty payments by an Australian payer to an offshore recipient (i.e. a non-resident) are not deductible **unless** the payer has complied with PAYG withholding obligations. However, while s. 26-25 denies the deduction when withholding tax is not paid, the deduction is retrospectively reinstated when the withholding tax is ultimately paid (s. 26-25(3)).

Residential rental property expenses

General expenses

A taxpayer is generally allowed a deduction under s. 8-1 for the expenses they incur in respect of owning a residential rental property, provided the expense is not private or domestic, of a capital nature or disallowed by a specific provision.

For example, interest on a bank loan used to acquire a residential rental property and land tax on the property are deductible under s. 8-1 to the extent the property is used for income-producing purposes. To the extent the property is not used for income-producing purposes (i.e. held for private purposes), these non-capital costs would be included in the cost base of the asset for capital gains tax (CGT) purposes (see Unit 4).

Travel expenses

Under s. 26-31, **travel expenses** related to the use of residential premises to provide residential accommodation (i.e. a residential rental property) are **not** tax deductible. However, the deduction denial provision does **not apply where** the taxpayer:

- is carrying on a business, or
- is a company, superannuation fund (excluding a self-managed fund), managed investment trust or public unit trust (s. 26-31(2)).

For example, travel expenses incurred by a landlord, who is an individual taxpayer, to conduct a rental property inspection, undertake maintenance or collect rent from a tenant are not tax deductible. This non-deductible travel is also specifically excluded from the cost base of the asset for CGT purposes (see Unit 4). For ATO guidance, see LCR 2018/7.

Second-hand goods

Under s. 40-27, a decline in value deduction is not available for certain second-hand assets used in residential rental properties. For further details, see Unit 5.

Payments to employees and contractors

Payments made by a business to employees and contractors (e.g. salary, wages, commissions, bonuses, allowances and director fees) are generally deductible under s. 8-1.

From 1 July 2019, under s. 26-105 a deduction is denied for payments made by a business to employees and contractors that have not provided an ABN, where the PAYG withholding requirements apply to that payment (see later in this unit) and either:

- The business has not withheld **any** amount of PAYG from these payments. Withholding the incorrect amount will not affect the entitlement to a deduction.
- After withholding an amount, the business has not complied with its reporting obligations. A business that is not a substantial employer (i.e. with fewer than 20 employees) must notify the ATO on or before the due date for payment of the withholding amount (regardless of whether it is paid). Substantial employers must notify the ATO on or before the day on which the employee or contractor payment is made.

Section 26-105 will not deny a deduction where the amount required to be withheld is nil, an ABN is provided, or the payer voluntarily notifies the ATO when they discover that they have failed to withhold an amount or comply with their reporting obligations.

Superannuation contributions for employees

Under s. 290-60, superannuation contributions for employees are generally **deductible when paid** (see Unit 11). However, an employer has an obligation to make minimum superannuation contributions. Where all or part of the required contributions are not made within the specified time frames, the employer must pay a superannuation guarantee charge (SGC) that is imposed under the *Superannuation Guarantee Charge Act 1992*. The SGC is broadly equal to the contribution shortfall plus interest and penalties. Under s. 26-95, an **SGC is specifically not deductible**.

Amounts provided as fringe benefits to employees

Expenses associated with providing non-cash benefits to an employee are deductible to the employer under s. 8-1, unless a specific provision applies to deny or limit the deduction. This is because the expenses are incurred in carrying on the employer's business. For example, where an employer gives a television to an employee, the cost of acquiring the television is deductible to the employer under s. 8-1. The employer would also need to consider the application of fringe benefits tax (FBT) to the expense (see Unit 3).

However, the following expenses cannot be deducted unless they give rise to a fringe benefit – in which case, they are deductible but are subject to FBT:

- Entertainment expenses (s. 32-5) – see analysis earlier in this unit.
- Recreational club memberships (s. 26-45).
- Travel costs of an accompanying relative (s. 26-30).

Vacant land expenses

Expenses associated with holding vacant land (e.g. interest on borrowings used to acquire the land) are generally deductible under s. 8-1 where the land is used to earn assessable income or there is a reasonable expectation that the land will be used to earn assessable income in the future. Where a deduction is not available, the holding expenses are included in the cost base of the land for CGT purposes (see Unit 4).

From 1 July 2019, under s. 26-102 a deduction is denied for expenses associated with holding vacant residential and commercial land that is not genuinely used to earn assessable income (e.g. land banking where there is a number of years between the time that land is acquired and a proposed future income-earning activity is undertaken). However, vacant land expenses may instead form part of the cost base of the land for CGT purposes (see Unit 4).

Under s. 26-102, vacant land **includes** the following:

- Land where there is no substantial and permanent structure in use or available for use on the land; for example, land which is fenced and has a retaining wall.
- Land where the only structures on that land do not have a purpose that is independent of, and not incidental to, the purpose of any other structure or proposed structure. For example, a residential garage or residential shed do not have an independent purpose and are incidental to the related residential property.
- Land where the structure on the land is residential premises, unless the premises are lawfully able to be occupied and are available for rent.

However, the deduction denial provision **does not apply**:

- to the extent the land is in use, or available for use, in carrying on a business by the taxpayer, their affiliate, or a connected entity,
- where the taxpayer is a company, superannuation fund (excluding a self-managed fund), managed investment trust or public unit trust,
- where land becomes, or is treated as being, vacant due to an event that is beyond the reasonable control of the taxpayer (e.g. fire, flood or substantial building defects) and that event happened within the prior three years or such later time as the Commissioner allows,
- where land (that does not contain residential premises) is under lease, hire or licence to another entity and a primary production business is being carried on by the taxpayer, their affiliate or a connected entity, or
- where land (that does not contain residential premises) is under an arm's length lease, hire or licence to another entity and the land is used in carrying on a business.

For example, where an individual taxpayer acquires land, and residential premises are being constructed or substantially renovated on that land, the interest and borrowing costs associated with the acquisition of that land will be denied a deduction under s. 26-102. However, they will form part of the cost base of the land for CGT purposes (see Unit 4).

Work, self-education, car and business travel expenses

A deduction is available under s. 8-1 for expenses incurred in deriving assessable income or in carrying on a business for the purpose of deriving assessable income, unless a specific provision applies to deny or limit the deduction.

However, certain types of expenses of an individual or a partnership must be substantiated (i.e. evidenced in documentary form): see Division 900. If the expenses are not substantiated, no deduction is generally available. Records for these expenses are not lodged with the income tax return, but must be made available to the ATO on request.

These specific substantiation rules do **not** apply to companies or trusts (s. 900-5), but all taxpayers are expected to keep records that explain:

- Income tax transactions (s. 262A ITAA 1936).
- Indirect tax (i.e. goods and services tax) transactions (Schedule 1 s. 382-5 TAA 1953).

Expenses included in the specific substantiation provisions are:

- Work expenses (Subdivision 900-B).
- Car expenses (Subdivision 900-C).
- Business travel expenses (Subdivision 900-D).

Work expenses

Scope

'Work expenses' are expenses incurred in producing salary or wages (s. 900-30), but specifically **exclude** car expenses. Work expenses are generally deductible to an individual, subject to satisfying the specific substantiation provisions. They include (but are not limited to the following):

- Compulsory union fees, subscriptions to a trade or professional magazine, professional body membership fees, etc.

  An employee is generally entitled to claim a deduction for these expenses provided they are not reimbursed by their employer. Reimbursed expenses, other than motor vehicle costs reimbursed on a cents-per-kilometre basis, are specifically non-deductible under s. 51AH ITAA 1936.

  Note: For analysis of expense payment fringe benefits and reimbursements, see Unit 3.
- Travel, meal and other allowance expenses (see below)

  An employee may be paid an allowance by their employer to cover estimated work expenses. Allowances are ordinary income and are generally included in the employee's assessable income under s. 6-5 or s. 15-2. Where the allowance is included in assessable income, the employee is generally entitled to claim a deduction under s. 8-1 for the actual work expenses they incur.

  Note: For analysis of the distinction between a travel allowance and a living-away-from-home allowance (LAFHA) fringe benefit, see Unit 3.
- Registered non-compulsory uniforms, occupation-specific and protective clothing

  An employee is entitled to claim a deduction under s. 8-1 for occupation-specific and protective clothing. Examples of occupation-specific clothing include a nurse's uniform, a chef's checkered pants and a religious cleric's ceremonial robes. Examples of protective clothing include overalls, aprons, goggles, hard hats and safety boots, when worn to protect the wearer.

  An employee is also entitled to claim a deduction in accordance with ss 34-10, 34-15 and 34-20 for registered non-compulsory uniforms. That is, corporate apparel that carries the employer's name and logo where the uniform design has been registered by the employer.

  Note: The ATO has released a number of rulings setting out their views in respect of the deductions available for specific occupations.

- Laundry expenses

  An employee is entitled to claim a deduction under s. 8-1 for laundry expenses related to registered non-compulsory uniforms, occupation-specific and protective clothing. Laundry expenses includes washing, ironing and drying. Laundry expenses exclude dry cleaning. Therefore dry cleaning does not qualify for the substantiation concessions applicable to laundry expenses; however, dry cleaning may be a work related expense.
- Decline in value of property used to produce salary and wages (see Unit 5).
- Expenditure in travelling between workplaces (s. 25-100)

  A taxpayer who travels between two places where assessable income-earning activities are carried on is entitled to a deduction for the cost of that travel. However, as noted earlier in this unit under general deductions, travel between a taxpayer's home and work is private expenditure, and therefore not deductible under s. 8-1.
- Home study/office expenses

  As noted earlier in this unit under general deductions, an employee may be entitled to a deduction under s. 8-1 for costs that have a direct connection to a home study/office that they use for work purposes (e.g. power and heating).

Employee travel expenses

The ATO's preliminary views on when deductions are allowed for employee travel expenses are set out in TR 2017/D6. The key considerations when determining the deductibility of employee travel expenses are set out in the following table.

Travel expenses key considerations for deductibility	
Transport expenses	**Accommodation, meal and incidental expenses**
Whether the work activities require the employee to undertake the travel	The employee's work activities require them to undertake the travel
Whether the employee is paid, directly or indirectly, to undertake the travel	The work requires the employee to sleep away from home overnight
Whether the employee is subject to the direction and control of their employer for the period of the travel	The employee has a permanent home elsewhere
Whether the above factors have been contrived to give a private journey the appearance of work travel	The employee does not incur the expenses in the course of relocating or living away from home

Substantiation requirements

As noted above, for an employee to claim an income tax deduction for their work expenses, the expenditure must be substantiated (s. 900-15). Substantiation generally requires the employee to have receipts, tax invoices or other appropriate documentary evidence.

However, no substantiation is required for:

- Reasonable claims against overtime meal allowances paid under an industrial instrument (s. 900-60).
- Reasonable claims against domestic travel allowances (s. 900-50).
- Laundry expenses of up to $150 (s. 900-40).
- Other work-related expenses, where the total of all work-related expense claims (including laundry, but excluding travel and meal allowance expenses) is $300 or less (s. 900-35).

A substantiation exception also applies for reasonable claims against overseas travel allowances, except that the taxpayer must hold written evidence for accommodation costs and, if a trip involves being away from home for six or more nights in a row, a travel diary (s. 900-55).

The ATO's determination of what are reasonable travel and overtime meal allowance expense amounts for the 2018–2019 income year are set out in TD 2018/11 (for the 2019–2020 income year refer TD 2019/11).

Where the total of all work-related expense claims (including laundry, but excluding travel and meal allowance expenses) is more than $300, the full amount of other work-related expenses must be substantiated.

However, minor expenses of less than $10 each and $200 for the year can be evidenced by personal records, such as diary entries (i.e. the taxpayer does not have to hold a receipt or invoice from the supplier) (s. 900-125).

Example – Work expenses: Substantiation

Mr Jim Smith, an individual taxpayer, has the following work expenses for the income year:

- Cost of washing and ironing of his compulsory uniform at a local bag wash service – $140.
- Cost of trade magazine $5 per issue × 26 issues per year = total $130.
- Cost of compulsory union fees – $200.

The total of all work expenses (including laundry, but excluding travel and meal allowances) is $470. Therefore, the taxpayer is required to substantiate his work expenses as follows:

- As the laundry expenses are not more than $150, there are no specific substantiation requirements for this portion of the total.
- As the cost of each trade magazine is $10 or less and the total for the income year is $200 or less, the taxpayer is not required to hold an invoice for each magazine. Instead, to claim a deduction, the taxpayer may simply maintain a diary recording the date and cost of each purchase.
- There is no substantiation exception applicable to the union fees. Thus even though the cost is less than $300, to claim a deduction the taxpayer must hold written evidence (e.g. an invoice or receipt issued by the supplier).

Self-education expenses

Under s. 82A ITAA 1936, the deduction that would be allowable to a taxpayer under s. 8-1 for self-education expenses in respect of a prescribed course of education is limited to the net amount in excess of $250. To determine the net amount, the total amount of self-education expenses must be reduced by educational assistance payments and other employer payments.

Self-education expenses includes amounts necessarily incurred by a taxpayer for or in connection with a prescribed course of education, but excludes higher education contributions (HECs) or other similar payments.

A prescribed course of education means a course of education provided by a school, college, university or other place of education, and undertaken by the taxpayer for the purpose of gaining qualifications for use in carrying on of a profession, business or trade or in the course of any employment.

For example, if the net amount of self-education expenses incurred by a taxpayer that would otherwise be allowable as a deduction under s. 8-1 is $600, then the available deduction is reduced to $350 (i.e. $600 – $250) under s. 82A ITAA 1936.

Note: Section 82A ITAA 1936 does not allow a deduction for self-education expenses that would not otherwise be deductible under s. 8-1. Therefore, the self-education expenses must have a direct nexus to a taxpayer's current income-earning activities. Self-education expenses are not deductible where they relate to an income-earning activity that the taxpayer will commence after the qualification is completed. For example, Sarah Smith earns assessable income of $10,000 from working in the deli at her local supermarket. Sarah incurs self-education expenses of $1,200 in respect of a graphic design course she is completing. The self-education expenses do not have a direct nexus to Sarah's current income-earning activities (i.e. her work in the supermarket) and therefore are not deductible under s. 8-1.

Car expenses

Scope and substantiation requirements

A taxpayer that owns or leases a car can calculate a deduction for car expenses using one of two available methods (s. 28-12).

Car expenses include amounts to do with a car, amounts to do with operating a car, and the decline in value of a car. However, they specifically exclude amounts in respect of travel outside Australia, and a taxi fare or similar expense (s. 28-13).

A car is defined in s. 995-1(1) to mean a motor vehicle (except a motor cycle or similar vehicle) designed to carry a load of less than one tonne and fewer than nine passengers.

The table below sets out how to calculate the car expense deduction and the substantiation rules contained in s. 900-70, which vary for each method.

Car expense deduction calculation methods and associated substantiation rules

Method	Deduction requirements and amount	Substantiation requirements
Cents per kilometre	Deduction formula (s. 28-25) Number of business kilometres travelled by the car in the income year × Rate of cents per kilometre for the income year Where: • The rate per kilometre is 68 cents (irrespective of engine capacity) for the income year ended 30 June 2019 (MVE 2018/1) • The number of business kilometres is restricted to a maximum of 5,000	No specific substantiation requirements under Subdivision 900-C However, all taxpayers must keep records that explain their income tax transactions (s. 262A ITAA 1936)
Log book or actual cost	Deduction formula (s. 28-90) Car expenses × Business use percentage Where: • Car expenses must be: – Otherwise deductible under another provision. Examples include decline in value of the car, interest on a loan to acquire the car, fuel and oil costs, repair and maintenance costs, registration and insurance costs. However, car expenses would exclude principal loan repayments as they are capital in nature and not otherwise deductible – Apportioned where the car is owned or leased for only part of an income year • The business use percentage = Number of business kilometres ÷ Total number of kilometres • Business kilometres can be estimated using a log book	• Written evidence (other than fuel and oil) • Log book kept for representative period of 12 weeks (update every five years) • Opening and closing odometer records for the income year

Note: Where a car is used by an employee under a fully novated lease, s. 51AF ITAA 1936 prevents the employee from claiming deductions.

Required reading

Sections 28-12, 28-25 and 28-90 ITAA 1997.

Activity 1.4: Car expenses

[Available online in myLearning]

Business travel expenses

Scope and substantiation requirements

A business travel expense is a travel cost that is incurred by an individual taxpayer in producing their assessable income **other than** salary or wages (s. 900-95). A business travel expense involves the individual being away from their ordinary residence for at least one night. The travel may be within or outside Australia.

Business travel expenses are generally be deductible to an individual under s. 8-1, subject to satisfying the specific substantiation provisions.

Business travel expenses must be substantiated as follows.

Business travel expenses	
Situation	**Documentation required**
Absent from home for less than six nights	Written evidence of expenditure
Absent from home for six nights or more	Written evidence of expenditure and travel diary

Note: Where overseas travel requires a travel diary, this document provides a useful means for apportioning expenditure between deductible (i.e. income-producing) and non-deductible (i.e. holiday) purposes.

Other specific deductions

Other specific deduction provisions that allow a deduction for an amount that may not otherwise be allowable include:

Other specific deduction modification provisions	
Provision	**Details**
s. 25-30	Mortgage discharge expenses
s. 25-40	Loss from profit-making undertaking (discussed above)
s. 25-45	Loss by theft or embezzlement
ss 25-60 to 25-70	Election expenses
Division 30	Gifts or contributions

A range of other specific deductions are discussed in other units in the TAXAU module. The following table provides signpost to the units in which these are covered.

Signpost to specific deductions in TAXAU module			
Act	**Provision**	**Details**	**TAX unit**
ITAA 1997	s. 25-20	Lease document preparation expenses	Unit 13
	s. 36-17	Deduction for prior year losses (company)	Unit 8
	s. 40-285	Loss on disposal of depreciating asset	Unit 5
	s. 230-15	Loss on a Division 230 financial arrangement	Unit 13
	Division 290	Superannuation contributions	Unit 11
	s. 775-30	Foreign exchange losses	Unit 13
ITAA 1936	Division 5	Partnership loss, and treatment of partners	Unit 9
	Division 6	Trust loss, and loss carry-forward rules	Unit 10

Note: A net capital loss under the CGT rules is not included in this list because a net capital loss is not deductible. Rather, it carries forward to future years indefinitely (subject to anti-avoidance rules) where it can only be applied to reduce capital gains (see Unit 4).

Section 12-5 lists the specific deduction provisions from the ITAA 1997 and ITAA 1936. A detailed understanding of all the listed items is outside the scope of the TAXAU module. However, the list of specific deduction provisions should be reviewed.

Required reading

Section 12-5 ITAA 1997.

Trading stock

Overview

This section examines how trading stock is treated and valued for taxation purposes under Division 70, which can be different from its accounting implications.

Division 70 is applicable only to taxpayers who are **carrying on a business**. The following three (3) key features of the tax treatment for trading stock are listed in s. 70-5:

- Gross outgoings and earnings are recognised for tax purposes rather than net profit or loss on the disposal of trading stock.
- Trading stock transactions are on revenue account, not capital account.
- The difference between the value of opening and closing trading stock is brought to account.

In other words, purchases are an allowable deduction under s. 8-1, sales are assessable income under s. 6-5, and the movement in trading stock values are dealt with under Division 70. Therefore, although the legislation takes a different approach to trading stock as compared with the accounting treatment, the overall impact on taxable income broadly aligns with the accounting methodology.

Trading stock issues applicable to small business entities are covered in Unit 6.

Required reading

Section 70-5 ITAA 1997.

Scope

According to the definition in s. 70-10 of 'trading stock', it 'includes':

(a) anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of a business; and

(b) live stock.

Trading stock does not include a Division 230 financial arrangement. (Note: Division 230 specifies the taxation of financial arrangements (TOFA). A brief overview of the TOFA provisions is provided in Unit 13. This is a complex area of taxation and you are not required to consider the topic beyond the scope of that unit.)

Given that the definition of trading stock is broad, the key words from the provision to note when analysing whether something is trading stock or not are:

- 'includes', which implies that the ordinary meaning of trading stock is used as a starting point
- 'held for purposes of manufacture, sale or exchange', and
- 'in the ordinary course of business'.

There is no requirement that the business be conducted in Australia.

It is not simply finished goods that are included in the definition of trading stock – raw materials and a manufacturer's work in progress are also included.

The following table shows the application of the trading stock definition in determining whether an item is trading stock or not. Please note that this is not an exhaustive list.

Application of the trading stock definition		
Item	**Satisfies trading stock definition?**	**References**
Computer software	If developed for sale – yes If developed for licence – no	TR 93/12
Containers, labels and packaging materials	If integrated for sale as part of the product (e.g. polystyrene foam around a product in its box to protect it from breakage while being transported from the manufacturer to the retailer) – yes If not a part of the product being sold (e.g. plastic bubble wrap that is secured around a product at the time of its sale to protect it from damage after leaving the shop) – no	TR 98/7
Crops/plants	**Crops** If severed (e.g. grapes picked from the vines) – yes If standing (e.g. grapes still on the vines) – no **Wool from sheep** Once shorn – yes If still on sheep – no **Plants** If in pots – yes If in ground – no	*FCT v. St Hubert's Island Pty Ltd* IT 33 with regard to nurseries
Land	In the hands of a dealer or trader in land – yes Where the land is acquired for resale and a business activity involving dealing in the land has commenced – yes If held on capital account – no	*FCT v. St Hubert's* *Island Pty Ltd*
Livestock	All animals used in a primary production business – yes Animals other than beasts of burden and working beasts used in a non-primary production business (e.g. animals for sale in a pet shop, racehorses for breeding) – yes	s. 995-1 definition of 'live stock'; TR 2008/2 with regard to racehorses
Returnable containers (e.g. wooden pallets, gas cylinders)	No. Items are usually treated as plant (i.e. depreciable asset) **Note:** Packaging items, such as containers, jars, tins, cartons, etc., are trading stock. This property passes to the purchaser and forms part of the core good	TR 98/7
Shares	If in the business of trading in shares – yes If held on capital account – no **Note:** Just because a taxpayer has trading stock does not mean that all of their assets will be trading stock. For example, a share trader and investor could hold shares for trading purposes (i.e. as trading stock) and on capital account. An asset by asset analysis would be required	*Investment and Merchant Finance Corporation Ltd v. FCT*
Spare parts/ consumables	If in the business of selling spare parts/consumables – yes If for repair and maintenance of customer equipment – yes If in the business of providing services that include supplies (e.g. a plumber) – yes If spare parts/consumables are held to be used as part of the production process – no	TR 98/8

Required reading

Sections 70-10 and 995-1 ITAA 1997 – definition of 'live stock'.

Calculation method

For taxation purposes:

- If the value of opening stock is less than the value of closing stock, then s. 70-35(2) includes the difference in assessable income.
- If the value of opening stock exceeds the value of closing stock, then s. 70-35(3) provides a deduction for the difference.
- Purchases of trading stock are deductible under the general deduction provision, s. 8-1, as long as the stock is on hand, or has been sold, by year end (s. 70-15).
- Sales of trading stock are assessable under the ordinary income provision, s. 6-5.

For accounting purposes, trading stock is accounted for in the cost of goods sold (COGS) and profit is determined by subtracting the COGS from sales revenue.

The following example compares the taxation treatment and the accounting treatment of trading stock.

Example – Trading stock: Accounting versus tax treatment

Coco Pty Ltd (Coco) is a distributor of coffee beans. Coco acquires coffee beans and then on-sells them. Coco's management accounts disclose the following.

Calculation of accounting profit		
	$	**$**
Sales revenue		600,000
Less: **COGS**		
Opening stock	(40,000)	
Purchases of trading stock	(200,000)	
Closing stock	70,000	
		(170,000)
Gross profit		430,000

For taxation purposes, the following table summarises the way in which the tax legislation operates to include trading stock items in the taxpayer's taxable income. In this example, the accounting and tax values are the same (i.e. there is no overall difference between the accounting profit and the taxable income).

Taxable income calculation		
Assessable income	**$**	**ITAA 1997 reference(s)**
Sales revenue	600,000	s. 6-5
Add: Excess of closing stock over opening stock	30,000	s. 70-35(2)* Opening stock – s. 70-40 Closing stock – s. 70-45
	630,000	
Less: Allowable deductions		
Purchases of trading stock	(200,000)	s. 8-1 (subject to s. 70-15)
Taxable income	430,000	

* If the value of opening stock exceeds the value of closing stock, then s. 70-35(3) provides a deduction for the difference.

However, most businesses would calculate taxable income by preparing a reconciliation from accounting profit to taxable income. The following table summarises one way in which Coco could practically apply the tax legislation.

Reconciliation from accounting profit to taxable income		
	$	**$**
Accounting profit		430,000
Add/less: Trading stock adjustment*		
Add: Accounting COGS	170,000	
Add: Excess of closing stock over opening stock	30,000	
Less: Purchases of trading stock	(200,000)	(0)
Taxable income		430,000

* This adjustment fully reverses the accounting values and recognises the tax values using the methodology set out in the legislation. Alternatively, Coco may recognise only the net movement in balance values (in this example, the net movement is nil), or may break down the trading stock movement into its components (i.e. show tax closing stock and tax opening stock separately).

In practice, no tax adjustments are made to the accounting profit because there is no net adjustment (unless the stock is valued differently for tax purposes – see below).

Consideration of the relevant tax rules that can affect the various elements in the taxable income calculation with regard to trading stock follows below.

Purchases

Timing of deduction ('on hand')

The purchase of trading stock is an allowable deduction under s. 8-1. However, under s. 70-15 the purchase of trading stock is only allowable as a deduction in the income year in which the expenditure is incurred (i.e. the current income year) if the trading stock is 'on hand' before or during that income year. Otherwise, the deduction is not allowable until the first income year:

- the trading stock is '**on hand**', or
- an amount is included in the taxpayer's **assessable income** in connection with the disposal of the trading stock.

For example, assume a taxpayer made a payment for the purchase of trading stock on 10 June 2019 and the item became 'on hand' on 10 July 2019. As the trading stock is not 'on hand' by 30 June 2019, a deduction is not available in the current income year unless an amount in respect of the disposal of that stock has been included in assessable income (e.g. the receipt of a non-refundable deposit in respect of the sale of that item of stock prior to 30 June 2019).

The view of the ATO is that a taxpayer's trading stock is '**on hand**' when the taxpayer has the power to dispose of the goods or is in a position to do so (see IT 2670). This is known as dispositive power.

The goods need not be physically delivered to the taxpayer for them to be considered trading stock 'on hand'. In *All States Frozen Foods Pty Ltd v. FCT*, the court held that trading stock en route at the end of the income year was trading stock 'on hand' of the taxpayer, as the 'risks' (evidenced by the bill of lading) associated with the trading stock had been accepted by the taxpayer (IT 2670).

Simply because a taxpayer physically has goods does not mean that the taxpayer will have dispositive power. For example, if a taxpayer holds consignment stock on 30 June 2019, a deduction is not available as the stock is not 'on hand'. However, in *FCT v. Sutton Motors (Chullora) Wholesale Pty Ltd*, the court held that cars held on a floor plan arrangement by a car dealer are trading stock 'on hand' of the dealer even though the manufacturer has the title to the cars.

Required reading

Section 70-15 ITAA 1997.

Market value substitution rule

If trading stock is acquired at **more than** its market value, then s. 70-20 treats the purchaser as having paid the arm's-length price, which will reduce the deduction under s. 8-1 to the market value.

The arm's-length rule **does not** apply where the amount paid is **less than** the market value (i.e. there is no uplift/increase to market value).

Section 70-20 also operates to make the sale at the arm's-length value assessable for the seller (i.e. there is symmetry between the vendor and the purchaser).

The market value is not applied automatically. The application of s. 70-20 highlights the importance of reading the section in its entirety. When reading s. 70-20, you should note the use of 'and' at the end of each paragraph (i.e. the section is conjunctive).

Example – Trading stock: non-arm's length rule

Mambo and Gloria are carrying on a furniture retail business as partners. The business sells custom-made furniture using premium hardwood timber. It also sells a small quantity of second-hand furniture.

In September 2018, the partnership acquired some furniture from Mambo's father for $30,000. The market value of this furniture at the time of acquisition by the partnership was $38,000. The furniture does not represent his father's trading stock.

The partnership would be entitled to a deduction of $30,000 as per ss 8-1 and 70-20. However, if the partnership paid $50,000 for the furniture, it would be entitled to a (reduced) deduction of $38,000 as per ss 8-1 and 70-20.

Required reading

Section 70-20 ITAA 1997.

Valuation methods

Trading stock on hand at the end of the income year (i.e. closing stock) represents assets of the taxpayer and needs to be valued. The closing stock value at year end automatically becomes the opening stock value at the start of the next income year. Therefore, the only significant exercise that is required to be undertaken for income tax purposes is the determination of the closing stock value.

For tax purposes, closing trading stock is valued by applying one of the three valuation methods or alternative special valuation rules.

Opening stock

The closing stock value for one year of income automatically becomes the opening stock value for the next year of income (s. 70-40). For example, if a taxpayer chose to value its closing stock for the income year ended 30 June 2018 at its market selling value of $300,000, then the opening stock value on 1 July 2018 remains $300,000, irrespective of the valuation method chosen to value closing stock for the income year ended 30 June 2019.

Section 70-40(2) states that the value of opening stock is nil if the item was not taken into account in the previous year. In *Bywater Investments Ltd v. FCT*, the court held that a purported non-resident did not have an opening stock value under s. 70-40(2) because they had not previously had an income tax assessment. However, see below section on property that becomes trading stock.

Closing stock

Regardless of the method used to value trading stock at year end for accounting purposes, only one of three methods can be used for taxation purposes. The example of Coco above demonstrated that the valuation of closing trading stock can affect a taxpayer's taxable income for the year.

Under s. 70-45, the three acceptable methods of valuing each article of trading stock on hand at year end is to value each one at either:

1. Cost price value.
2. Market selling value.
3. Replacement value.

The valuation of each item of trading stock may be changed on a year-by-year basis, and each item of trading stock may be valued individually under one of the three methods permitted by s. 70-45. For example, for a manufacturer that produces vacuum cleaners and steam mops, these items would be considered to be different items of trading stock and can be valued differently. In fact, each vacuum cleaner and each mop also could be valued differently if the taxpayer so decides.

Cost price value

In *Philip Morris Ltd v. FCT*, it was held that, for a manufacturer, the full absorption cost method was relevant for determining the cost of work in progress and finished goods on hand at the end of the income year. Full absorption costing includes not only the cost of direct labour and materials that are used to manufacture goods, but also an appropriate portion of variable and fixed factory overheads (e.g. power, rent, rates).

IT 2350 provides details of the expenditure that should be included when determining the cost of trading stock to a manufacturer. TR 2006/8 outlines the principles of absorption costing applicable to retailers and wholesalers. TR 2006/8 makes it clear that freight, purchasing costs and warehouse cost should be absorbed into the cost of the stock on hand. Because these costs are sometimes expensed for accounting purposes, an adjustment in the reconciliation of accounting profit to taxable income is sometimes required.

Methods available to determine cost of items on hand

Practically, it may not be possible to specifically identify the cost of each item of stock on hand; for example, where there have been numerous purchases of stock throughout the year at fluctuating prices (which can be the result of exchange rate movements). The Commissioner accepts that the following valuation methods may be used provided they consistently produce a valuation that approximates an item's full absorption cost:

- FIFO (first in, first out).
- Average cost method (where the actual cost cannot be ascertained (IT 2289)).
- Standard cost method.
- Retail inventory method.

The last in, first out (LIFO) method is not acceptable because, as stated in IT 2350 at para. 15: 'in times of steadily rising prices, it tends to undervalue the cost of stock on hand at the end of a year'.

In this unit, where the cost price method for the valuation of closing stock is to be applied, candidates will be told the cost of the stock. Accordingly, candidates will not be required to apply the various methods for determining the cost of items on hand.

Market selling value

The market selling value of trading stock is its current selling value in the particular taxpayer's own selling market at year end. It is based on a sale in the ordinary course of the taxpayer's business, not a breakup or fire sale (*Australasian Jam Co. Pty Ltd v. FCT*). Post-balance date changes in the value of trading stock are not relevant. For example, if shares are trading stock, they are valued on 30 June, even if they fall in value shortly thereafter.

Market selling value is not the same as the accounting concept of net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

Replacement value

The replacement value of trading stock is the price at which it can be replaced at year end. The Commissioner considers that this is the amount the taxpayer would have to pay in its normal buying market on the last day of the income year to obtain an item that is substantially identical and available in the market (TD 92/198).

Livestock – natural increase

Like other items of trading stock, livestock may be valued at cost, market selling value or replacement value. If cost is chosen, the issue that arises is at what cost the natural increase (i.e. births occurring during the year) should be recorded. Where natural increase is being brought to account for the first time, the taxpayer may elect, under s. 70-55, either the actual cost of the animal, or the amount prescribed by ITAR 1997 r. 70-55.01. For example, the Regulations prescribe $4 as the cost of natural increase for a sheep.

These rules only apply where livestock has been valued at cost price. If a taxpayer is valuing livestock at market selling value, then natural increase must also be accounted for at that value. Note that special rules may apply to livestock that are horses.

Obsolescence

Trading stock may be written down to a lower value than that which is possible under s. 70-45 if it is obsolete or becoming obsolete, or if special circumstances exist (s. 70-50).

Stock may be written down to a lower value if it is:

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

In TR 93/23, the Commissioner provides guidelines to assist in determining whether stock is obsolete and whether special circumstances exist.

The example of Coco above is continued in the following example. However, this example demonstrates the effect on taxable income where the accounting and tax values differ.

Example – Trading stock: Closing stock values

Coco Pty Ltd (Coco) is a distributor of coffee beans. Coco acquires coffee beans and then on-sells them. Coco's management accounts disclose the following (as provided in the earlier example):

Calculation of accounting profit		
	$	$
Sales revenue		600,000
***Less:* Cost of goods sold (COGS)**		
Opening stock	(40,000)	
Purchases of trading stock	(200,000)	
Closing stock	70,000	
		(170,000)
Gross profit		430,000

Assume for taxation purposes that Coco valued its closing trading stock for the prior year end at its market selling value of $60,000. Therefore, the opening trading stock value for tax purposes is $60,000 (i.e. the opening tax value of the stock is **higher** than the accounting value). Also assume that the market selling value of its closing stock at the current year is $40,000, due to stock obsolescence that can be taken into account for taxation purposes (i.e. the closing tax value of the stock is **lower** than the book value). Coco chooses to value its closing trading stock at market selling value, as this will minimise its taxable income.

The following table summarises the way in which the tax legislation operates to include trading stock items in the taxpayer's taxable income.

Taxable income calculation		
Assessable income	**$**	**ITAA 1997 reference(s)**
Sales revenue	600,000	s. 6-5
Less: Excess of opening stock over closing stock ($60,000 – $40,000)	(20,000)	s. 70-35(3) Opening stock – s. 70-40 Closing stock – s. 70-45
	580,000	
Less: Allowable deductions		
Purchases of trading stock	(200,000)	s. 8-1 (subject to s. 70-15)
Taxable income	380,000	

However, as noted earlier, most businesses would calculate their taxable income by preparing a reconciliation from accounting profit to taxable income. The following table summarises the way in which Coco could practically apply the tax legislation.

Reconciliation from accounting profit to taxable income		
	$	**$**
Accounting profit		430,000
Add/less: Trading stock adjustment*		
Net movement in **opening** stock values		
Add: Accounting	40,000	
Less: Tax	(60,000)	(20,000)
Net movement in **closing** stock values		
Less: Accounting	(70,000)	
Add: Tax	40,000	(30,000)
Taxable income		380,000

* This adjustment fully reverses the accounting values and recognises the tax values. No adjustment is made for purchases as, in this example, the accounting and tax values are the same. In practice, the following formula is used to calculate the trading stock adjustment:

Trading stock adjustment = [(Book opening value – Tax opening value) – (Book closing value – Tax closing value)]
= [(40,000 – 60,000) – (70,000 – 40,000)] = [–20,000 – 30,000] = –50,000.

Taxpayers need to ensure they correctly identify that it is the movement in the opening and closing tax values, in this example $20,000 (i.e. $60,000 – $40,000), that is an allowable deduction under s. 70-35(3) and the $200,000 that is an allowable deduction under s. 8-1.

Required reading

Sections 70-35, 70-40, 70-45 and 70-50 ITAA 1997.

Activity 1.5: Trading stock – minimum taxable income

[Available online in myLearning]

Disposals

Trading stock can be disposed of in a number of ways, resulting in different tax adjustments to the taxable income calculations. The tax rules associated with common trading stock disposals are described below.

Sale in the ordinary course of business

Where trading stock is sold in the ordinary course of business, the proceeds are brought to account as ordinary income under s. 6-5. In the example of Coco above, this was referred to as 'sales'.

Lost or destroyed

Trading stock that is lost (including through theft) or destroyed will not be included in the closing stock value – that is, the closing stock value will be nil. The taxpayer effectively obtains a deduction for the lost or destroyed stock as a result of the operation of the trading stock account, in one of two ways:

- under s. 8-1 as purchases, if it was acquired during the year

or

- under s. 70-35(3), if opening stock exceeds closing stock. Remember that if the stock was purchased in the previous year, it would be recorded in the opening stock but not in the closing stock, as it is not on hand at year end. Given that opening stock is greater than closing stock, the taxpayer effectively deducts the value of the items lost or destroyed.

Compensation for any loss of trading stock will be assessable under s. 70-115. Broadly, the value of any compensation received through insurance would be assessable under this specific section.

Market value substitution rules

Overview

Where trading stock, crops or trees that have been planted and tended for the purpose of sale are disposed of other than in the ordinary course of business, the taxpayer is required by s. 70-90 to bring to account as assessable income the market value of the items at the date of disposal (the actual sale proceeds are made non-assessable non-exempt income).

Correspondingly, the purchaser will be deemed to have purchased the stock at market value (s. 70-95). There is, therefore, symmetry between the vendor and the purchaser. This section may be triggered when a business that comprises many assets, including trading stock, is sold (refer *CoT (WA) v. Newman* and *Farnsworth v. FCT*). In *Case 2/99*, the value of trading stock sold other than in the ordinary course of business was the market value attributed to the trading stock by the parties in the sale agreement (and not that determined by reference to the price at which the stock had been purchased by the vendor). This was because the parties actively bargained for the price to be paid, which inherently created the requisite market value. On the other hand, where one party passively acquiesces to the price allocation, or is indifferent (so that there is no robust bargaining), the price in the sale agreement will be adjusted under ss 70-90 and 70-95.

Gifts of trading stock

Gifts of trading stock to a 'deductible gift recipient' (broadly, an approved charity) are tax deductible under s. 30-15. The donation may be treated as a disposal of stock that occurs outside the ordinary course of business. Generally, the deduction available to the taxpayer (s. 30-212 deals with valuations) is equivalent to the market value of the trading stock gifted and included in the taxpayer's assessable income, as required by s. 70-90. The section may apply, for example, where a bakery donates its unused bread for the day to a soup kitchen, which is an approved deductible gift recipient.

The net effect would be that the s. 70-90 assessable amount would offset the s. 30-15 deduction. Therefore, the taxpayer would end up with a tax deduction under s. 8-1 for the cost of buying the stock, which would equate with the taxpayer's economic loss.

It is possible (and generally likely in practice) that the donation would be made in the ordinary course of business – that is, in the form of marketing – if the gifting is part of the taxpayer's normal business operations. For example, if a bakery regularly makes donations of excess bread, s. 70-90 would not apply. In this instance, a deduction for the cost of the trading stock donated would be provided under s. 8-1, which again will equate with the taxpayer's economic loss.

Where stock is gifted to employees, a tax deduction would be available via the trading stock movement account (i.e. as the value of closing stock will be less than the value of opening stock there will be a deduction under s. 70-35). However, the FBT provisions would need to be considered (see Unit 3).

Change in ownership or interest in trading stock

Where there is a change in the ownership or interest in trading stock, in circumstances such as the formation, variation or dissolution of a partnership, s. 70-100 applies – resulting in a notional disposal of trading stock by all the old owners to the new owners. Such a disposal is treated as being made at market value (s. 70-100(2)).

However, where:

- the trading stock becomes an asset of a business carried on by the new owners and the former owners retain an interest in the trading stock of at least 25% of the market value of the stock, and
- the market value of the trading stock is more than the value of the stock recorded in the books of the former owners just before the change in ownership,

the old and new owners can elect that s. 70-90 does not apply. If this election is made, a deemed disposal may occur at the value at which the stock is recorded (e.g. at cost and not market value) (see ss 70-100(4), (5) and (6)).

Required reading

Sections 30-15, 70-90, 70-95, 70-100 and 70-115 ITAA 1997.

Activity 1.6: Trading stock – disposal by gift

[Available online in myLearning]

Change in purpose

As noted above, for property to be trading stock it must be 'held for the purpose of manufacture, sale or exchange in the ordinary course of a business'. Therefore, special tax rules exist to deal with property that becomes or ceases to be trading stock.

Property that becomes trading stock

Section 70-30 provides that where a taxpayer starts holding an item as trading stock that it already owns but does not hold as trading stock, there is:

- A deemed disposal of the item by the taxpayer.
- A deemed reacquisition of the item by the taxpayer.

This section would need to be considered where a taxpayer holds an asset on capital account and the purpose of the asset changes to being held as trading stock (e.g. shares held on capital account are reclassified as trading shares), or where an asset is initially held as a depreciable asset and the asset is subsequently held as trading stock (e.g. a salesman's company car is now held for sale as part of the used car fleet for a car retailer).

A taxpayer has the ability to elect whether the notional disposal and reacquisition occurs at **either cost, or market value**.

- Electing to use **cost for a capital asset** will usually not have any adverse tax consequences as the asset is simply being sold for its original cost to the taxpayer.
- By electing to use **market value for a capital asset**, a capital gain may be triggered on the notional disposal (see CGT event K4 in Unit 4). The individual circumstances of the taxpayer need to be considered; for example, the availability of capital losses.

  In addition, using market value will establish a higher deemed reacquisition amount in situations where the market value exceeds the item's cost.

The **consequences for depreciable assets** are considered further in Unit 5.

Property that ceases to be trading stock

Section 70-110 deals with property that stops being trading stock of a taxpayer but continues to be held by the taxpayer (i.e. there is a change of use or a conversion). In such a case, s. 70-110 deems the item of stock to have been **disposed of at cost and immediately reacquired at cost**. By deeming a disposal at cost, generally no taxable income arises (i.e. the sale at cost is recognised as assessable income under s. 6-5 and the movement in stock value is recognised as an allowable deduction under s. 70-35).

Section 70-110 would be applicable where the taxpayer holds the asset initially as trading stock and the purpose of holding the asset **changes to being held on capital account or being a depreciable asset**.

The consequences for **depreciable assets** are considered further in Unit 5.

Private use of trading stock

The cost of an item of trading stock appropriated for the private use of the business owner is included as assessable income as per s. 70-110. The following example illustrates the taxation treatment of stock that is taken for private use.

Example – Trading stock: Taken for private use at actual values

A chemist takes home headache tablets from his own business for his personal consumption.

The chemist is deemed to have sold the tablets at cost, as per s. 70-110. A tax deduction for the cost of the tablets would have been claimed when purchased. The deemed sale amount effectively equates to the cost claimed as a deduction.

Certain taxpayers, such as sole traders and partners in a partnership, have the option of applying the Commissioner's deemed annual values for stock taken as private use, instead of determining the cost of all stock taken for private use over the income year. For the 2018–2019 income year, see TD 2019/2.

Practically, this determination simplifies the process of applying s. 70-100 for business owners such as butchers, fruit vendors and bakers. The following example illustrates the options for valuing stock when taken for private use, applying the Commissioner's values.

Example – Trading stock: Taken for private use at deemed values

Malcolm Mudguts is the sole proprietor of a butchery business that trades under the name of 'Meaty Morsels'. Malcolm is married and has two children, aged 8 and 10. Every second night, Malcolm takes home some meat for his family's consumption. The cost of the goods taken for private use over the income year is $2,600.

Malcolm has two options for determining the deemed sale value when applying s. 70-110: he can either include the actual cost as the deemed sale amount (option 1), or apply the Commissioner's annual values (option 2). The Commissioner's list of values per family member for a butcher that is applicable in the 2018–2019 income year (TD 2019/2) is:

- $830 for an adult or child over the age of 16
- $415 for a child aged 4–16 years.

Therefore, under s. 70-110:

- Option 1 – if the actual cost of the goods is used, $2,600 would be included in Malcolm's assessable income.
- Option 2 – using the Commissioner's values, an amount of $2,490 (2 × ($830 + $415)) would be included in Malcolm's assessable income.

As long as Malcolm's actual private consumption of meat closely reflects the specified values published by the Commissioner, he can use those values, which will minimise his taxable income.

Change of residence

There are no trading stock rules that deal with a change of residence, unlike the CGT provisions, which contain CGT event I1 (see Unit 4). Therefore, if a taxpayer leaves Australia with trading stock, the tax treatment is unclear.

The ATO's view in PR No: 1012827324841 is that a non-resident who held shares as trading stock when they became an Australian resident is deemed to have acquired the trading stock at cost or market value, under s. 70-30. Even though the shares were trading stock when the taxpayer was a non-resident, the ATO's view is that they were not trading stock for s. 70-30 purposes. In other words, the ATO used common sense to allow the taxpayer to get a fair tax cost for the shares. Otherwise, s. 70-40(2) would have given the non-resident a nil opening value (see above in the section on opening stock values).

Required reading

Sections 70-30 and 70-110 ITAA 1997.

Worked example 1.6: Trading stock – change in use

[Available online in myLearning]

State taxes

Overview

Three of the most important state taxes are payroll tax, stamp duty and land tax. These are all imposed by separate state laws in each state that can differ materially. In addition, not all states levy all three taxes. This unit provides an awareness of how stamp duty, land tax and payroll tax function. A detailed understanding is not required for the TAXAU module.

Land tax

Land tax is a state tax imposed in all states on land ownership. The land owner at a point in time during the year is liable to pay the tax at the appropriate rate on the value of the land. The value of the land is the unimproved value as assessed by the relevant authority (usually the Valuer-General).

There are two noteworthy exemptions to land tax:

- Principal residence.
- Land used for primary production.

Land tax rates vary from state to state. Land tax rates can also vary based on the residency status of the landholder. For example, Victoria has a land tax surcharge of 1.5% for non-residents and New South Wales has a surcharge of 2% for non-residents.

Stamp duty

'Stamp duty' is a term covering various taxes imposed by the states on specified transactions in relation to specified property. Stamp duty is imposed either at a fixed rate or an *ad valorem* rate on the value of the transaction, and is generally calculated based on the GST-inclusive amount of the consideration paid.

Historically, stamp duty was imposed by all states on the lodgement of documents. To avoid the payment of stamp duty, a transaction could be structured where no documents were created. To protect the revenue position of the state, several states including Queensland, New South Wales, the Australian Capital Territory, Victoria and Tasmania rewrote their stamp duty legislation to ensure that stamp duty is payable based on the transaction. South Australia, Western Australia and the Northern Territory broadly adopted the methodology that stamp duty payable is calculated based on the lodgement of documents.

The following are some of the key transactions that need to be considered:

- Conveyancing (acquisition and transfer) of property, both real and personal. In New South Wales, this includes the transfer of land, business assets and goodwill.
- Leasing real property.
- Transferring unquoted securities. With the exception of Victoria, Tasmania and Western Australia, most states tax the transfer of unlisted market securities.
- Entering a hire arrangement. With the exception of Victoria, nearly all states have abolished stamp duty payable on hire duty.
- Registering a mortgage or taking out a loan.

Even more than other states-based taxes, the rate of stamp duty varies from state to state, so to accurately determine a stamp duty liability you should review the relevant laws in detail. Stamp duty rates can also vary based on the residency status of the purchaser in respect of residential property. For example, Victoria has a stamp duty surcharge for non-resident purchasers on residential property of 7% and New South Wales has a surcharge for non-resident purchasers of 8%.

Payroll tax

Payroll tax is a state tax that is imposed on an employer taxpayer's payroll. Payroll includes all taxable wages paid to employees for services performed and paid for within a state, as well as bonuses, commissions and directors' fees, whether paid in cash or not. Payroll also includes employer superannuation contributions and fringe benefits. Payments to contractors and subcontractors for services are included in payroll if these are not covered by an exemption. The tax is a percentage of an employer's total payroll cost. In all states, there is a tax-free threshold that applies before a taxpayer/employer becomes liable for payroll tax. This threshold and rate vary between states.

Payroll tax issues become more complicated when dealing with related employers or employers with multi-state activities. Employers that are related companies, companies that are commonly controlled, or companies that use employees in common are grouped when determining whether the payroll tax threshold has been met. If a group's total payroll cost is greater than the threshold, payroll tax must be paid even when individual group members do not reach the threshold. In the case of employers that have employees in more than one state, the entire national payroll cost is used to determine whether the relevant state thresholds have been met and what the appropriate rate is. Tax is then charged at the appropriate rate on only the payroll for the relevant state.

For more information on payroll tax, access the state revenue office websites for the various Australian states and territories.

Administration

Overview

Each year, the Commissioner requires taxpayers to lodge an income tax return, which explains how their taxable income and any claims for tax offsets have been calculated.

Generally, the due date for lodgement of an income tax return is:

- For individuals, partnerships and trusts – by 31 October.
- For large/medium companies and superannuation funds – by 15 January.
- For small companies and superannuation funds – by 28 February.

Note: For certain taxpayers, there are special lodgement time arrangements (e.g. under the tax agent lodgement program).

In response to the lodgement of the income tax return, the ATO either:

- issues the taxpayer with an assessment notice showing the tax payable (or refundable), or
- deems the tax return that is lodged by a company or superannuation fund to be an assessment.

The self-assessment system in Australia operates on the assumption that income tax returns are accepted as lodged.

Taxpayers generally pay their income tax under the pay as you go (PAYG) tax collection process (see below). A taxpayer is entitled to a credit for PAYG amounts at the time the Commissioner makes an assessment of income tax.

A taxpayer is entitled to a refund of income tax if total credits exceed income tax payable. Alternatively, if total credits are less than income tax payable, an income tax liability is due and payable:

- For individuals and trusts – by the later of 21 days after the due date for lodgement of the taxpayer's return and 21 days after a notice of assessment has been given to the taxpayer.
- For companies and superannuation funds – by 1 December.

Penalty and interest regimes are also applicable for taxpayers that fail to satisfy their taxation obligations.

Pay as you go (PAYG) tax collection process

If income tax were only collected on assessment, taxpayers would enjoy a substantial timing advantage and the Government would not receive a regular inflow of income tax throughout the year. The PAYG system addresses this by collecting income tax on a regular basis and crediting taxpayers with the tax collected at the time of their annual income tax assessment. PAYG is imposed under Schedule 1 TAA 1953 and comprises:

- PAYG withholding.
- PAYG instalments.

PAYG withholding

Scope

PAYG withholding requires tax be withheld by the payer from specified types of payments to a recipient. The most common example is salary and wages.

Exempt income, NANE income, and expense reimbursements that have been subject to FBT are excluded from the operation of the PAYG withholding provisions.

Section 10-5(1) in Schedule 1 TAA 1953 lists the various PAYG withholding events, and 'signposts' the reader to specific sections that set out the circumstances in which PAYG withholding is required. The most significant withholding events are set out in the table below.

Significant PAYG withholding events

TAA 1953 Schedule 1 provision	Withholding event
s. 12-35	Salary, wages, commission, bonuses or allowances paid to employees
s. 12-40	Remuneration payments to company directors
Subdivision 12-C	Superannuation income stream or annuity, employment termination payments and unused leave payments
Subdivision 12-D	Social security benefits, work-related compensation, sickness or accident payments
s. 12-140	Payments where the recipient fails to quote a tax file number (TFN) or Australian business number (ABN) to a financial institution (e.g. a bank), unit trust or public company
s. 12-175	Distributions from closely held trusts (e.g. family trusts) to beneficiaries who have not quoted their TFN to the trustees
s. 12-190	Suppliers carrying on a business who do not quote their ABN number to payers. This provision targets the 'cash economy' (i.e. businesses that avoid paying tax by requesting cash payments)
Subdivision 12-F	Dividend, interest and royalty payments made to an overseas person or entity (Australia waives its right to withhold tax on the franked component of a dividend – see Unit 8 and Unit 14)
Subdivision 12-FB; Taxation Administration Regulations 2017 (TAR 2017) rr 31, 32 and 33	Payments to foreign residents who are: • Engaged in construction and infrastructure projects • Involved in sporting and entertainment activities • Paid by casino operators to come to Australia on a gaming junket

Withholding rate

The rate of PAYG withholding is published by the Commissioner (e.g. for PAYG withheld from wages) or in the tax law (e.g. failure to quote a TFN or ABN to a financial institution triggers withholding at the highest personal marginal tax rate, currently 47% including the Medicare levy).

Consequences for payer

Reporting PAYG withholding amounts

For the significant PAYG withholding events described above, the payer must not only remit the PAYG withheld to the ATO, but also provide information electronically regarding the parties to whom payments were made (including TFN and ABN information where available).

Where the payer is **an employer**, the payer must **report** their salary and wage amounts and PAYG withholding amounts to the ATO at the time of payment using single touch payroll (i.e. a payroll or accounting software product that automatically provides information to the ATO each time a payment is made). Note, the requirement to use single touch payroll only applies from

1 July 2019 (with a transitional concession to 30 September 2019) for employers with fewer than 20 employees.

Employers that have implemented single touch payroll are not required to complete annual reports or to issue employees with a payment summary. Employees will instead interact directly with the single touch payroll system administered by the ATO.

Note: From 1 July 2019, employers must also report compulsory superannuation contributions using single touch payroll.

Remitting PAYG withholding amounts

PAYG withholding amounts are required to be remitted to the ATO according to a schedule that is based on the size of the taxpayer. For example, 'large' withholders (i.e. organisations with more than $1 million in PAYG withholding for the prior 12-month period) must remit the amount by electronic funds transfer within a week of the withholding event. Medium-sized and smaller businesses receive extended time to remit.

Note:

- A deduction for interest and royalty payments to non-residents is not allowed until the payer has complied with the PAYG withholding rules (see earlier in this unit and Unit 14).
- From 1 July 2019, a deduction is not allowed for payments to employees and contractors that have not quoted an ABN if the payer has not complied with the PAYG withholding rules (see earlier in this unit).

Consequences for recipient

Data matching

Information received from employers forms an important element of the ATO's data matching activities.

As a consequence of data matching, a taxpayer's failure to declare salary and wages, interest or dividend income, for example, will often be detected quite quickly by the ATO.

Some data collected by the ATO is also made available electronically to tax agents and individual taxpayers to assist them by 'pre-populating' parts of the relevant income tax returns (e.g. by identifying salary, trust, interest and dividend income).

Claiming PAYG withholding amounts

A taxpayer is entitled to a credit for PAYG withholding amounts in respect of salary and wages at the time the Commissioner makes an income tax assessment. In other words, the PAYG withholding amounts reduce the income tax payable by, or increase the income tax refundable to, the taxpayer.

However, not all PAYG withholding amounts are used in this manner. For example, PAYG withholding amounts in respect of dividends, interest and royalties paid to a non-resident are treated as a final tax. The taxpayer does not include the income in their assessable income and is not entitled to reduce their income tax payable by the related PAYG withholding amounts.

The dividend, interest and royalty withholding regime is analysed in detail in Unit 14.

PAYG instalments

Scope

The PAYG instalment system collects income tax on a regular basis from business taxpayers, superannuation funds, and individual taxpayers with non-employment income (e.g. investors whose investment income disclosed in the most recent tax return is $4,000 or more).

Taxpayers enter the PAYG instalment system by being issued a PAYG instalment rate by the ATO. This rate is calculated by reference to data on the taxpayer's most recently lodged income tax return and takes account of their income, deductions and offset entitlements.

Example – Consequences of entering the PAYG instalment system

After several years employed as a director of ABC Accountants, Jalpa is admitted as a partner on 1 July 2018. Up until that date, a PAYG withholding amount was deducted from her salary paid by the partnership. From 1 July 2018, however, she is no longer an employee and no PAYG withholding event applies to the monthly partnership distributions she receives.

When Jalpa lodges her tax return for the income year ended 30 June 2019, the ATO will learn for the first time that she earns partnership income and will issue:

- an income tax assessment relating to the year ended 30 June 2019, and
- a PAYG instalment rate notification, the rate being calculated by reference to income, deductions and tax offset information provided in her tax return for the year ended 30 June 2019. As from the quarter in which Jalpa receives this rate notification, she will be obliged to pay quarterly PAYG instalments.

This example also illustrates the important role that tax advisors play in informing their clients as to when large payments are due and cash flow planning. Jalpa should keep money aside from her partnership income to meet the large tax liability that will arise when she receives her 2019 income tax assessment. She should also budget for her quarterly PAYG instalments.

Frequency of PAYG instalments

Most taxpayers pay PAYG instalments quarterly, either 21 or 28 days after each quarter ends (the exact date is advised by the ATO).

However, PAYG instalments are payable monthly (instead of quarterly) for all entities with a turnover of $20 million or more.

On the other hand, concessionary arrangements apply to the following taxpayers:

- Those who are not carrying on a business that requires them to be registered for GST (or are not partners in a GST-registered partnership) and whose income tax for the previous year was assessed at less than $8,000 – may pay one annual instalment.
- Primary producers, authors, artists and sports persons – may pay two instalments.

Quarterly PAYG instalments calculation methods

A quarterly PAYG instalment may be calculated using either the:

- instalment income method
- gross domestic product (GDP)-adjusted notional tax method.

All taxpayers are entitled to use the instalment income method, but access to the GDP-adjusted notional tax method is typically confined to:

- individuals
- companies and superannuation funds that recorded a business or investment income of $2 million or less in their most recently assessed income tax return.

Instalment income method

In this method, instalments are calculated using the following formula:

Instalment income for the quarter × PAYG instalment rate

Instalment income method	
Instalment income for the quarter	**PAYG instalment rate**
For all taxpayers, 'instalment income' is the sum of: • ordinary income, and • net gains from Division 230 financial arrangements in the quarter for which an instalment is due Superannuation funds must also include statutory income (e.g. capital gains) in their instalment income (Schedule 1 s. 45-120 TAA 1953) **Note:** Expenses incurred in deriving ordinary income do not reduce the instalment income amount because such expenses are taken into account by the ATO in calculating the PAYG instalment rate	The ATO advises the taxpayer of the PAYG instalment rate. It is calculated by reference to the taxpayer's data (i.e. income, deductions and tax offset entitlements) in the most recently lodged tax return The instalment rate can be varied down by the taxpayer using calculations that are based on their current year's tax data, but excessive variations will attract an interest charge on the tax shortfall

GDP-adjusted notional tax method

PAYG instalments calculated under this method are based on the income tax liability that arises from the taxpayer's most recently lodged income tax return adjusted for movements in GDP (published by the Australian Bureau of Statistics). The ATO notifies taxpayers of the amount and frequency of GDP-adjusted PAYG payments.

A taxpayer who considers that the amount advised by the ATO is excessive can vary down their PAYG instalments. Again, excessive variations will attract an interest charge.

Remitting PAYG instalments

PAYG instalments are usually paid either monthly or quarterly to the ATO. Interest can be imposed for late payment.

For non-business taxpayers, an instalment activity statement (IAS) is used to report PAYG instalment amounts to the ATO and to allow taxpayers to vary their PAYG instalments.

For business taxpayers, a business activity statement (BAS) is used to report PAYG instalments. It also records details for other taxes that are administered by the ATO, such as GST and FBT. Business taxpayers with an annual turnover of $20 million or more must lodge a BAS on a monthly basis. For other business taxpayers, the BAS is lodged quarterly.

Penalties can apply when a BAS is lodged late.

Self-assessment system

In Australia, a self-assessment system of taxation is used. This section examines the key features of the self-assessment system, including the penalty and interest regimes applicable to taxpayers who fail to satisfy their taxation obligations (e.g. where there is a tax shortfall).

'Self-assessment' is defined for income tax purposes in s. 995-1(1) as an assessment:

(a) for the making of which the Commissioner wholly accepts statements of the taxpayer; or

(b) that, under section 166A of the Income Tax Assessment Act 1936 or a provision of another law, is taken to have been made by the Commissioner.

The self-assessment system operates on the basis that the returns lodged by taxpayers are generally accepted by the Australian Taxation Office (ATO) and assessments are issued accordingly.

For income tax purposes, companies and funds are subject to a full self-assessment system and do not receive assessments. Instead, the Commissioner is taken to have made an assessment and the return itself is deemed to be a notice of the assessment made on the day that the return is lodged.

For goods and services tax (GST) purposes, taxpayers are required to lodge a GST return on a monthly, quarterly or yearly basis, detailing their GST liability (or refund) for that period. The GST return is included as part of their business activity statement (BAS) for the applicable period. Where GST self-assessment applies, the GST return is treated as a notice of assessment made by the Commissioner on the day the GST return is lodged.

Where a taxpayer fails to lodge an income tax return, the Commissioner has the power to issue a default assessment (s. 167 ITAA 1936). The Commissioner also has the power to make a GST assessment of an assessable amount at any time (Schedule 1 ss 155-5 and 155-10 TAA 1953).

To promote the accuracy and fairness of the self-assessment system, taxpayers can amend their returns and the ATO has the ability to conduct tax audits and issue amended assessments and penalties based on the culpability of taxpayers who do not, in the opinion of the Commissioner, satisfy their taxation obligations.

Key elements of the self-assessment system include the following:

- Elections and notifications.
- ATO rulings.
- Amended assessments.
- Objections and appeals.
- The Commissioner's rights and obligations.
- Record-keeping.

Broadly, the various elements of the self-assessment system focus on the:

- lodgement of forms in the approved format within certain time frames
- payment of taxation debts within certain time frames.

The office of Inspector-General of Taxation (IGT) is an independent statutory agency which investigates complaints about the administrative actions of the ATO and Tax Practitioners Board (TPB). Generally, administrative actions relate to the conduct of the ATO and the TPB in their interactions with taxpayers, including the policies and procedures which guide these actions.

The IGT also seeks to improve the administration of the tax system for the benefit of all taxpayers by undertaking broader reviews and making recommendations to the ATO, TPB and the Government. The analysis of complaints data can also lead to reviews and drive a culture of continuous improvement and engagement within the tax system.

A broad outline of the key elements of the self-assessment system is provided below.

Elections and notifications

In certain circumstances, the income tax law requires the taxpayer to elect or choose to treat a particular item in a specific manner (e.g. electing or choosing to apply either the prime cost method or the diminishing value method when calculating decline in value of an asset). In most instances, the taxpayer is not required to lodge the election/choice notice with the Commissioner. However, the self-assessment system still requires taxpayers to make and keep a record of the election/choice.

ATO rulings and guidelines

- The ATO issues various rulings and guidelines, including: Public rulings – which are powerful public statements that ATO officers are bound to comply with (e.g. taxation rulings, taxation determinations, class rulings, GST ruling and law companion rulings – on the meaning of new laws). A taxpayer cannot object to a public ruling.
- Private rulings – which only the taxpayer applying for ruling can rely on. A taxpayer that receives an unfavourable private ruling can either accept the ruling and lodge their income tax return following its outcome, disregard the ruling and lodge their income tax return ignoring the ruling outcome, or can object to the private ruling in the approved format within the appropriate time frame. However, once an assessment is issued, the taxpayer cannot object against the private ruling. They must object against the assessment (see Schedule 1 s. 359–60(3)(a) TAA 1953).
- Practical compliance guides (PCGs) – which provide broad law administration guidance and are not binding on the ATO. However, where taxpayers rely on the approach provided by the ATO in good faith, it is suggested that the ATO will not take action to apply any change of view retrospectively.
- Legislative instruments – the Commissioner has a statutory remedial power to make a legislative instrument to modify the operation of a taxation law to ensure the law can be administered to achieve its intended purpose or object.

Amended assessments

The Commissioner has the power to amend income tax and GST assessments, both unilaterally and at the request of the taxpayer. A taxpayer's application to the Commissioner for an amendment to either of these assessments must be made within the required time frame.

The Commissioner also has the power to further amend an amended assessment by making such alterations and additions as are considered necessary, even when tax under that assessment has already been paid (for income tax purposes, under s. 170 ITAA 1936).

Section 170(1) ITAA 1936 provides a table that itemises the Commissioner's general power to amend income tax assessments. Broadly, the five basic time frames available to the Commissioner within which to amend income tax assessments are:

- The two-year amendment period for certain individuals and small business entity (SBE) taxpayers (s. 170(1) items 1, 2 and 3 ITAA 1936). Taxpayers specifically excluded from this amendment period include the following:
  - Individuals who carry on a business that is not an SBE.
  - Taxpayers who are partners in a business at any time in the year, unless the partnership is an SBE.
  - Taxpayers who are trustees and/or potential beneficiaries of a trust estate (regardless of whether or not they actually receive a distribution), unless the taxpayer is an SBE. In practice, being a beneficiary of a trust means that the four-year amendment period is often open.
  - Where it is reasonable to conclude that Part IVA ITAA 1936 may apply (see Unit 15).

  - Circumstances prescribed by the Regulations (note that there are numerous circumstances listed, including deemed dividends, foreign income, employee share schemes and related party transactions (see r. 14 ITR 2015), so care should be taken before concluding that a two-year time limit applies to a taxpayer).

  The Federal Court decision in *Yazbek v. C of T* makes it clear that if an individual is a potential beneficiary of a trust (other than an SBE), rather than just an actual beneficiary, then the two-year amendment period does not apply.

- The four-year amendment period for all other taxpayers (s. 170(1) item 4 ITAA 1936). Item 4 applies where items 1, 2 or 3 do not apply.
- An unlimited time frame to amend where the Commissioner is of the opinion that there has been fraud or evasion. In these circumstances, the Commissioner may amend the assessment at any time, regardless of the type of taxpayer (s. 170(1) item 5 ITAA 1936).
- An unlimited time frame to amend an assessment to give effect to a decision on review or appeal, or as a result of an objection made by the taxpayer or pending a review or appeal (s. 170(1) item 6 ITAA 1936).
- With regards to the amendment period for amending amended assessments (s. 170(3) ITAA 1936), the time frame available to the Commissioner is subject to how the original assessment was amended. For assessments subject to items 1 to 3 in the table in s. 170(1), the time frame may be two years after the day on which the Commissioner gives notice of the later assessment to the taxpayer. In some other cases, the Commissioner has four years, and in still others, the time period starts from when the original assessment was issued.

Schedule 1 ss 155-35 to 155-60 TAA 1953 detail the time frames in which the Commissioner has the power to amend GST assessments. Generally, an amendment period of four years applies; however, the Commissioner can amend a GST assessment at any time:

- To give effect to a private ruling requested within the amendment period.
- Where the Commissioner makes a declaration under the general GST anti-avoidance provisions.
- To give effect to certain decisions.
- Where the Commissioner is of the opinion there has been fraud or evasion.

Objections and appeals

For income tax assessments, individuals and SBEs generally have two years to object after being issued with an original notice of assessment. For all other taxpayers, four years is the relevant period (or 60 days after the amended assessment is issued). For GST assessments, the period is generally four years.

If an objection is disallowed, the taxpayer may seek a review by the Administrative Appeals Tribunal (AAT), or may appeal to the Federal Court of Australia (Federal Court).

The objections and appeals process follows the following six steps:

Step 1

Assessment: A notice of assessment or other taxation decision is served on the taxpayer by the Commissioner

↓

Step 2

Objection lodged: An objection against the assessment or other taxation decision is lodged with the Commissioner within two to four years of service of the notice of assessment or decision (or 60 days of the amended assessment). The taxpayer may apply for an extension of time

↓

Step 3

Commissioner makes an objection decision: The Commissioner serves the taxpayer with notice of a decision allowing (in whole or in part) or disallowing the objection. If a decision is not made within 60 days, the taxpayer may require the Commissioner to make a decision within a further 60-day period

↓

Step 4

Application of the AAT or Small Taxation Claims Tribunal (STCT) for review of the objection decision: The taxpayer then applies within 60 days of service of the Commissioner's decision to the AAT or the STCT (if the amount of tax in dispute is less than $5,000) for review of the objection decision. As an alternative, the taxpayer may appeal directly to the Federal Court (see Steps 5 and 6 below) in respect of the decision

↓

Step 5

Appeal to the Federal Court against the objection decision: The taxpayer may appeal to the Federal Court against the Commissioner's decision. Such an appeal must be made within 60 days of the Commissioner serving notice of the decision on the taxpayer

↓

Step 6

Further appeal to a higher court: It is possible to appeal to the Federal Court against an AAT or STCT decision on a matter of law. Such an appeal must be lodged within 28 days. An appeal from the Federal Court lies to the Full Federal Court, but must be lodged within 21 days. An appeal against a decision of the Full Federal Court lies to the High Court, but only with special leave of the High Court. The High Court will only hear tax cases in exceptional circumstances

Note: In relation to proceedings before the AAT, the STCT and the courts, it is the taxpayer who bears the onus of proof (ss 14ZZ and 14ZZO TAA 1953). Under s. 177 ITAA 1936, if there are court proceedings in respect of income tax, the Commissioner can produce the notice of assessment in court. This production constitutes the fact that the assessment has been duly made, except in relation to technical issues in dispute. These are dealt with under Part IVC TAA 1953 (*FJ Bloeman Pty Ltd v. FCT*; *FCT v. Futuris Corp. Ltd*).

A taxpayer who is dissatisfied with an assessment or a taxation decision may object to it under Schedule 1 s. 155-90 TAA 1953 (see also s. 175A ITAA 1936 for income tax specifically). To be valid, an objection must:

- be in the approved form
- be lodged with the Commissioner within the appropriate time limits, and
- state fully and in detail the grounds on which the taxpayer relies in disputing the matter.

The time limits within which objections must be lodged were discussed above at the beginning of this section. The Commissioner is bound to consider the taxpayer's objection and serve the taxpayer with written notice of the decision to disallow the objection, or to allow it wholly or in part (s. 14ZY TAA 1953).

Commissioner's rights and obligations

Power to access and request information

The TAA 1953 gives the Commissioner powers of access and the power to request information regarding a taxation law (including income tax, FBT and GST). The ATO exercises these powers when conducting income tax and GST audits or reviews.

Access

Under Schedule 1 s. 353-15(1) TAA 1953, the Commissioner has full and free access to all premises, places, documents, goods and other property for any purpose of the Act and may make extracts or copies of them. Note that the Commissioner's powers under this section do not extend to the seizure of documents, which generally requires a search warrant. The courts have always interpreted this section very widely (*Industrial Equity Ltd v. Crawley & DCT*).

Schedule 1 s. 353-15(2) TAA 1953 provides that an officer is not entitled to enter or remain on any premises if the occupier of the premises requests proof of authority and the officer fails to produce an authority signed by the Commissioner stating the officer is authorised to exercise powers under the section. This is referred to as 'black wallet' authority.

Schedule 1 s. 353-15(3) TAA 1953 explains that the taxpayer must provide the officer with all reasonable facilities and assistance for the effective exercise of the officer's powers under the section. This may mean the use of photocopiers, providing advice on locating documentation and ensuring there is sufficient lighting for them to perform their duties.

Request information

Under Schedule 1 s. 353-10 TAA 1953, for the purposes of administrating or operating a taxation law, the Commissioner has the power to request, by written notice, that any person:

- Give the Commissioner such information as the Commissioner may require.
- Attend and give evidence before the Commissioner and produce any documentation in the person's possession.

The Commissioner's power under this section overrides a banker–client contract. The bank is required to open safety deposit boxes if the ATO requests it to do so (*FCT v. Australia & New Zealand Banking Group Ltd*; *Smorgon v. FCT*).

Taxpayers cannot rely on the privilege against self-incrimination (*Stergis v. Boucher*).

Under Schedule 1 Subdivision 353-B TAA 1953, the Commissioner may also issue an 'offshore information notice' which requests a party to give information or produce documents where the Commissioner believes the information or documents are located outside Australia. Where such information or documents are not provided, they are inadmissible in any subsequent dispute.

Limits on the Commissioner's powers – legal professional privilege

The only restraint on the Commissioner's powers under Schedule 1 ss 353-10 and 353-15 TAA 1953 is the doctrine of legal professional privilege. The Commissioner is obliged to give taxpayers the opportunity to claim this privilege. Legal professional privilege belongs to the client (i.e. taxpayer), not the lawyer (*FCT v. Citibank Ltd*).

Legal professional privilege applies to:

- Confidential communications between a lawyer and a client produced in the context of the lawyer-client relationship.
- Communications consisting of legal advice or legal services relating to litigation.
- Communications created for the dominant purpose of providing that legal advice (*Esso Australia Resources Ltd v. FCT)*.

Legal professional privilege can be extended to documents that are given to an accountant by a legal advisor to aid such legal advice. This was confirmed in *Pratt Holdings Pty Ltd v. FCT*. It is, however, unlikely to extend to the accountant's confidential communications with the client.

When access is exercised, the ATO must give taxpayers the opportunity to claim legal professional privilege (*JMA Accounting Pty Ltd and Entrepreneur Services Pty Ltd v. Carmody*).

After the ATO's raid in *FCT v. Citibank Ltd*, the ATO issued access guidelines granting an administrative privilege to accountants. These are contained in the ATO's *Approach to information gathering*. Although accountants' administrative privileges lack legislative force, taxpayers have a legitimate expectation that they will be followed.

Legal professional privilege is lost when disclosure is made to a third party. At times, taxpayers choose to waive their claim to this privilege. Privilege is not available where the communication is calculated to further an illegal object. This exception to legal professional privilege is called the 'fraud-crime-illegality' exception.

Remedial power

Under Schedule 1 s. 370-5 TAA 1953, the Commissioner has the power to make a legislative instrument to modify the operation of a taxation law to ensure the law can be administered to achieve its intended purpose or object.

Third party reporting power

Under Schedule 1 s. 396-50 TAA 1953, the Commissioner has the power to require taxpayers to give information about transactions that could reasonably be expected to have tax consequences for other entities.

The **taxable payment reporting system** requires certain taxpayers to lodge an annual report by 28 August each year detailing taxable payments made to contractors for providing services. The ATO uses the information gathered to identify contractors who may not be correctly reporting their assessable income.

Contractors can include subcontractors, consultants and independent contractors. They can be operating as sole traders (individuals), companies, partnerships or trusts. The reporting system applies to the following:

- Government-related entities and taxpayers in the building and construction industry.
- The courier and cleaning industries (from 1 July 2018).
- The security, road freight transport, and computer system design industries (from 1 July 2019).

Note: From 1 July 2019, all business to business payments above $10,000 must be handled via the banking system (i.e. cash transactions will not be allowed for tax purposes).

Record-keeping

Taxpayers are required to keep certain taxation records. The major record keeping rules are as follows:

- Section 262A ITAA 1936 requires those carrying on a business to keep records that record and explain all transactions that may be relevant for the purposes of the taxation Acts. The records must be kept in writing and in English (or readily convertible to English), but they may be retained electronically.
- Records must generally be retained for five years after the records were prepared (s. 262A(4)(a) ITAA 1936). However, most individual taxpayers and businesses lodging under the SBE regime only have to keep certain records for two years.
- There are special transfer pricing documentation rules in Schedule 1 Subdivision 284-E TAA 1953. Specifically, transfer pricing documentation must be prepared before lodging the tax return and it must be maintained in Australia (see Unit 14).
- There are penalties for failure to keep the appropriate records.

The general application of the record-keeping requirements that apply to business taxpayers is explained in TR 96/7. The application of the record-keeping requirements and Commissioner's access powers in respect of electronic records are explained in TR 2018/2.

Uniform administrative penalty regime

The uniform administrative penalty regime applies to all taxation laws (e.g. income tax and GST). It consists of three distinct components, contained in Schedule 1 TAA 1953:

- Penalties relating to statements and schemes (Schedule 1 Division 284 TAA 1953), including:
  - Making a statement that is false or misleading, or does not apply the income tax law in a manner that is 'reasonably arguable' (Schedule 1 Subdivision 284-B TAA 1953).
  - Participating in schemes (Schedule 1 Subdivision 284-C TAA 1953) (see Unit 15).

    (The administrative penalties applicable to participating in schemes are outside the scope of the TAXAU module.)
- Penalties for late lodgement of returns and other documents (Schedule 1 Division 286 TAA 1953).
- Penalties for failing to meet other taxation requirements (Schedule 1 Division 288 TAA 1953).

Penalties relating to statements

An administrative penalty is applicable under Schedule 1 Subdivision 284-B TAA 1953 when a statement made to the Commissioner by either the taxpayer or their agent:

- regarding any taxation law is false or misleading in a material particular (Schedule 1 s. 284-75(1) TAA 1953), or
- does not apply the income tax law in a manner that is 'reasonably arguable' (Schedule 1 s. 284-75(2) TAA 1953).

Alternatively, an administrative penalty applies where the taxpayer has failed to make a statement to the Commissioner regarding any taxation law, which has resulted in the Commissioner determining a tax-related liability (Schedule 1 s. 284-75(3) TAA 1953). For example, this penalty would apply in a situation where the taxpayer has not lodged an income tax return.

However, an administrative penalty is **not applicable** for false and misleading statements where:

- The taxpayer and the agent (if relevant) took reasonable care in connection with the making of the statement (Schedule 1 s. 284-75(5) TAA 1953).
- The taxpayer engages an agent and provides them with all relevant taxation information, if the false or misleading nature of the statement did not result from intentional disregard or recklessness by the agent (Schedule 1 s. 284-75(6) TAA 1953). In practice, this concession is hard to obtain.

'Reasonably arguable' position

Schedule 1 s. 284-15(1) TAA 1953 defines a reasonably arguable position as one that is 'more likely to be correct than incorrect'. The reasonably arguable standard applies to income tax law (s. 284-75(2)), but does not apply to GST.

The reasonably arguable standard only applies to taxpayers with a shortfall amount that exceeds the reasonably arguable position threshold (Schedule 1 s. 284-90(1) item 4 TAA 1953), as follows:

- For taxpayers other than a trust or partnership – the greater of $10,000 or 1% of the income tax payable by the taxpayer based on their income tax return.
- For a trust or partnership – the greater of $20,000 or 2% of net income of the entity based on the entity's income tax return.

In determining whether they have a reasonably arguable position, the taxpayer can refer to a wide range of authorities, including ITAA 1936 or ITAA 1997, a decision of the court or the AAT, a public ruling or any other relevant authority to support a particular treatment of an item.

The fact that a public ruling is a relevant authority in working out whether the taxpayer has a reasonably arguable position really stacks the odds in favour of the ATO. In addition, the taxpayer's individual circumstances are not considered (see MT 2008/1); therefore, the fact that the taxpayer has exercised reasonable care is irrelevant.

Note that where the taxpayer has used a tax agent, the taxpayer may still be vicariously liable for any penalties as a result of the agent's conduct on their behalf (subject to the tax agent safe harbour concession, which allows taxpayers to be relieved of penalties where errors have been made by the tax agent). A statement made by an agent in the approved form is taken to have been made by the taxpayer (Schedule 1 s. 284-25 TAA 1953).

The ATO has provided guidance on shortfall penalties where the taxpayer has taken a position that is not reasonably arguable in MT 2008/2.

Shortfall amount

A shortfall amount arises where the amount of the relevant liability, payment or credit is less than or more than it would have been in comparison to the proper tax payable if the tax had been calculated in accordance with the law (Schedule 1 s. 284-80 TAA 1953).

Penalty unit

The value of one penalty unit with effect from 1 July 2017 is $210 (s. 4AA *Crimes Act 1914*). The amount is indexed every three years based on the Consumer Price Index.

Penalty amount

Under Schedule 1 s. 284-85 TAA 1953, the formula for calculating the administrative penalty amount is:

BPA	+	[BPA	×	(Increase % – Reduction %)]

Where, for entities that are not a significant global entity:

- BPA is the **base penalty amount**. The BPA is identified for a variety of situations in the table in Schedule 1 s. 284-90(1) TAA 1953. The different BPAs in the table reflect the level of care taken by the taxpayer or agent in making the statement. For example:
  - Where there is a shortfall amount that results from an intentional disregard of a taxation law, the BPA is calculated as 75% of the tax shortfall amount (Schedule 1 s. 284-90(1) item 1 TAA 1953).
  - Where there is a shortfall amount that results from a failure to take reasonable care, the BPA is calculated as 25% of the shortfall amount (Schedule 1 s. 284-90(1) item 3 TAA 1953).
  - Where a statement is false or misleading because of recklessness but did not result in having a shortfall amount, the BPA is calculated as 40 penalty units (Schedule 1 s. 284-90(1) item 3B TAA 1953).
  - Where there is a shortfall amount that results from a statement that does not apply the income tax law in a manner that is 'reasonably arguable' and the shortfall amount exceeds the reasonably arguable threshold, the BPA is calculated as 25% of the shortfall amount.
  - Where the taxpayer is a significant global entity (SGE) the above rate is doubled. For example, the failure to lodge BPA is calculated at 50% of the tax shortfall amount.
- 'Increase %' is the percentage increase (if any) under Schedule 1 s. 284-220 TAA 1953. It is an adjustment to the BPA based on the taxpayer's degree of culpability. The BPA is increased by 20% where the taxpayer obstructs the ATO, did not inform the ATO of a shortfall amount within a reasonable time, or has repeat offences.
- 'Reduction %' is the percentage decrease (if any) under Schedule 1 s. 284-225 TAA 1953. The BPA is reduced by 20% where the taxpayer voluntarily tells the ATO about a shortfall amount.

The ATO has provided guidance on the interpretation of the terms ‘reasonable care’, ‘recklessness’ and ‘intentional disregard’ in MT 2008/1. For example, the reasonable care test considers the taxpayer’s individual circumstances (e.g. the taxpayer’s knowledge) and whether a taxpayer in similar circumstances would have exercised greater care. Unfortunately, the greater the taxpayer’s knowledge, the greater the reasonable-care onus.

As noted above, a BPA can be increased or decreased based on the culpability of the taxpayer. For example, where a BPA was applied in a prior period for a transposition error on a BAS and an error of the same nature was then made in the subsequent period due to a failure to take reasonable care, the BPA would be increased by 20% (Schedule 1 s. 284-220(1)(c) TAA 1953).

Note: The BPA can be reduced by up to 80% where the taxpayer makes a voluntary disclosure before the Commissioner commences an investigation into the taxpayer’s affairs. However, once an investigation commences, the base penalty amount can normally only be reduced by up to 20%, even where the taxpayer assists the Commissioner.

Penalties for failing to lodge returns and other documents

An administrative penalty is generally imposed when a taxpayer fails to lodge a taxation document with the Commissioner by a particular day or in an approved form (Schedule 1 s. 286-75 TAA 1953).

The amount of the penalty is calculated in accordance with Schedule 1 s. 286-80 TAA 1953, and has two components:

- BPA based on the timing of the lodgement of the approved form.

  All entities are liable for the base penalty amount where the approved form is not lodged by the required time. Schedule 1 s. 286-80(2) TAA 1953 identifies that **base penalty amounts** are calculated as one penalty unit ‘for each period of 28 days or part of a period of 28 days’ during which the documents remained outstanding or were not lodged in the approved form.
- Increase (if any) in BPA based on the size of the taxpayer.

  Entities are classified as small, medium or large. For the threshold test classification of entities, see Schedule 1 ss 286-80(3) and (4) TAA 1953. The amount of the BPA is increased as follows:
  - Small entity (which includes most individuals) – no increase in the BPA.
  - Medium entity – the BPA is multiplied by two (Schedule 1 s. 286-80(3) TAA 1953).
  - Large entity – the BPA is multiplied by five (Schedule 1 s. 286-80(4) TAA 1953).
  - Significant global entity (SGE) – the BPA is multiplied by at least 100.

As noted above under penalties relating to statements, the value of one penalty unit with effect from 1 July 2017 is $210 (s. 4AA of the *Crimes Act 1914*). The amount is indexed every three years based on the Consumer Price Index.

For example, if a large entity is late in lodging by 28 days or less the penalty will be $1,050 (i.e. $210 × 5). However, for an SGE the penalty will be $105,000 (i.e. $210 × 5 × 100).

Penalties for failing to meet other taxation requirements

Schedule 1 Division 288 TAA 1953 incorporates miscellaneous penalties that apply under various taxation laws into, broadly, three key penalty provisions. A taxpayer will be liable for a penalty of 20 penalty units where they have failed to:

- Keep or retain records (Schedule 1 s. 288-25 TAA 1953).
- Retain or produce declarations (Schedule 1 s. 288-30 TAA 1953).
- Provide access in order to assist a taxation officer to effectively carry out their duties (Schedule 1 s. 288-35 TAA 1953).

Activity 1.7: Administrative penalties

[Available online in myLearning]

Interest regime

Where a taxpayer has underpaid tax or a tax shortfall exists, the taxpayer would generally be liable to pay a:

- general interest charge (GIC), and/or
- shortfall interest charge (SIC).

General interest charge

A GIC is payable on an outstanding **tax** debt (and an outstanding SIC amount) where payment has not been made by the due date (s. 8AAB TAA 1953). GIC applies for each day the debt remains unpaid, is calculated on a compounding daily basis (s. 8AAC TAA 1953) and is based on a markup of the average yield of the 90-day bank-accepted bill rate published by the Reserve Bank of Australia (s. 8AAD TAA 1953).

The GIC applies to most taxes, including income tax, GST, FBT and PAYG. The rate generally changes each quarter. For example, for the quarter ended 31 December 2019, the GIC annual rate was 7.98%.

The GIC is tax deductible under s. 25-5.

Shortfall interest charge

Where the Commissioner issues an amended assessment increasing an **income tax** liability, the taxpayer may be liable to pay an SIC on the additional amount. The SIC operates in a similar manner to the GIC (i.e. compounded on a daily basis under Schedule 1 s. 280-105 TAA 1953) but at a lower rate. The rate generally changes each quarter. For example, for the quarter ended 31 December 2019 the SIC rate was 3.98%.

It applies to the additional amount from the due date for payment of the **income tax** liability under the original assessment until the day before the amended assessment is issued. It does not apply to other taxes. The amended income tax assessment or income tax shortfall and the related SIC are due 21 days after the amended income tax assessment is issued.

The SIC is tax deductible under s. 25-5.

Other key resources

‘Tax takes’ video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 2: Goods and service tax (GST)

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Explain and calculate the net GST payable/refundable.
2. Outline the GST provisions that apply to second-hand goods.
3. Outline the GST anti-avoidance provisions.
4. Describe the administrative and compliance arrangements relating to the GST.

Introduction

The goods and services tax (GST) is a transaction-based tax, that is, it applies to transactions rather than taxable income. Consequently, GST is a tax that has an immediate impact on costs and pricing of transactions, and thus can have a significant impact on a business's profits.

The GST imposed by the GST Act is a broad-based consumption tax (also known as a value-added tax) that aims to tax 'private final consumption expenditure' in Australia – that is, although the tax is imposed on businesses, the intention is that the end consumer of the goods or services bears the tax.

GST is calculated and collected on the value that is added by each participant in the production chain. To ensure that the end user of the goods or services is the one who actually bears the cost of the tax, the GST features a credit (i.e. refund) mechanism.

This unit covers the fundamentals of GST, including the concepts of taxable supplies, taxable importations, creditable acquisitions and creditable importations. It also considers the main exceptions to GST (i.e. GST-free supplies and input taxed supplies) and provides an overview of the GST general anti-avoidance provisions and certain special rules. A clear understanding of these concepts is required when determining GST liabilities and entitlements to input tax credits.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be considered.
- Unless otherwise indicated, legislative references in this unit relate to *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) and *A New Tax System (Goods and Services Tax) Regulations 2019* (GST Regulations).
- The GST year covered in the TAXAU module is 30 June 2019 (i.e. the quarterly tax periods ending 30 September 2018, 31 December 2018, 31 March 2019 and 30 June 2019). Therefore, the amendments to the GST provisions that are applicable from 1 July 2019 are outside the scope of this offering of the module. The details provided in this unit are for reference purposes only. However, they are useful when referring to current GST legislation (as it may include these amendments).

GST framework

Design of the GST

The GST Act has been written in the 'plain English' style and follows a definition-driven model. In progressing through this topic, candidates should read the GST Act, which will assist in understanding its application. The starting point is s. 7-1, which outlines when GST is payable and when the entitlement to input tax credits arises, as follows:

(1) GST is payable on *taxable supplies and *taxable importations.

(2) Entitlements to input tax credits arise on *creditable acquisitions and *creditable importations.

Note the terminology. The asterisk denotes that each of these terms is specifically defined in the GST Act. The terms and their specific requirements under the GST Act will be discussed later in this unit.

The Dictionary to the GST Act is located in Part 6-3 Division 195.

Calculation methodology

The term 'net amount' is used throughout the GST Act and is defined in Division 17. The net amount is the GST amount payable by an entity to the ATO, or by the ATO to an entity, in relation to a particular tax period – that is, the total GST liability and input tax credit entitlement in a tax period.

The net amount is worked out using the formula:

GST liability – Input tax credit = Net amount

The net amount is then increased by the amount of any increasing adjustments for the period, and decreased by the amount of any decreasing adjustments in the period (discussed later in this unit under special rules).

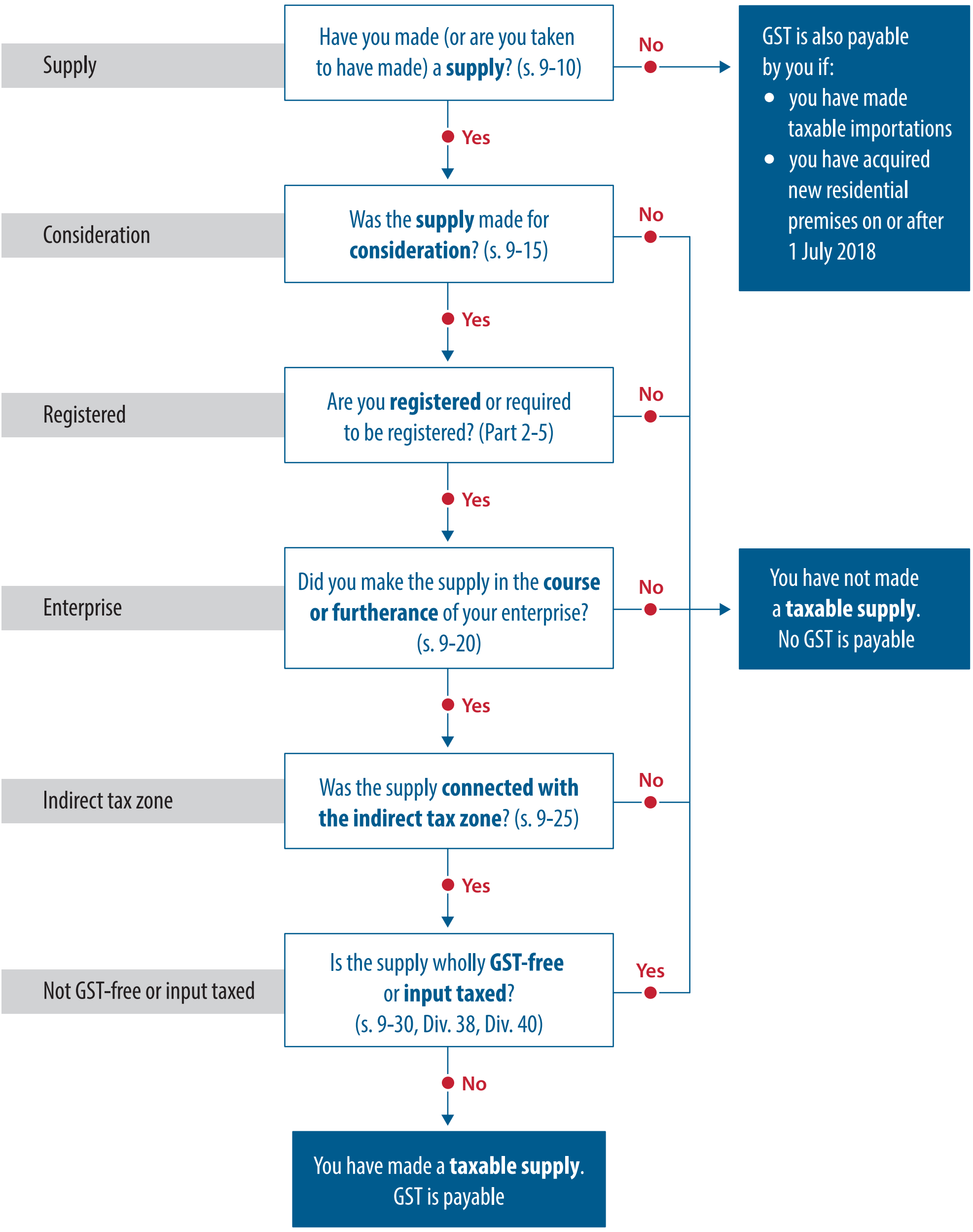
Two important points to note are:

- A liability to **pay** GST to the ATO relates to taxable supplies and taxable importations. In other words, when an enterprise makes a sale it needs to determine if GST must be charged as part of the sale price and then remitted to the ATO.
- A **refund** of GST from the ATO relates to creditable acquisitions or creditable importations. In other words, when an enterprise purchases goods or services, it needs to determine if it has paid GST as part of the purchase price and if so, can a refund of GST be claimed from the ATO.

GST taxable supplies

Overview

The notion of a taxable supply is central to the operation of the GST. GST is payable in respect of a taxable supply, and a creditable acquisition (discussed below) cannot be made without a taxable supply. The following flow chart (representing s. 9-5) demonstrates how an enterprise determines whether it has made a taxable supply:



There are a number of elements to a taxable supply, and each of these must be satisfied for a supply to be a taxable supply. Using an acronym of the above steps (i.e. the 'SCREIN' process) encourages working through each of the required elements.

Required reading

Section 9-5 GST Act.

Supply

'Supply' is very broadly defined in s. 9-10 as 'any form of supply whatsoever'. It therefore includes the supply of both tangible things and intangible things. However, it generally excludes the supply of money (i.e. currency or digital currency).

The High Court in *CoT v. Qantas Airways Limited* held that there is a taxable supply where fares are received for flights booked but not undertaken by prospective passengers. This case raised fundamental questions as to what constitutes a supply for GST purposes, and at what point that supply can be identified as a taxable supply.

Consideration

'Consideration' is defined in s. 9-15. It includes 'any payment, or any act or forbearance, in connection with a supply of anything'. It does not matter whether the payment is voluntary or involuntary. Note that consideration does not have to be money, which ensures that barter-type transactions (for non-monetary consideration) are also caught in the GST net. There are a number of departures from the general consideration rules. In particular, refer to Divisions 81, 99 and 102.

An important aspect of the concepts of supply and consideration is drawing a nexus between the two for there to be satisfaction of the first two elements of a taxable supply.

Registered or required to be registered

A supply will only be a taxable supply where the entity making the supply is registered or required to be registered. The fact that an entity is not registered does not affect the taxable status of a supply if that entity is required to be registered. Registration requirements are analysed later in this unit.

Enterprise

'Enterprise' is defined in s. 9-20. It includes (but is not limited to) 'any activity, or series of activities, done in the form of a business, or in the form of an adventure or concern in the nature of trade'. For ATO guidance on the meaning of enterprise refer MT 2006/1.

An entity must be an enterprise in order to obtain an ABN and/or GST registration. An entity can apply for an Australian Business Number (ABN) without applying for GST registration if its turnover is below the compulsory registration threshold.

There are three important **exclusions** from the definition of enterprise:

1. The activities of employees are stated not to amount to an enterprise. The practical effect is that wages are not subject to GST. In addition, activities connected to the earning of certain withholding payments are not an enterprise.

   The specified withholding payments are set out in s. 9-20 and summarised as follows:

Withholding payments covered (s. 9-20)	
Schedule 1 TAA 1953	**Subject matter**
Section 12-35	Payment to employee
Section 12-40	Payment to company director
Section 12-45	Payment to office holder
Section 12-60	Payment under labour hire arrangement or specified by regulations

2. Activities that are carried out as hobbies or recreational pursuits are not an enterprise, regardless of whether they result in profit. This has the practical effect of denying input tax credits for private expenses incurred when engaging in hobbies or recreational pursuits that will only ever result in losses.

In *FCT v. Swansea Services Pty Ltd*, the court held that the acquisition and very occasional sale of artworks and antiques was an enterprise, even though it was a borderline hobby.

3. Activities carried on by individuals or partnerships only, but not carried on with a reasonable expectation of profit or gain, are not enterprises.

Note that the definition of a taxable supply requires that the supply be made 'in the course or furtherance of an enterprise that you **carry on**'. Carrying on an enterprise is defined in s. 195-1 to include anything done 'in the course of the commencement or termination of the enterprise'. A business which is in the process of being wound down would still be an enterprise provided that the activities have not stopped completely.

Connected with the indirect tax zone (i.e. Australia)

The fifth element of the definition of a 'taxable supply' is that the supply must be connected with the indirect tax zone (ITZ). The ITZ is defined under s. 195-1 to mean Australia, excluding its external territories (i.e. excluding Christmas Island, Cocos (Keeling) Islands, Territory of Ashmore and Cartier Islands, Norfolk Island and MacDonald Islands, where GST does not apply).

Inclusions

Under s. 9-25, a supply is **connected** with the ITZ if it involves:

- **Goods** that are:
  - delivered to or made available in the ITZ (i.e. **domestic transactions**), or
  - being **removed from** the ITZ, or
  - being **brought to** the ITZ and the supplier is the importer.

  For ATO guidance on when goods are connected with the ITZ see GSTR 2018/1.
- **Real property** situated in the ITZ.

  For ATO guidance on when real property is connected with the ITZ see GSTR 2018/2.
- Anything other than goods or real property (i.e. **intangible supplies**) where:
  - the thing is done in the ITZ, or
  - the supply is made through an enterprise the supplier carries on in the ITZ, or
  - the thing is a right or option to acquire another thing and the supply of that other thing would be connected with the ITZ, or
  - the recipient is an Australian consumer.

  Examples of **intangible supplies** include digital products such as streaming or downloading of movies, music, apps or games, and other services such as consultancy and professional services.

  For draft ATO guidance on the supply of anything other than goods or real property connected with the ITZ, see GSTR 2019/D2.

  An **Australian consumer** is defined under s. 9-25(7). An entity that is a recipient of a supply is an Australian consumer if:

  - the entity is an Australian resident (but not an Australian resident solely because they are a resident of the external territories where GST does not apply), and
  - either the entity:
    - is not registered for GST, or
    - is registered for GST and does not acquire the supply solely or partly for the purpose of an enterprise it carries on.

  However, a supplier may treat a recipient as **not** being an Australian consumer if, after taking reasonable steps or using reasonable procedures, the supplier reasonably believes that to be the case (s. 84-100).

  For ATO guidance on the meaning of Australian consumer see GSTR 2017/1.

Under s. 9-27, an **enterprise is carried on in the ITZ** if it is:

- carried on by one or more relevant individuals who are in the ITZ, and
- carried on:
  - in a fixed place in the ITZ, or
  - in one or more places for 183 days in a 12-month period.

For ATO guidance on when an enterprise is carried on in the ITZ see LCR 2016/1.

- An **offshore supply of low-value goods** where:
  - the recipient is a consumer (s. 84-75(1)), and
  - the goods are brought to the ITZ with the assistance of the seller (i.e. retailer), an electronic distribution platform (EDP) operator (s. 84-70), or a re-deliverer (s. 84-77).

  Low-value goods are defined under s. 84-79 as goods (except for tobacco products and alcoholic beverages) that have a customs value of $1,000 or less at the time of supply. For ATO guidance on low-value goods see LCR 2018/1.

  Consumer is defined under s. 84-75(2). It is the same as the definition of Australian consumer under s. 9-25(7) that applies to intangible supplies (see above). However, a supplier may treat a recipient as **not** being a consumer if the supplier reasonably believes that to be the case (s. 84-105).

Exclusion for intangible supplies

Under s. 9-26, a supply of anything other than goods or real property (i.e. an **intangible supply**) is **not connected** with the ITZ if **all** of the following are satisfied:

- The supply is made by a **non-resident**.
- The supply is **not** made through an enterprise the supplier carries on in the ITZ.
- The thing is done in the ITZ.
- The recipient of the supply is:
  - an Australian based business recipient (i.e. an enterprise that is registered for GST), or
  - a non-resident that acquires it for the purpose of an enterprise it carries on outside the ITZ.

Example - Intangible supplies connected and not connected with ITZ

Applying the above rules, **intangible supplies by a foreign-based business** to:

- An Australian-based **business are not connected** with the ITZ under s. 9-26. Where GST would have ultimately been payable on a supply but for this exclusion, the obligations are shifted to the Australian-based business recipients that are already registered for GST, through the operation of reverse charge provisions in Division 84 (see discussion later in this unit).
- An Australian resident **individual for private consumption are connected** with the ITZ under s. 9-25. The foreign-based business would need to determine if it is required to register for GST (see discussion later in this unit).

Exclusion for low-value goods

An offshore supply of **low-value goods** will **not be connected** with the ITZ if:

- After taking reasonable steps, the supplier reasonably believes that the goods would be imported into Australia as a taxable importation (s. 84-83).
- The goods are imported into Australia as a taxable importation (s. 84-85). This section applies if s. 42-15 has not applied to make the importation a non-taxable importation.

For further guidance see discussion later in this unit on GST importations.

Example – Low-value goods connected with indirect tax zone

Katie is an Australian resident who purchases a computer for $500 (excluding delivery charges and GST where applicable) from a retailer in China. The retailer posts the computer to Katie's nominated address in Australia. Katie is not registered for GST.

The computer satisfies the definition of low-value goods as it has a customs value of $1,000 or less at the time of supply (i.e. when the consideration for the supply is first agreed). The customs value of the computer is $500 (i.e. cost excluding delivery charges and GST where applicable).

Katie satisfies the definition of a consumer as she is not registered for GST. Based on the facts, it would not be reasonable for the retailer to believe that Katie is not a consumer.

The computer is an offshore supply of low-value goods to a consumer, because it is a supply of low-value goods, it is brought into the ITZ with the assistance of the retailer (the supplier), and Katie is a consumer. Therefore, the supply is connected with the ITZ.

Note: The computer is a non-taxable importation (see discussion later in this unit).

Example – Low-value goods not connected with indirect tax zone

Katie is an Australian resident who purchases a computer for $500 (excluding delivery charges and GST where applicable) from a retailer in China. Katie supplies her ABN to the retailer and declares that she is registered for GST. The computer is to be used solely in Katie's business in Australia. The retailer posts the computer to Katie's nominated address in Australia.

The computer has a customs value of $500 and is low-value goods (see example above).

Katie is **not** a consumer as she is registered for GST and has acquired the computer solely for the purpose of an enterprise she carries on. Even if Katie was a consumer (i.e. because she did not in fact use the computer in her business), the retailer would be entitled to treat her as **not** being a consumer. It is reasonable for the retailer to believe that Katie is not a consumer as she has provided the retailer with her ABN and declared that she is registered for GST.

The computer is **not** an offshore supply of low-value goods to a consumer (despite the fact that it is a supply of low-value goods that is brought to the ITZ with the assistance of the retailer) as Kate is not a consumer. Therefore the supply is **not** connected with the ITZ.

Note: The computer is a non-taxable importation (see discussion later in this unit).

Not GST-free or input taxed

With regard to the final element of a taxable supply, supplies that are GST-free or input taxed are **not** taxable supplies (see discussion later in this unit).

A supply that is connected with the indirect tax zone might nevertheless be GST-free or input taxed; for example, if it is exported (s. 38-185) or consumed outside the indirect tax zone (s. 38-190). Therefore, just because a supply is connected with the indirect tax zone does not mean it is subject to GST.

Liability for GST on taxable supplies

Who is liable

The supplier is liable for GST (s. 9-40). However, a supplier should have adjusted the price of their supply to factor in the GST resulting in the GST burden being passed on to the end consumer. This is what is meant when a tax is referred to as an 'indirect tax'. The GST is indirectly imposed on private consumption.

A supplier that fails to incorporate the GST into the price of their supply will bear the GST burden.

Required reading

Section 9-40 GST Act.

Amount of GST

The GST rate is often discussed as being 10%, but the way in which the 10% is arrived at is not just a matter of 'add 10%'. The GST relies on the concepts of value and price.

Under s. 9-70, the amount of GST on a taxable supply is 10% of the value. Value is defined in s. 9-75 to be $^{10}/_{11}$ of the price. Subdivision 9-C explains the concepts of **value** and **price** in the GST context.

Example – GST liability

SmithCo is an Australian resident company that carries on an enterprise of selling toothbrushes and is registered for GST. It makes a taxable supply for a GST-inclusive price of $550,000. The value of the supply is $^{10}/_{11} \times \$550{,}000 = \$500{,}000$. SmithCo should recognise this amount in its assessable income for income tax purposes.

The amount of SmithCo's GST liability will be 10% of the value, or $10\% \times \$500{,}000 = \$50{,}000$. Another way of determining the GST component of the price is to multiply it by $^{1}/_{11}$. Thus, $^{1}/_{11} \times \$550{,}000 = \$50{,}000$. SmithCo should remit the GST component to the ATO.

Required reading

Subdivision 9-C (ss 9-70 to 9-99) GST Act.

Supplies for inadequate consideration

Under s. 72-70, where the consideration for a taxable supply to an associate is less than the GST-inclusive market value, its **value** is the GST-exclusive market value of the supply. However, this section does not apply if the associate is registered (or required to be registered) for GST and acquires the thing supplied solely for a creditable purpose.

Example – GST liability: Inadequate consideration paid

Bob is an Australian resident who carries on a garden maintenance enterprise and is registered for GST. He makes a taxable supply to his sister Jane for her private consumption (i.e. it is not supplied for a creditable purpose). The consideration for the supply is $8,800 but the market value is $11,000.

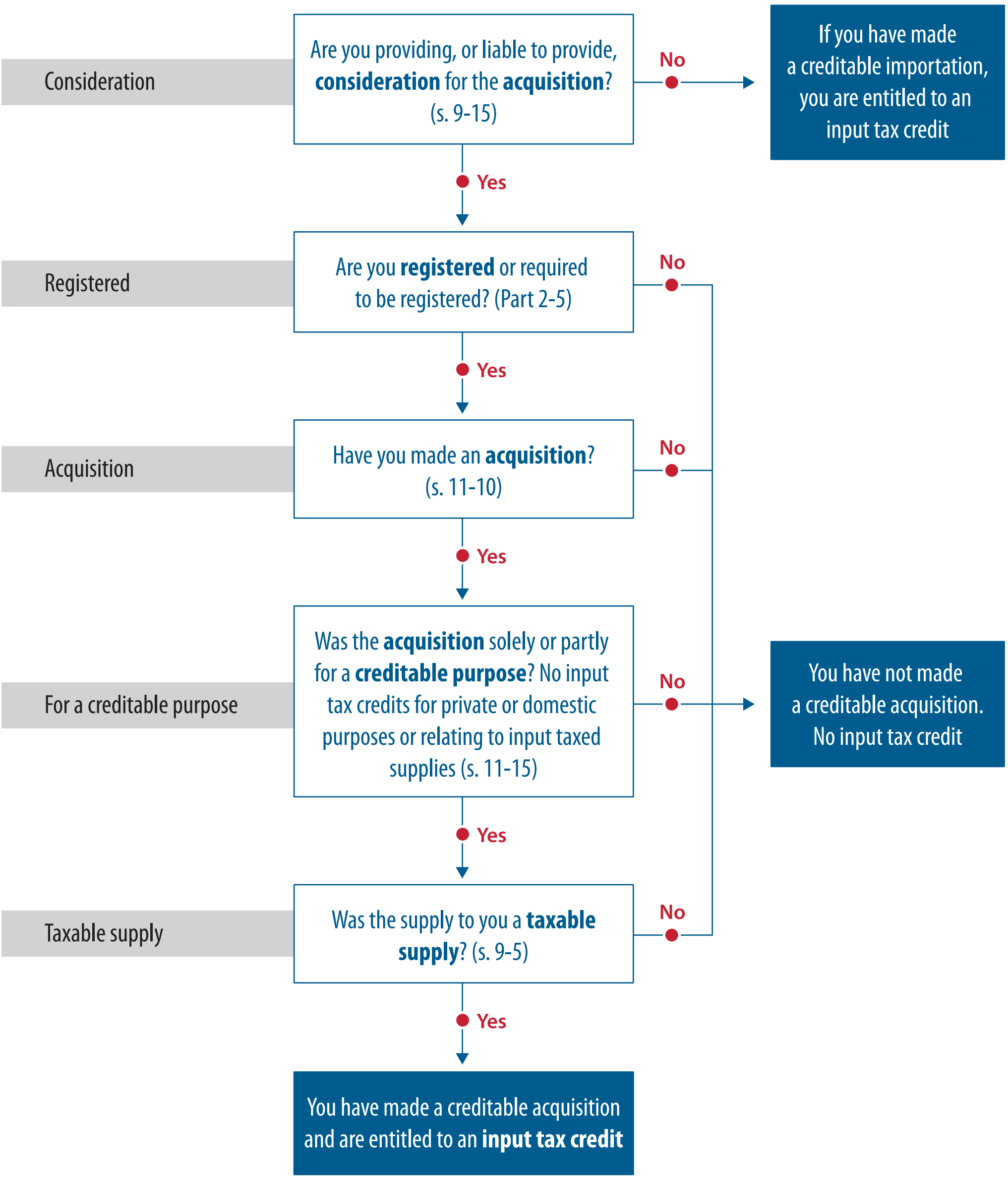
The value of the supply for GST purposes is $^{10}/_{11} \times \$11{,}000 = \$10{,}000$. Therefore, Bob's GST liability will be 10% of the value or $10\% \times \$10{,}000 = \$1{,}000$. Bob should remit GST of $1,000 to the ATO when lodging his next Business Activity Statement (BAS). It does not matter that the GST Bob actually collected from his sister was only $800.

GST creditable acquisitions

Overview

The other side of the GST relates to input tax credits and creditable acquisitions. An input tax credit is the mechanism by which an enterprise claims the GST that it has paid on acquisitions, resulting in GST being passed down the value chain to the end consumer (who is unable to claim an input tax credit).

Before an enterprise can claim an input tax credit for the GST it has paid, **GST must have been paid on a creditable acquisition** and a number of other conditions also met. The following flow chart (representing s. 11-5) shows how an enterprise can determine whether it has made a creditable acquisition:



Again, an acronym – 'CRAFT' – may be used to recall the various steps in the process of determining whether a creditable acquisition has been made.

As with a taxable supply, a number of elements needs to be satisfied in order for an acquisition to be a creditable acquisition. In particular, you need to understand the key concepts of 'acquisition' and 'creditable purpose'.

Acquisition

'Acquisition' is defined very broadly in s. 11-10 to be 'any form of acquisition whatsoever'. Note that it mirrors the definition of 'supply', as discussed above. It therefore includes the acquisition of both tangible things (e.g. goods and real property) and intangible things (e.g. services, advice and information, digital property, rights and options).

Creditable purpose

Under ss 11-15 and 15-10, you acquire or import a thing for a creditable purpose to the extent that 'you acquire it in carrying on your enterprise'. (See the discussion above on what constitutes carrying on an enterprise.)

An acquisition is **not** made for a creditable purpose to the extent that it:

- relates to making supplies that would be input taxed (see the discussion below on input taxed supplies), or
- is of a private or domestic nature.

Note that an entity will not be taken to make an input taxed supply and will not be denied an input tax credit if the supply is a financial supply, and

- the value of those supplies does not exceed the **financial acquisitions threshold**, or
- the acquisition consists of a borrowing that relates to making supplies that are not input taxed.

An in-depth understanding of the financial acquisitions threshold is not required. See the section on the *de minimis* rule later in this unit.

Required reading

Sections 11-5, 11-15 and 15-10 GST Act.

Entitlement to input tax credits

Under s. 11-20, an entity is entitled to an input tax credit for any creditable acquisition that it makes.

Amount of input tax credit

The amount of input tax credit for a creditable acquisition is basically the same as the **amount of GST paid** on the taxable supply (s. 11-25).

Where the supply is either a GST-free supply or an input taxed supply, no GST will have been paid on the acquisition. As a general rule, if there is no GST paid on an acquisition, then there is no entitlement to claim an input tax credit (i.e. you cannot claim a refund for something you have not paid for).

Apportionment of the input tax credit will be required where the acquisition is only partly for a creditable purpose (e.g. where the taxpayer uses the goods or services partly for private purposes).

Example – Input tax credits

SmithCo is an Australian resident company that carries on an enterprise of selling toothbrushes and is registered for GST. It makes a taxable supply for a GST-inclusive price of $550,000 to DentistCo. DentistCo is also registered for GST and uses the toothbrushes for creditable purposes.

The value of the supply is $^{10}/_{11} \times$ $550,000 = $500,000. DentistCo should recognise this amount as an allowable deduction for income tax purposes.

The amount of GST paid by DentistCo will be 10% of the value, or 10% × $500,000 = $50,000. Another way of determining the GST component of the price is to multiply it by $^{1}/_{11}$. Thus, $^{1}/_{11} \times$ $550,000 = $50,000. DentistCo is entitled to claim an input tax credit (i.e. refund of GST) of $50,000 from the ATO when lodging its next BAS.

Exceptions

Under Division 69, input tax credits are **not available** to the extent that the expenditure relates to the following **non-deductible** expenses:

- Penalties.
- Relatives' travel expenses.
- Family maintenance.
- Recreational club expenses (unless it gives rise to a fringe benefit and is deductible under s. 26-45(3) ITAA 1997)
- Expenses for a leisure facility or boat.
- Entertainment expenses.
- Non-compulsory uniforms.
- Agreements for the provision of non-deductible, non-cash business benefits.
- Car parking for certain self-employed persons, partnerships and trusts.

Meal entertainment provided to employees is deductible for income tax purposes to the extent it is subject to FBT – refer s. 32-20 ITAA 1997. Therefore, input tax credits can be claimed for meal entertainment to the extent it is subject to FBT. The FBT rules for determining the taxable value of meal entertainment fringe benefits are explained in Unit 3.

Example – Input tax credits: Entertainment

RestaurantCo is an Australian resident company that operates a restaurant and is registered for GST. It supplies restaurant meals (i.e. taxable supplies) for a GST-inclusive price of $1,100 to DentistCo. The meals are provided to DentistCo employees and 50% are subject to FBT. DentistCo is registered for GST.

The value of the supply is $^{10}/_{11} \times \$1,100 = \$1,000$. RestaurantCo should recognise this amount as assessable income for income tax purposes.

The amount of GST collected by RestaurantCo/paid by DentistCo will be 10% of the value, or $10\% \times \$1,000 = \$100$. Another way of determining the GST component of the price is to multiply it by $^{1}/_{11}$. Thus, $^{1}/_{11} \times \$1,100 = \$100$.

RestaurantCo has a GST liability of $100 and should remit this amount to the ATO when lodging its next BAS.

DentistCo has paid GST of $100, however it is not entitled to claim the full amount as an input tax credit. DentistCo's input tax credit is limited to $50\% \times \$100 = \$50$ as this is the portion of the expense that is subject to Fringe Benefits Tax (FBT). DentistCo's allowable deduction for income tax purposes is also limited to $50\% \times \$1,000 = \$500$ as this is the portion subject to FBT (see Units 1 and 3).

Other **exceptions to the regular process** of determining creditable acquisitions include the following:

- Input tax credits are not available for the portion of the GST on a **motor vehicle** that is a car, as defined for income tax purposes, that exceeds the car depreciation cost limit (s. 69-10). The cost limit for the 2018–2019 income year is $57,581. Thus, the maximum input tax credit that can be claimed is $5,234.63 ($^{1}/_{11}$ of $57,581). This can be important in an income tax context. For example, the GST input tax credit ceiling on cars may have an impact on the calculation of the terminating value of the cars (see s. 40-325 ITAA 1997 and Unit 5).
- Where the expenditure relates to an **enterprise** carried on by the taxpayer that makes **input taxed supplies,** the amount of input tax credit available to a taxpayer may be **reduced** (see the section on input taxed supplies later in this unit).
- **Cancellation of GST registration** can result in an increasing adjustment if the entity retains any assets for which input tax credits have been claimed (see the section on adjustment events later in this unit).
- Input tax credits are denied for acquisitions of real property where the vendor and purchaser agree to use the **margin scheme** (see the section on the margin scheme later in this unit).
- Input tax credits are available under Division 111 for certain **reimbursements made to an employee** (or their associate). The reimbursement is treated as consideration for the acquisition and the fact that the supply by the employee is not a taxable supply (i.e. activities of an employee are not an enterprise s. 9-20) does not stop the acquisition being a creditable acquisition (see interaction between FBT and GST covered in Unit 3).
- Limited registration entities are **not** entitled to input tax credits (s. 146-10 see later in this unit).

Worked example 2.1: Net GST amount
[Available online in myLearning]

GST importations

Overview

Where goods are imported into Australia, GST may be payable at the time of importation by the importer (i.e. GST is payable on taxable importations).

However, where the importer uses the goods in carrying on an enterprise, the importer may be entitled to claim a refund of the GST it paid (i.e. a GST input tax credit is available for creditable importations).

Taxable importations

The term 'taxable importation' is defined in s. 13-5 to be an importation of **goods** into Australia, **but not** to the extent that it is a non-taxable importation (refer below).

Goods are imported into Australia where they are 'entered for home consumption' (within the meaning of the *Customs Act 1901* (Customs Act)). This is an important point. Note that the taxing point is not when the goods are imported into Australia within its ordinary meaning, but rather when they are 'entered for home consumption' (i.e. when they are cleared by customs for a formal local entry).

Unlike taxable supplies, it is the **acquirer** (or, more accurately, the importer), rather than the supplier, who is liable for GST on taxable importations. Under s. 13-20, the GST payable by the importer is 10% of the value of the taxable importation.

The value of a taxable importation is defined in s. 13-20(2) to be the sum of:

- The customs value of the goods imported.
- The amount paid, or payable, for international transport of the goods to their place of consignment and to insure the goods for that transport.
- Any customs duty payable in respect of the importation of the goods.
- Any wine tax payable in respect of the local entry of the goods.

An option to calculate the value of transport, insurance and other ancillary costs of importation is available under s. 13-20(4). Under this option, a percentage of the customs value may be used for goods other than wine or luxury cars. This is particularly useful when the actual costs are not known at the time of importation. The percentage is currently set at 10%.

Example – GST payable on imports

ForCo is a non-resident company that does not carry on an enterprise in Australia and is not registered for GST. ForCo sells toothbrushes to SmithCo for $500,000. SmithCo is an Australian resident company that carries on an enterprise of selling toothbrushes and is registered for GST. SmithCo imports the toothbrushes into Australia and uses them for a creditable purpose (i.e. SmithCo is not an Australian consumer).

At the time of acquisition, SmithCo pays $500,000 (i.e. not low-value goods) to ForCo and should recognise this amount as an allowable deduction for income tax purposes.

There is no GST paid to/collected by ForCo. ForCo does not have a GST liability. This is because ForCo is not carrying on an enterprise in the indirect tax zone (i.e. Australia) and the supply is not connected with the indirect tax zone.

However, at the time of importation (i.e. when the goods are entered for home consumption) SmithCo has a GST liability as it makes a taxable importation. SmithCo's GST liability is equal to 10% of the value of the importation.

Assuming there are no other costs related to the import of the toothbrushes, the GST liability is 10% × $500,000 = $50,000.

SmithCo must pay this amount to Australian customs at the time of importation. It is not remitted to the ATO in SmithCo's next BAS. However, SmithCo may be able to enter into a tax deferral scheme with the ATO (see below under creditable importations).

Assuming there are other unknown costs associated with the import, the taxpayer may choose to apply the option under s. 13-20(4). Under this option, the value of the importation would be $500,000 + 10% × $500,000 = $550,000. The GST liability on importation would be $550,000 × 10% (i.e. GST rate) = $55,000.

Key learning – The importer of **goods** into the indirect tax zone (i.e. Australia) does not pay GST as part of the purchase price to the non-resident supplier. However, where there is a taxable importation, the importer must pay GST direct to Australian Customs.

Non-taxable importations

Under s. 13-10 an importation is a non-taxable importation if it would have been a **GST-free or input-taxed supply** had it been a supply made in the indirect tax zone (i.e. Australia). For example, the supply of fresh fruit and vegetables is GST-free and therefore would be a non-taxable importation.

Under s. 42-5, certain other importations are also non-taxable importations. This section is tied to Schedule 4 of the *Customs Tariff Act 1995*, and essentially results in importations that are duty-free, being non-taxable importations. For example, a GST (and customs duty) exemption generally applies to imported goods (excluding alcoholic beverages and tobacco products) with a **customs value of no more than $1,000**. However, these supplies may be subject to GST at the time of acquisition.

Supplies to consumers of imported goods (excluding alcoholic beverages and tobacco products) valued at $1,000 or less at the time of sale are an 'offshore supply of low-value goods' and are 'connected with the indirect tax zone' (i.e. Australia) under s. 9-25(3A) (see earlier in this unit). Where the supply is a taxable supply, the supply is a non-taxable importation under s. 42-15. This ensures GST is not paid twice on goods that are imported to the indirect tax zone.

For ATO guidance on the importation of goods into Australia see GSTR 2003/15 and GSTR 2003/15A3.

Example – GST payable on import of low-value goods

Jane purchases a **camera for $2,200** from a non-resident supplier for her own personal consumption. The supplier packages and sends the camera to Jane. The camera is not a low-value good (under Subdivision 84-C) as its cost is more than $1,000. The camera is a taxable importation. Thus, Jane is liable for GST at the time of importation equal to 10% of the value.

Jane also purchases a **mobile phone for $500** (excluding delivery charges and taxes) from a non-resident supplier for her own personal consumption. The non-resident supplier packages and sends the mobile phone to Jane. The mobile phone is a low-value good (under Subdivision 84-C) as its cost is $1,000 or less. Where the supplier is registered for GST (or required to be registered), the supply will be a taxable supply (i.e. it will satisfy the requirements of the SCREIN acronym) and is a non-taxable importation (assuming the supplier sends the required notices to Australian customs). Thus, the non-resident supplier is liable for GST equal to $^{1}/_{11}$ of the value of the taxable supply.

Note: If Jane purchases, for her own personal consumption:

- Tobacco products and alcoholic beverages from a non-resident supplier, they are not 'low-value goods' as defined under Subdivision 84-C irrespective of their value.
- Digital products from a non-resident supplier, they are not goods – rather they are intangible supplies that are connected with the indirect tax zone under s. 9-25(5), and therefore a taxable supply irrespective of their value.

Creditable importations

In addition to creditable acquisitions, input tax credits are also available for creditable importations under Division 15. A creditable importation is defined in s. 15-5. An entity makes a creditable importation if:

- the entity imports goods solely or partly for a creditable purpose
- the importation is a taxable importation, and
- the entity is registered or required to be registered.

The definition mirrors that of a creditable acquisition. It also has the same effect, in that an entity can also claim an input tax credit on a creditable acquisition.

To be eligible for an input tax credit on a creditable importation, GST must have been paid on the importation (i.e. the importation must have been a taxable importation under Division 13). For example, the importation of machinery is a taxable importation as it is not a GST-free supply or an input taxed supply. However, the importation of fresh fruit is not a taxable importation as it is a GST-free supply. As a general rule, if there is no GST paid on an acquisition, then there is no entitlement to claim an input tax credit (i.e. you cannot claim a refund for something you have not paid for).

The GST on taxable importation is usually payable at the time of customs' clearance (s. 33-15). To avoid cash flow difficulties, some taxpayers may be able to enter the deferred GST scheme and pay the GST on the same BAS on which they claim the credit (r. 33-15.01). These two amounts will usually offset each other.

Example – Input tax credits on imports

Using the same facts as above (where there are no other costs associated with the import), SmithCo has paid GST of $50,000 at the time of import of the toothbrushes into Australia.

As SmithCo uses the toothbrushes for a fully creditable purpose, it is entitled to claim an input tax credit (i.e. a refund) of $50,000 for the GST paid on importation.

SmithCo should include this claim on its next BAS, thereby offsetting the $50,000 which it paid on its taxable importations.

GST-free supplies

Overview

Under Australia's GST regime, there are a number of exemptions. These should not be confused with transactions that are 'out of scope', such as supplies for which there is no consideration, or consideration for which there is no supply. These exemptions fall under two categories – GST-free supplies and input taxed supplies.

GST-free supplies are supplies on which no GST liability arises, but the supplier remains entitled to claim input tax credits on acquisitions made in making the GST-free supply (see the discussion on creditable acquisitions above).

Division 38 covers GST-free supplies. GST-free supplies include (but are not limited to) the following:

- Food, subject to specific exclusions (Subdivision 38-A).
- Health (Subdivision 38-B) – including medical services other than for cosmetic reasons (e.g. doctors' fees), other health services (e.g. physiotherapist, optometrist, dentist or nurse fees), hospital treatment, medical aids and appliances, medicines on prescription, health insurance premiums, and from 1 January 2019 feminine hygiene products.
- Education (Subdivision 38-C) – including school, university, professional or trade course fees if a prerequisite for entry/practice. However, not all education costs are GST-free. For example, general update courses/training are not GST-free.
- Childcare (Subdivision 38-D) – including approved childcare services and family daycare.
- Exports and other cross-border supplies (Subdivision 38-E).
- Supplies of going concerns (Subdivision 38-J).

Food

Food is generally a GST-free supply under s. 38-2. However s. 38-3 contains a list of food that is **not** GST-free, including:

- Food for consumption on the premises from which it is supplied (e.g. restaurant meals).
- Food of a kind specified in the legislation or a regulation. Under Schedule 1 of the GST Act, food that is **not** GST-free includes:
  - Prepared foods (e.g. sandwiches and pizza).
  - Confectionery, snacks (e.g. crisps), and ice-cream products.
  - Bakery products, excluding bread (e.g. cakes).
  - Biscuit products, excluding breakfast cereal.

Rather than stating which food is exempt, the legislation lists certain types of food that are not exempt. Broadly, what this means is that exempt food:

- **Includes** fresh products (e.g. fruit, vegetables, eggs, nuts, unflavoured milk and meats) and most basic grocery items (e.g. bread, breakfast cereal, flour, sugar, and tinned vegetables).
- **Excludes** meals you do not prepare yourself and 'junk food' (i.e. unhealthy snacks). A good way to understand the distinction is to look at your receipt from the grocery store. All items (i.e. food and other products) on which GST has been charged should be identified.

Example – GST treatment of food

FreshCo is an Australian resident company that operates a fruit and vegetable wholesale enterprise and is registered for GST. It supplies fruit and vegetables for $20,000 to RestaurantCo. RestaurantCo operates a restaurant and is registered for GST.

The supply by FreshCo is a GST-free supply as it is food that is not excluded from the concession. Therefore, FreshCo should recognise the full $20,000 as assessable income for income tax purposes and has no GST liability.

Note: Even though all of FreshCo's supplies are GST-free, FreshCo will be entitled to claim input tax credits (i.e. a GST refund) in respect of its creditable acquisitions (i.e. the expenses it incurs in operating the wholesale enterprise).

The purchase by RestaurantCo is not a creditable acquisition as the supply by FreshCo is not a taxable supply. RestaurantCo should recognise the full $20,000 as an allowable deduction for income tax purposes and is not entitled to an input tax credit (i.e. refund of GST). This is a logical outcome for RestaurantCo as it has not actually paid any GST.

Exports

Section 38-185 contains a list of when exports are GST-free. The focus of the TAXAU module is on '**Item 1 – Export of goods: general**'.

A supply of **goods** will be GST-free if the supplier **exports** them from the indirect tax zone (i.e. Australia) **within 60 days** of the earlier of the date of invoicing and the date of receipt of any of the consideration for the supply (or such further period as the Commissioner allows).

However, a supply is not a GST-free export if the supplier re-imports the goods into the indirect tax zone (i.e. Australia).

To fit within this item, the supplier must be the exporter. However, the ATO accepts that if the contract requires the supplier to arrange export (e.g. the contract is on a 'cost insurance freight' (CIF) basis), or the supplier delivers them to the international carrier or freight forwarder, this requirement will be met.

In limited cases and subject to a number of conditions, a supply can be GST-free if the purchaser exports the goods. However, this only applies to a purchaser who is not registered or not required to be registered.

The requirement that the goods actually be exported within 60 days is a rigid rule. If goods are not exported within that time frame, the supply is automatically taxable. In limited cases, the ATO may extend this time (e.g. if dock workers go on strike).

Example – GST treatment of exports

JonesCo is an Australian resident company that operates an enterprise and is registered for GST. It supplies goods for $200,000 to David. David is a non-resident, does not carry on an enterprise in Australia and is not registered for GST.

The supply by JonesCo is a GST-free supply if the goods are exported from the indirect tax zone (i.e. Australia) by JonesCo within 60 days and not re-imported. In this situation, JonesCo should recognise the full $200,000 as assessable income for income tax purposes and has no GST liability.

Note: If the goods were fresh fruit and vegetables, they would be GST-free food under Subdivision 38-A and the timing of the export or re-import (if any) would not be relevant.

Supplies for consumption outside the indirect tax zone

Section 38-190 contains a list of when supplies of things other than goods or real property (i.e. intangible supplies) are GST-free. The focus in the TAXAU module is on '**Item 3 – Supplies used or enjoyed outside the indirect tax zone**'.

A supply will be GST-free, but only if the recipient of the supply is not in the indirect tax zone (i.e. Australia) when the thing supplied is done and the effective use and enjoyment of which takes place outside the indirect tax zone. For example, a hairdresser in Germany provides haircuts to Australian tourists holidaying in Germany. The haircuts are GST-free as they are consumed outside the indirect tax zone (i.e. Australia).

Note: These supplies will be 'connected with the indirect tax zone' (i.e. Australia) where the recipient of the supply is an Australian consumer that is not registered for GST (see earlier in this unit). However, as a GST-free supply is not a taxable supply, the supplier will not have a GST liability.

Supplies of going concerns

There are two ways of transferring a business. One is to sell the entity that owns the business (e.g. selling the shares in a company that owns a business). The other is to sell the assets of the business itself to a new entity.

Subdivision 38-J allows some businesses to be transferred GST-free, removing the cash flow burden that would otherwise fall on the purchaser.

Subsection 38-325(1) provides that a supply of a going concern is GST-free if:

(a) the supply is for consideration; and

(b) the recipient is registered or required to be registered for GST; and

(c) the supplier and the recipient have agreed in writing that the supply is of a going concern.

Under s. 38-325(2), a supply of a going concern is made where the supplier:

(a) supplies to the recipient all of the things that are necessary for the continued operation of an enterprise, and

(b) carries on, or will carry on, the enterprise until the day of the supply (whether or not as part of a larger enterprise carried on by the supplier).

GSTR 2002/5 considers this exemption in detail. The ruling states that the 'all the things that are necessary' test does not mean everything in a business. Rather, it means all of the attributes that are essential for the continuation of that business. It is also applied in an objective sense – that is, if something is necessary for the continuation of the business in general (e.g. business premises) but the premises are not supplied (perhaps because the purchaser has their own premises), the exemption will not apply. For these reasons, careful consideration of the ATO's view is essential before relying on this exemption, particularly by the vendor.

In *Aurora Developments P/L v. FCT*, the Federal Court held that the sale of bare land by a property developer when the development project had failed was not a sale made as part of the developer's business of property development, and therefore could not be a supply of a going concern.

Worked example 2.2: GST-free supply
[Available online in myLearning]

Activity 2.1: Net GST payable/refundable
[Available online in myLearning]

GST input taxed supplies

Overview

Input taxed supplies are supplies on which **no GST liability** arises, but for which the supplier is generally **unable to claim input tax credits** on the acquisitions related to making the input-taxed supply. Under Division 40, input taxed supplies include the following:

- Financial supplies, subject to specific thresholds and exceptions.
- Residential rent – a landlord of a rental property (e.g. house or apartment) does not have a GST liability. However, the landlord is not entitled to claim input tax credits.
- Residential premises, subject to exceptions.

Financial supplies

Under s. 40-5, financial supplies made by a registered entity will be input taxed. Financial supplies are defined in r. 40-5.09. They include most financial dealings – primary and incidental – that involve money, the making of loans and overdraft facilities, the provision of bank accounts, debt and equity securities, unit trusts, futures, options and warrants, underwriting, superannuation funds, life insurance, and hire purchase arrangements. However, to make a financial supply, an entity must be a financial supply provider (defined in r. 40.5.06).

The general rule for entities making input-taxed supplies is that there is no entitlement to input tax credits in respect of the GST included in the price of acquisitions made that relate to the input taxed supply. Where purchases are made that relate to input-taxed and/or taxable or GST-free supplies, the entity will need to apportion the GST attributable to those purchases so that credits are only claimed in respect of the taxable/GST-free supplies and not for the input-taxed supplies. However, where acquisitions are made in relation to the making of financial supplies, input tax credits may still be available in certain circumstances.

Financial acquisition threshold – the *de minimis* rule

Under s. 11-15(4), an entity may still be treated as making an acquisition for a creditable purpose where the acquisition relates to making financial supplies and the entity does not exceed the financial acquisitions threshold. This is referred to as the *de minimis* rule. The rule applies such that input tax credits will be available where the value of the input tax credits attributable to acquisitions relating to the financial supply is less than both of the following:

- 10% of the entity's total input tax credit entitlement.
- $150,000 (i.e. $1.65 million in GST-inclusive purchases).

For example, assume the only acquisitions that are related to financial supplies are accounting fees of $55,000 (including GST). The GST on these supplies represents 100% of all acquisitions. Therefore, the 10% test is failed even though the $150,000 test is passed. Therefore, no input tax credits are claimable on all acquisitions.

The test is applied for a 12-month period ending at the end of the month in which the relevant acquisition is made. The test is also applied for the 12-month period commencing from the beginning of the current month.

The application of the financial acquisition threshold means that some entities making a small amount of financial supplies do not need to differentiate input tax credits relating to acquisitions made for financial supplies from those relating to taxable/GST-free supplies.

Reduced input tax credits (RITC)

Despite making financial supplies, even where an entity fails to satisfy the financial acquisition threshold, that entity may still be entitled to partial or reduced input tax credits for certain acquisitions relating to the making of financial supplies. Only certain acquisitions relating to financial supplies are eligible for RITC. Other input-taxed acquisitions relating to non-financial supplies (i.e. residential rents) are ineligible. The types of services that give rise to a partial input tax credit are outlined in Division 70 GST Regulations, including:

- Certain transaction banking and cash management services.
- Some payment and fund transfer services.
- Some securities transaction services.
- Loans services, debt collection services and insurance services.

Where a supplier satisfies the requirements of Division 70 GST Regulations (and the other relevant GST Regulations), it may be entitled to an input tax credit of 75% of the input tax credit that would otherwise be available if the acquisition was related to the making of a taxable supply. GSTR 2004/1 provides further guidance on RITC acquisitions.

Residential premises

Subdivision 40-C deals with the GST treatment of residential premises. Section 40-65 states that the sale of real property is input-taxed to the extent that the property is residential premises to be used predominantly for residential accommodation. However, such a sale will not be input-taxed to the extent that the residential premises are either:

- Commercial residential premises.
- New residential premises.

'Residential premises', 'new residential premises' and 'commercial residential premises' are defined in s. 195-1. The meaning of 'residential premises', 'commercial residential premises' and 'long-term accommodation in commercial residential premises' is considered in GSTR 2012/5, GSTR 2012/6 and GSTR 2012/7 respectively. The meaning of 'new residential premises' is considered in GSTR 2003/3 (and note GSTR 2003/3A).

Example – Residential rental property

OwnerCo is an Australian resident company that owns a residential rental property (i.e. an apartment, unit or house) in Australia. OwnerCo rents the property to Julie, an Australian resident individual, for $1,500 per week. OwnerCo's total rental income for the year is $78,000. OwnerCo incurs expenses of $22,000 GST-inclusive ($20,000 GST-exclusive) in respect of the rental property.

As residential rent is an input-taxed supply, OwnerCo would not charge GST and does not have a GST liability. OwnerCo would include the full $78,000 in its assessable income for income tax purposes.

OwnerCo has paid $2,000 (i.e. $22,000 × $^1/_{11}$) in GST on its acquisitions. However, as these acquisitions relate to the rental income which is an input-taxed supply, they are not creditable acquisitions. Therefore, OwnerCo is not entitled to claim any input tax credits. OwnerCo would include the full GST-inclusive amount of $22,000 as an allowable deduction for income tax purposes (i.e. an allowable deduction is only reduced for input tax credits that the taxpayer is entitled to claim).

Note: OwnerCo is not required to be registered for GST. GST turnover under s. 188-10 excludes the value of input-taxed supplies.

GST special and other rules

Overview

There are many special and other rules in the GST Act that apply for certain entities and for certain transactions. These include (but are not limited to) provisions in respect of the following:

- GST groups – treating certain groups of individual entities as if they were a single entity (Division 48). This is not discussed further in this unit.
- Margin scheme.
- Second-hand goods.
- Electronic distribution platforms and re-deliverers.
- Reverse charges.
- New residential premises.
- Adjustment events.
- Anti-avoidance.

Candidates only need to have a general awareness of these special rules for the purposes of the TAXAU module. However, they can have significant commercial application for particular businesses or transactions.

Margin scheme

The margin scheme (Division 75) is a special set of rules that may apply to taxable supplies of real property that involve selling a freehold interest in land, selling a stratum unit, or granting or selling a long-term lease. Where the buyer and seller agree in writing to apply the margin scheme, it will ensure that the value of property prior to the introduction of the GST is not taxed when it is sold (i.e. the margin subject to GST will generally be the increase in the property's value since the introduction of GST). It also operates when property is first brought within the GST net (i.e. sold from an unregistered person to a registered person).

To be eligible for the margin scheme, a taxable supply of real property must satisfy several conditions. If the margin scheme applies, GST is calculated as $^1/_{11}$ of the margin, and the buyer cannot get an input-taxed credit for the acquisition.

Example – Margin scheme for commercial property

Austen Pty Limited (Austen) is in the business of trading in derivatives and foreign currencies. In the income year ended 30 June 2019, Austen purchased and sold a building it was using for office space.

- The building was purchased from WidMan Pty Limited (WidMan) for $5 million. WidMan is an Australian manufacturer of widgets. WidMan had been using the building as a head office since it acquired it in 2015 for $3 million.
- The building was sold to Alyssa Pty Limited (Alyssa) for $10 million.
- All parties are registered for GST and all prices include GST, where relevant.

GST liability – general rules

Under the general rules, GST applies to taxable supplies as defined in s. 9-5. The SCREIN acronym is applied to determine whether the sale of the building to Alyssa is a taxable supply.

All the elements of the SCREIN acronym are satisfied (see GST on taxable supplies earlier in this unit). Even though the business Austen conducts involves financial supplies that are input-taxed supplies in accordance with s. 40-5, the building is not a financial supply and therefore is not an input-taxed supply. The building is not a GST-free supply as it does not fall within the supplies listed in Division 38.

As all of the above requirements are satisfied, the supply of the building is a taxable supply made by Austen. The amount of the GST that is payable on the taxable supply under the general rules is 10% of the value of the taxable supply (i.e. $^1/_{11}$ of the sale price as determined by ss 9-70 and 9-75). Therefore, the GST payable is calculated as follows:

GST rate	×	Consideration for the supply	=	GST payable
$^1/_{11}$	×	$10,000,000	=	$909,090

GST liability – margin scheme

As the sale of the building is a taxable supply of real property, the margin scheme can apply to calculate GST on the margin from the sale where the requirements of s. 75-5 have been satisfied. The key requirements for the margin scheme to apply include the following:

- The building was purchased by Austen under a taxable supply and the margin scheme was used (s. 75-10(2)).
- Austen and Alyssa agree in writing to apply the margin scheme on or before the supply of the building (ss 75-5(1) and (1A)).

Assuming the requirements of the margin scheme are satisfied, the GST liability on the sale of the building is calculated as $^1/_{11}$ of the margin. Under s. 75-10(2) the margin is calculated as follows:

Consideration for the supply	–	Consideration for the acquisition	=	Margin
$10,000,000	–	$5,000,000	=	$5,000,000

Therefore, the GST payable is calculated as follows:

GST rate	×	Margin	=	GST payable
$^1/_{11}$	×	$5,000,000	=	$454,545

Note: Under s. 75-20, where the margin scheme applies, the buyer, Alyssa, cannot get an input tax credit for the acquisition.

Entitlement to input tax credits on purchase

Input tax credits are available on creditable acquisitions as defined in s. 11-5. The CRAFT acronym is applied to determine whether the purchase of the building by Austen is a creditable acquisition.

Not all elements of the CRAFT acronym are satisfied (see creditable acquisitions earlier in this unit). The acquisition was not 'for a creditable purpose' as it relates to making input-taxed supplies (s. 11-15). Even though Austen carries on a business, that business is making financial supplies (s. 40-5), that is, trading derivatives and foreign currency (r. 40.05.09 (3), items 9 and 11). It is assumed that Austen's financial supplies exceed the *de minimis* threshold.

Austen is not entitled to input tax credits on the purchase of the building. This is the case irrespective of whether the margin scheme was applied when Austen purchased the building, as the basic requirements (as set out in the CRAFT acronym) have not been met.

Second-hand goods

Division 66 sets out special rules allowing second-hand goods dealers that are registered for GST to claim input tax credits for acquisitions of second-hand goods in certain circumstances, even though the supply of the goods to the dealer was not taxable.

If a second-hand goods dealer **acquires second-hand goods from an unregistered entity**, the supply will not be a taxable supply and, normally, no input tax credit will arise. However, the unregistered entity will have paid GST in acquiring the goods and will not have claimed an input tax credit, and will factor this into the price of the supply to the second-hand goods dealer. This will result in the second-hand goods dealer effectively paying GST on GST when selling the goods. To overcome this potential double taxation, Division 66 allows notional input tax credits to be **claimed in the tax period in which the dealer makes the sale of the acquired second-hand goods**.

The **notional input tax credit** is generally $^1/_{11}$ of the consideration paid to acquire the goods, but cannot exceed the amount of the GST payable in respect of the subsequent sale.

Note: Gold, silver and platinum are excluded from the definition of second-hand goods (subject to exceptions for antiques).

Electronic distribution platforms and re-deliverers

Where an **inbound intangible consumer supply** is made by a non-resident to an Australian consumer with the assistance of an electronic distribution platform (EDP) operator or a re-deliverer (e.g. Google Play, Steam, eBay, etc.), the EDP operator or re-deliverer may be treated as having made the supply, for consideration, and in the course or furtherance of their enterprise (s. 84-55). Therefore when applicable, it is the EDP operator or re-deliverer that has the GST liability rather than the non-resident supplier.

A supply is an inbound intangible consumer supply if, broadly, it is of something other than goods or real property and the supply is neither wholly done in the indirect tax zone (i.e. Australia) nor made through an enterprise carried on in the indirect tax zone (s. 84-65).

Where an **offshore supply of low-value goods** is made by a non-resident, irrespective of whether the recipient is a consumer, the above rules in s. 84-55 may be extended to those supplies (s. 84-81). If the recipient is not a consumer this information will be included in the customs documentation provided by the EDP operator or re-deliverer.

For ATO guidance on the liability of EDP operators, see LCR 2018/2, and for re-deliverers, see LCR 2018/3.

Reverse charge rules

Offshore supplies by non-residents

Subdivision 84-A sets out the reverse charge rules for supplies by non-residents of intangible property (i.e. a supply of anything other than goods and real property) and of low-value goods.

Section 84-5 treats a supply as a taxable supply (except to the extent it is GST-free or input taxed) to the extent:

- The supply is for consideration, and
- The recipient is registered or required to be registered for GST, and
- If the supply is of intangible property:
  - the supply is **not** connected with the indirect tax zone (i.e. is not a taxable supply under the general GST rules), and
  - the recipient acquired it solely or partly for the purposes of an enterprise carried on in the indirect tax zone (i.e. Australia), but not solely for a creditable purpose.
- If the supply is a right or option to acquire intangible property:
  - the supply is connected with the indirect tax zone because of s. 9-25(5)(c), and
  - the recipient acquired it solely or partly for the purposes of an enterprise carried on in the indirect tax zone (i.e. Australia), but not solely for a creditable purpose.
- If the supply is of intangible property where the supplier believed the recipient was not an Australian consumer:
  - the supply is connected with the indirect tax zone because of s. 9-25(5)(d) (i.e. the recipient is an Australian consumer, because even though registered for GST, the supply is wholly a private or domestic acquisition), and
  - the supplier treated the recipient as not being an Australian consumer under s. 84-100 (i.e. the Australian enterprise provided information to the non-resident supplier that it is not an Australian consumer in respect of the supply, resulting in the supplier treating the supply as not subject to GST).
- If the supply is of offshore low-value goods:
  - the supply is **not** connected with the indirect tax zone (i.e. is not a taxable supply under the general GST rules),
  - the recipient acquired it solely or partly for the purposes of an enterprise carried on in the indirect tax zone (i.e. Australia), but not solely for a creditable purpose, and
  - the importation of the goods is not a taxable importation on which the recipient is liable to pay GST.
- If the supply is of offshore low-value goods where the supplier believed the recipient was not a consumer:
  - the supply **is** connected with the indirect tax zone solely because of Subdivision 84-C (i.e. the recipient is a consumer, because even though registered for GST, the supply is wholly a private or domestic acquisition),
  - the supplier treated the recipient as not being a consumer under s. 84-105, and
  - the importation of the goods is not a taxable importation on which the recipient is liable to pay GST.

Where Subdivision 84A treats a supply as a taxable supply, **any GST is reverse charged**, that is, payable by the recipient (rather than the non-resident supplier).

For draft ATO guidance on the supply of anything other than goods or real property connected with the indirect tax zone see GSTR 2019/D2.

Example – Business-to-business supplies with private use

Where use is solely for private purposes

Jessie is an Australian resident who purchases a **computer for $500** (excluding delivery charges and GST where applicable) from a retailer in China. Jessie supplies her ABN to the retailer and declares that she is registered for GST. The computer is to be used by Jessie solely for private purposes. The retailer posts the computer to Jessie's nominated address in Australia.

The computer has a customs value of $500 and is a low-value good (see example earlier in this unit for explanation).

Jessie is a consumer as, despite being registered for GST, at the time of purchase she only intends to use the computer for private purposes. Prima facie as a result, the supply would be an offshore supply of low-value goods to a consumer and therefore connected with the ITZ.

However, Jessie has represented to the retailer that she is not making the acquisition as a consumer, by quoting her ABN and declaring that she is registered for GST. Thus, despite Jessie actually being a consumer, the retailer would reasonably believe that Jessie was not a consumer. Therefore, the retailer would treat the supply as not being connected with the ITZ.

Despite not being connected with the ITZ under the general rules, Jessie is subject to the reverse charge rules in Division 84A. To the extent the supply is deemed to be a taxable supply under the reverse charge provisions (i.e. to the extent the computer was not acquired for a creditable purpose), Jessie will have a GST liability in respect of the computer. Jessie is also potentially subject to administrative penalties for her false representation and declaration to the retailer.

Where use is for partly private and partly business purposes

Alternatively, assume Jessie had acquired the computer partly for the purposes of her Australian-based business and partly for private purposes.

Jessie is not a consumer as she is registered for GST and has acquired the computer partly for the purpose of an enterprise she carries on. In addition, Jessie has represented to the retailer that she is not making the acquisition as a consumer, by quoting her ABN and declaring that she is registered for GST. Thus, the retailer would reasonably believe that Jessie was not a consumer. Therefore, the retailer would treat the supply as not being connected with the ITZ.

Despite not being connected with the ITZ under the general rules, Jessie is subject to the reverse charge rules in Division 84A. To the extent the supply is deemed to be a taxable supply under the reverse charge provisions (i.e. to the extent the computer was not acquired for a creditable purpose), Jessie will have a GST liability in respect of the computer.

Taxable supplies by non-residents

Division 83 also contains reverse charge rules that may apply to a supply, that is connected to the indirect tax zone, made between a non-resident supplier and a recipient that is registered or required to be registered for GST. These rules apply to taxable supplies if the supplier and the recipient **agree** that the GST on the supply will be payable by the recipient.

New residential premises

For contracts entered into on or before 30 June 2018 and settled before 1 July 2020

The sale of new residential premises is **not** an input taxed supply (see earlier in this unit). It is therefore a taxable supply.

The supplier (i.e. the builder/developer) is required to charge and remit the GST to the ATO in respect of the taxable supply (see above for the general rules in respect of liability for GST).

For contracts entered into on or after 1 July 2018 (or excluded from above exception)

Where a supplier makes a taxable supply of newly constructed residential premises or a new subdivision of potential residential land by way of sale or long-term lease, the recipient of the supply (i.e. the purchaser) is required to withhold $^1/_{11}$ of the contract price. The purchaser must remit the GST directly to the ATO as part of the settlement (i.e. prior to or at the time consideration is first provided, other than a deposit) (Schedule 1 s. 14-250 TAA 1953).

The supplier must lodge its Business Activity Statement (BAS) taking into account the supply. However, the supplier is entitled to a credit for the GST withholding payment made by the purchaser.

The GST withholding rules do not apply to:

- Contracts entered into on or before 30 June 2018 which settle before 1 July 2020.
- Business to business supplies.
- Supplies of commercial residential premises.
- Supplies of new residential premises created through substantial renovations.

For sales subject to the margin scheme, the withholding amount reduces to seven per cent of the contract price, ignoring settlement adjustments. Any true-up of the amount remitted by the purchaser and the amount correctly payable under the margin scheme will be made by the supplier in the BAS following settlement.

Suppliers (i.e. the builder/developer) must give a notice to the purchaser advising whether the sale is subject to GST withholding and the rate. Failure to do so will attract significant penalties.

For ATO guidance on a purchaser's obligation to pay an amount of GST, see LCR 2018/4.

Example – GST withholding on new residential property

Brian Brown, an Australian resident individual taxpayer, entered into a contract on 1 July 2018 to acquire a new townhouse for $770,000 from a property developer. Under the terms of the contract, he must pay an instalment of 10% of the contract price on settlement, with the remaining amount payable in six months. The margin scheme does not apply to the sale.

Under the GST withholding rules, Brian must withhold and remit $^1/_{11}$ of the contract price to the ATO on settlement. Thus, his payment on settlement of $77,000 (i.e. 10% × $770,000) must be split with $70,000 (i.e. $^1/_{11}$ × $770,000) being remitted (i.e. paid) to the ATO and the balance of $7,000 being paid to the seller.

In six months, Brian must make a further payment of $693,000 to the seller. There is no further GST withholding liability at that time (i.e. the entire GST withholding liability arose at the time of settlement even though Brian was not required to pay fully the contract price at that time).

Adjustment events

The net amount payable by an entity to the ATO, or refundable by the ATO to the entity, in relation to a particular tax period is increased by the amount of any increasing adjustments for the period, and decreased by the amount of any decreasing adjustments in the period.

Adjustments for supplies and acquisitions

Division 19 addresses adjustment events. An adjustment event will occur as a result of any event that has the effect of:

- Cancelling a supply or acquisition.
- Changing the consideration for a supply or acquisition.
- Causing a supply or acquisition to become, or stop being, a taxable supply or creditable acquisition.

There are two types of adjustments arising from adjustment events:

- Increasing adjustments, which will arise where the 'corrected GST amount' is greater than the 'previously attributed GST amount'.
- Decreasing adjustments, which will arise where the 'corrected GST amount' is less than the 'previously attributed GST amount'.

Technically speaking, adjustment events can only arise in a tax period other than the one in which the original transaction occurred.

Note that if an adjustment is a decreasing adjustment, the entity must hold an adjustment note from the supplier.

Adjustments for bad debts

An adjustment for both the supplier and the recipient arises under Division 21 if a debt for a supply or acquisition is written off as bad, or is overdue for payment by 12 months or more. If, after making such an adjustment, an amount is subsequently recovered, the supplier and recipient make corresponding adjustments.

Adjustments for a change in creditable purpose

Another way in which an adjustment occurs is as a result of a change in the extent of the creditable purpose of an acquisition. This is dealt with in Division 129. The division operates where an entity has made an acquisition, assessed an extent of creditable purpose, and then finds that its actual creditable purpose differs from its originally assessed creditable purpose. The adjustment can be either an increasing or a decreasing adjustment. There can also be further adjustments, depending on the number of adjustment periods that are attributable to the acquisition.

Section 129-40 provides the method to work out any adjustment that arises from a change in the extent of creditable purpose.

Adjustment periods for changes in creditable purpose

Subsection 129-20(3) outlines the adjustment periods for acquisitions. An adjustment period is the tax period that finishes on (or closest to) 30 June in any year. The first adjustment period will be the June tax period that commences at least 12 months after the acquisition. This always makes it the second June tax period after the acquisition is made. After that, the entity must make an adjustment (if necessary) each June tax period until the last adjustment period for the relevant item.

Subsections 129-20(2) and (3) specify the number of adjustment periods (one, five or ten), which are available for acquisitions or importations. Further explanation on this matter is provided in GSTR 2000/24.

Example – GST change in creditable purpose

Brian Brown is an Australian resident individual taxpayer who is registered for GST and carries on business as a sole trader. He purchases a new computer on 15 September 2018 for $3,300, GST-inclusive. The GST component of the purchase price is $300 (i.e. $3,300 × 1/11).

If, at the time of acquisition, Brian intends to use the computer 100% for business purposes, then he would be entitled to claim an input tax credit in the current tax period (most likely the quarter ended 30 September 2018, as most enterprises have a quarterly tax period) for the full $300 GST component. However, if Brian's use of the computer for business purposes changes to only 80%, then he should only be entitled to an input tax credit of $240 (i.e. 80% × $300).

An adjustment for a change in use is made annually in the tax period that ends on 30 June. However, the first adjustment period must start at least 12 months after the tax period in which the acquisition was made. So, as the acquisition was made in the 30 September 2018 tax period, the first adjustment period cannot start before 1 October 2019. Therefore, the first 30 June tax period after 1 October 2019 is the tax period ending 30 June 2020.

In the BAS for the quarter ended 30 June 2020, Brian should include a 20% increasing adjustment. That is, $300 original intended use – $240 actual use = $60 increasing adjustment (i.e. Brian must give back $60 of the input tax credit he originally claimed to the ATO).

The reason for the delay in when an adjustment event happens is to allow Brian to accurately assess the business use of the computer.

Note: The obligation to make adjustments does not continue forever. As the computer's cost is more than $1,000 but less than $5,000, Brian has two adjustment periods – 30 June 2020 (as above) and 30 June 2021. If the business use remains at 80%, then there will be no adjustment in the tax period ending 30 June 2021.

Required reading

Section 129-20 GST Act.

Adjustments for goods applied to private or domestic use

An increasing adjustment occurs under s. 130-5 where goods that were acquired solely for a creditable purpose are later applied solely to private or domestic use (e.g. where a business owner takes goods from the trading stock of their business for their own personal use).

General anti-avoidance

Like the income tax legislation, the GST Act includes general anti-avoidance provisions, which are designed to prevent taxpayers from gaining a GST benefit under a scheme that is otherwise in accordance with the GST law (s. 165-1):

> If the dominant purpose or principal effect of a scheme is to give an entity such a benefit, the Commissioner may negate the benefit an entity gets from the scheme by declaring how much GST or refund would have been payable, and when it would have been payable, apart from the scheme.

Section 165-5 sets out the circumstances in which Division 165 will apply, which, in summary, comprises three necessary components:

- There must have been a scheme.
- A GST benefit must have been obtained from the scheme.
- It must be reasonable to conclude that the sole or dominant purpose, or the principal effect of the scheme, must have been to obtain a GST benefit.

Scheme

'Scheme' is very broadly defined under s. 165-10(2) to be:

(a) any arrangement, agreement, understanding, promise or undertaking:
  (i) whether it is express or implied; and
  (ii) whether or not it is, or is intended to be, enforceable by legal proceedings; or

(b) any scheme, plan, proposal, action, course of action or course of conduct, whether unilateral or otherwise.

GST benefit

Section 165-10(1) describes a GST benefit from a scheme to be:

- a reduction of the GST payable
- increasing a refund
- delaying a payment of GST, or
- accelerating a refund of GST.

Sole or dominant purpose test

Section 165-15(1) sets out the matters to be considered in determining the purpose or effect of a scheme. These are:

(a) the manner in which the scheme was entered into or carried out;

(b) the form and substance of the scheme, including:
  (i) the legal rights and obligations involved in the scheme; and
  (ii) the economic and commercial substance of the scheme;

(c) the purpose or object of [the GST Act, the Customs Act] (in so far as it is relevant to [the GST Act]) and any relevant provision of the [GST Act or the Customs Act] (whether the purpose or object is stated expressly or not);

(d) the timing of the scheme;

(e) the period over which the scheme was entered into and carried out;

(f) the effect that the [GST Act] would have in relation to the scheme apart from [Division 165];

(g) any change in the avoider's financial position that has resulted, or may reasonably be expected to result, from the scheme;

(h) any change that has resulted, or may reasonably be expected to result, from the scheme in the financial position of an entity (a connected entity) that has or had a connection or dealing with the avoider, whether the connection or dealing is or was of a family, business or other nature;

(i) any other consequence for the avoider or a connected entity of the scheme having been entered into or carried out;

(j) the nature of the connection between the avoider and a connected entity, including the question of whether the dealing is or was at arm's length;

(k) the circumstances surrounding the scheme;

(l) any other relevant circumstances.

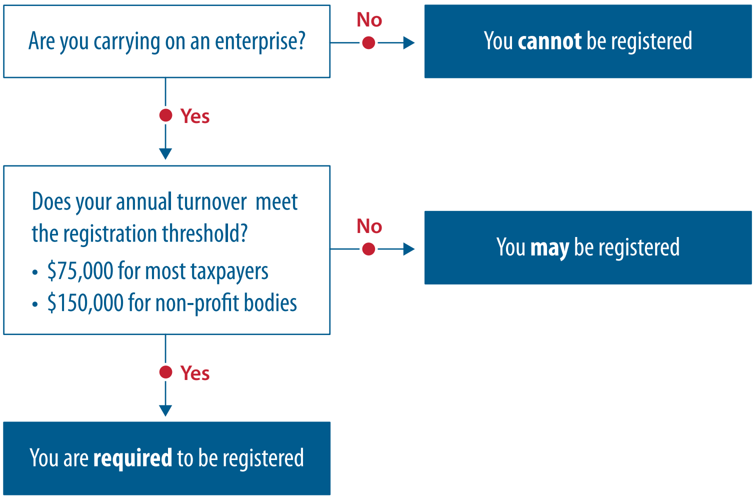
GST administration

Registration

A central tenet of making taxable supplies is that the entity making the supply is registered or required to be registered. An entity that is not registered or not required to be registered for GST is not subject to the GST Act.

General requirements

The registration requirements are covered in Division 23 of the GST Act and GST Regulations. The following flow chart illustrates how to determine whether an entity is required to register.



Under s. 23-5, an entity is **required to register** for GST if it is carrying on an enterprise and its GST turnover meets the following thresholds:

- Most entities – $75,000 (s. 23-15 and r. 5).
- Not for profit bodies – $150,000 (s. 23-15 and r. 10).
- Entities that supply **taxi travel** are required to register regardless of their turnover (Division 144). 'Ride-sharing' services (e.g. Uber) are taxi travel services (see *Uber v. CoT*).

GST turnover is defined in s. 188-10. Applying this definition and the registration turnover threshold, most entities are **required** to register if either:

- their current annual turnover (CAT) is $75,000 or more, unless the ATO is satisfied that the projected annual turnover (PAT) is below $75,000, or
- their PAT is $75,000 or more.

Current annual turnover

An entity's CAT is calculated, in accordance with s. 188-15, by adding up the value of all the supplies made during a 12-month period ending at the end of the current month. However, the value of supplies **excludes** supplies:

- that are made from one member of a GST group to another member of that GST group
- that are input taxed (i.e. financial supplies or supplies of residential accommodation)
- that are for no consideration (and are not taxable supplies under s. 72-5)
- that are not made in connection with the enterprise that the taxpayer carries on

- that are not connected with the indirect tax zone (i.e. Australia) – see earlier discussion
- that are a right or option to acquire intangible property that is connected with the indirect tax zone (i.e. Australia) under s 9-25(5)(c), **unless** it is a supply to an Australian consumer and that supply is not GST-free, or
- that are GST-free supplies made by a non-resident that does not make the supply through an enterprise that the non-resident carried on in the indirect tax zone (i.e. Australia).

There is no exclusion from annual turnover for the 'offshore supplies of low-value goods' made by a non-resident to a 'consumer'. These supplies are 'connected with the indirect tax zone' (see earlier in this unit). Therefore, unless the supply is GST-free or input taxed, it will be a taxable supply and included in the calculation of annual turnover.

Non-resident sellers, that do not carry on an enterprise in Australia, that have annual turnover of $75,000 or more, from offshore supplies of low-value goods to consumers and intangible supplies to Australian consumers, will be required to register for, collect and remit GST.

However, where an 'offshore supply of low-value goods' or 'intangible supply to an Australian consumer' is treated as being made by an EDP operator or re-deliverer instead of the non-resident seller, these supplies will count towards the EDP operator's or re-deliverer's annual turnover and not the non-resident seller's annual turnover.

Entities that are only required to be registered because they make 'offshore supplies of low-value goods to consumers' or 'intangible supplies to Australian consumers' can choose to be a limited registration entity under Division 146 (see below).

Projected annual turnover

An entity's PAT is calculated, in accordance with s. 188-20, by adding up the value of all supplies made or likely to be made during the 12-month period, starting at the beginning of the current month.

The value of supplies excludes the same supplies as detailed for the CAT. However, for the PAT calculation, the following are also **excluded** under s. 188-25:

- Transfer of capital assets.
- Supplies made solely as a consequence of ceasing to carry on an enterprise or substantially and permanently reducing its size or scale.

Voluntary registration

Registration below the required threshold is **optional**, provided the entity is carrying on an enterprise (s. 23-10). This option is attractive because registration enables an entity to claim an input tax credit, reducing the cost of their good/service. This would be particularly desirable to an entity making GST-free supplies. There will, however, be a compliance cost that the entity should take into consideration before making this decision.

Example – Registration for GST: Resident

SmithCo is an Australian resident company that carries on an enterprise of selling toothbrushes. It makes $100,000 in supplies to both Australian resident and non-resident customers during the current year.

SmithCo is required to be registered for GST as its current annual turnover is $75,000 or more. The fact that some of its supplies are to non-residents and may be GST-free is not relevant as the supplies are connected with the indirect tax zone (i.e. Australia).

Example – Registration for GST: Non-resident

ForCo is a foreign-based business (i.e. a non-resident company that does not carry on an enterprise in the indirect tax zone). It makes $100,000 in supplies of movie downloads to Australian consumers (i.e. resident individuals that are not registered for GST) for consumption in Australia during the current year.

The supplies ForCo makes to Australian consumers are:

- Not goods or real property (i.e. are intangible property) and therefore are connected with the indirect tax zone under s. 9-25.
- Are for consumption in Australia and therefore are not GST-free under s. 38-190.

The supplies are included in ForCo's current annual turnover calculation. ForCo is required to be registered for GST as its current annual turnover is $75,000 or more.

As the supplies are inbound intangible consumer supplies, ForCo can choose to be a limited registration entity (see below).

Note: If the same supplies were provided by a foreign-based business to an Australian-based business, those supplies would be excluded from the turnover calculations as they are not connected with Australia under s. 9-25.

Limited registration entity

Under s. 146-5, a non-resident may elect to be limited registration entity with simplified administration for GST purposes if they are only required to be registered because they make either of the following:

- Inbound intangible supplies to Australian consumers.
- Offshore supplies of low-value goods to consumers.

Limited registration entities:

- Are not entitled to input tax credits (ITCs) (s. 146-10).
- Cannot make creditable importations (s. 146-15).
- Must have a quarterly tax period (s. 146-25).

As limited registration entities do not have an ABN, they are unable to issue tax invoices. Practically, as Australian consumers are not entitled to input tax credits, tax invoices are not required.

Tax periods and attribution

Central to the GST is the concept of attribution – that is, the timing rules for when GST is payable by an entity. When considering GST, input tax credits, adjustments and net amounts, there is an underlying premise that these will be attributable to a period or, more specifically, a tax period.

Tax periods

Division 27 specifies what tax periods will apply to an entity. Under the general rule in s. 27-5, the standard tax period is three months (ending on 31 March, 30 June, 30 September and 31 December). However, all taxpayers may elect to have a one-month tax period apply. Furthermore, where an entity's turnover exceeds the tax period turnover threshold of $20 million in s. 27-15(3), that entity **must** apply a monthly tax period. An entity might choose to have a one-month tax period if it is likely to be regularly entitled to a net GST refund, so that it is not at a cash flow disadvantage (e.g. because it only makes GST-free supplies). Additionally, some businesses prefer to account for their tax more regularly to avoid accumulating large liabilities or compliance burdens.

Some small businesses may elect, under Division 151, to pay and report GST on an annual basis in July each year. To be eligible to make this election, the entity must:

- Have a turnover below the registration turnover threshold.
- Not have elected to pay GST by instalments.

Attribution

As mentioned above, attribution is central to the GST. It determines when an entity is required to pay GST and when it is entitled to receive a refund. Attribution is the next step after determining whether there has been a taxable supply or creditable acquisition.

Section 29-5 specifies when GST on taxable supplies is attributed. Entities that do not account for GST on a cash basis are commonly referred to as accounting for GST on an accruals or non-cash basis. Such entities attribute GST on a taxable supply to:

- the period in which they receive any of the consideration for the supply, or
- before any consideration is received, the period in which an invoice is issued for the supply.

Entities that account for GST on a cash basis attribute GST to the period in which consideration is received, but only to the extent that the consideration is received in that period.

In relation to acquisitions, similar rules apply (see s. 29-10). Accruals taxpayers attribute the input tax credit to:

- the tax period in which they provide any consideration, or
- before any consideration is provided, the tax period in which an invoice is received.

For a taxpayer using a cash basis, the input tax credit is attributable to the tax period in which consideration is paid, but only to the extent that the consideration is provided.

It is important to note that s. 29-10(3) requires an entity that attributes an input tax credit to a tax period to hold a tax invoice. If the entity does not hold a tax invoice, the input tax credit is attributable to the first tax period in which the entity does hold the tax invoice (see requirements below).

Cash versus accruals

As noted above, the GST Act allows for GST to be accounted for in either of two ways: the cash method, or the non-cash (accruals) method. An entity must use the non-cash method unless it satisfies the criteria for using the cash method. Subdivision 29-B specifies that an entity may choose to account for GST on a cash basis if **any** of the following conditions are satisfied:

- The entity is a small business entity as defined in the income tax legislation – that is, it has an annual turnover of less than $10 million (see Unit 6).
- The entity accounts for income tax using the receipts method.
- The enterprise is of a type that the Commissioner has determined in writing may use cash accounting.
- The entity applies to the Commissioner and receives permission to account for GST on a cash basis.

Under Division 157, certain charitable institutions, gift deductible entities and government schools may also choose to account for GST on a cash basis.

Tax invoices

As mentioned above, the recipient is required to hold a tax invoice before they can attribute an input tax credit to a particular tax period. Subdivision 29-C specifies what is required for an invoice to be a valid tax invoice (as well as adjustment notes, which are required by an entity making a decreasing adjustment: refer below).

Section 29-70 states that a tax invoice must satisfy all the following requirements:

- Be issued by the supplier.
- Show the ABN of the supplier.
- Show the price of the supply.
- Be in the approved form.
- Contain enough information to enable the matters in s. 29-70(1)(c) to be clearly ascertained.
- It 'can be clearly ascertained from the document that the document was intended to be a tax invoice'.

There is no obligation to issue or hold a tax invoice if:

- The value of the supply excluding GST is $75 or less ($82.50 including GST) (s. 29-80, r. 15).
- The supply is an inbound intangible consumer supply (i.e. from a non-resident, that is not carrying on an enterprise in the indirect tax zone, to an Australian consumer) (s. 84-50).
- The supply is a supplier-taxed offshore supply of low-value goods (i.e. from a non-resident, that is not carrying on an enterprise in the indirect tax zone, to a consumer) (s. 84-87). However, they must ensure relevant information is included in customs documentation.

Returns, payments and refunds

GST returns

Division 31 specifies an entity's obligations in relation to GST returns. The business activity statement (BAS) includes the GST return.

Section 31-8 contains a table showing when entities with quarterly tax periods should lodge a GST return to the Commissioner. This table is reproduced below.

When quarterly GST returns must be given		
Item	**If this day falls within the quarterly tax period …**	**Lodge the GST return to the Commissioner on or before this day**
1	1 September	The following 28 October
2	1 December	The following 28 February
3	1 March	The following 28 April
4	1 June	The following 28 July

For entities that are not on quarterly tax periods, s. 31-10 requires the GST return to be lodged on the 21st day of the month following the end of a tax period.

The GST Act gives taxpayers the option of lodging their GST return electronically. However, note that entities with an annual turnover that exceeds $20 million **must** lodge their GST returns electronically.

Note: Small businesses may be able to complete a simpler BAS.

GST payments

A GST payment is required under s. 33-3 and s. 33-5 where the net amount of an entity for a tax period is greater than zero. The payment is required to be made at the same time the GST return is due.

Division 162 contains special rules that allow certain entities to pay quarterly GST instalments, followed by an annual reconciliation and balancing amount.

GST refunds

GST refunds arise where the net amount for a tax period is less than zero (s. 35-5), with an entitlement to a refund arising upon lodging a GST return with the Commissioner (s. 35-10).

Activity 2.2: GST administration
[Available online in myLearning]

Other key resources

Quick reference guides
2.1: Overview of supplies under GST
2.2: Overview of entitlement to claim input tax credits
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 3: Fringe benefits tax (FBT) and employment remuneration

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Determine when FBT applies.
2. Explain and calculate an employer's FBT liability.
3. Explain the interaction between income tax, GST and FBT.
4. Explain and calculate the effect on an individual's assessable income on deriving termination payments.
5. Explain the taxation treatment of employee share schemes.

Introduction

There are various tax rules that arise out of the relationship between employers and employees, including:

- **Pay as you go (PAYG) withholding tax rules**

  The PAYG rules in the income tax law collect income tax on employee salary, wages, commissions, bonuses and allowances at the time of payment. These rules are covered in Unit 1.

- **Fringe benefits tax (FBT) rules**

  The FBT rules tax employers on certain non-cash benefits provided to employees. The PAYG system is considered ill-equipped in this regard, mainly due to problems in identifying whether a benefit has been provided to an employee, valuing the benefit received, and maintaining equity in the tax system.

  FBT is a separate tax regime that is levied on employers at the top marginal tax rate plus the Medicare levy for individual taxpayers. The FBT rate is set out in the following table.

Fringe benefits tax	
Year ended 31 March	**Rate**
2016 and 2017	49%
2018 and later	47%

  Note: The FBT rate increased temporarily to 49%, from 1 April 2015 to 31 March 2017, as a result of the imposition of the 2% temporary budget repair levy.

- **Employment remuneration-specific provisions**

  The FBT law's coverage of employee benefits is **not** all-encompassing. Income tax law also contains measures that deal with specific types of employment remuneration, such as employment termination payments (ETP), used leave payments, genuine redundancy payments and employee share schemes (ESS).

- **Payroll tax**

  While tax on employee remuneration is within the Government's jurisdiction, state governments also have a keen interest in employee remuneration arrangements because of their reliance on payroll tax as a source of revenue. An awareness of payroll tax is provided in Unit 1.

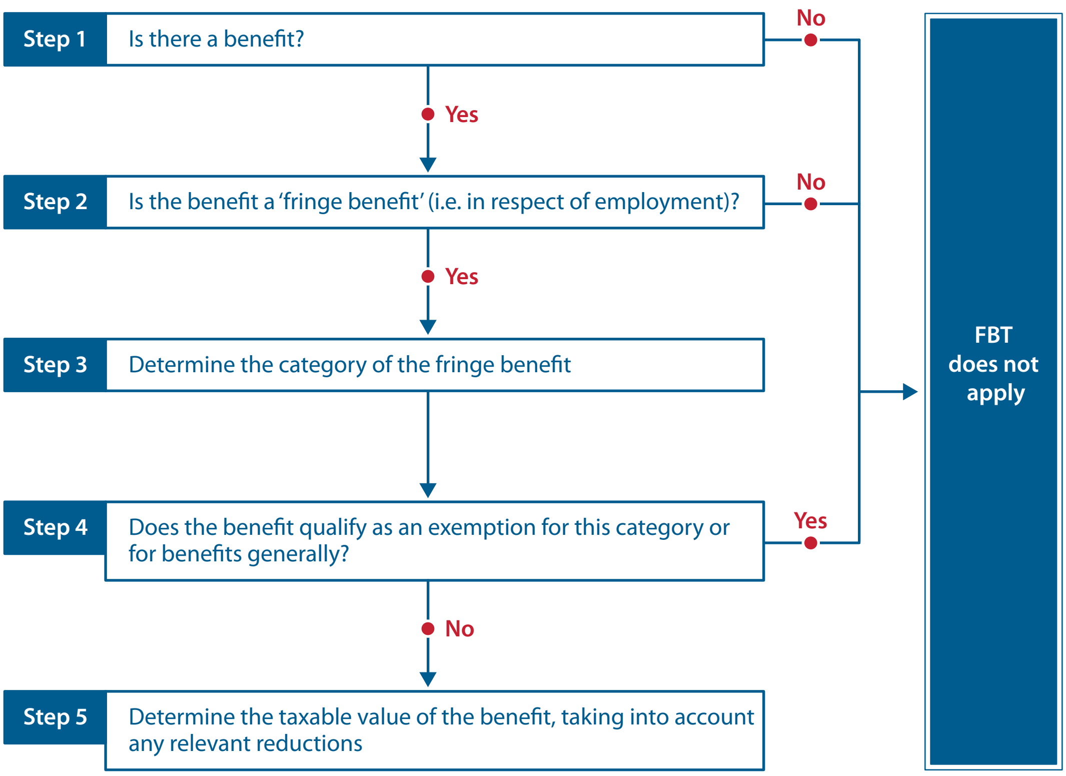
Note: The TAXAU module considers the FBT year ended **31 March 2019** and the income tax year ended **30 June 2019.** Thus:

- Unless otherwise stated, for the sake of simplicity, this unit assumes that the FBT rate for all FBT years is 47% and that the top marginal tax rate plus Medicare levy for all income tax years is 47%. In other words, the impacts of the temporary changes in the tax rates are outside the scope of the TAXAU module.
- Any law changes that are not applicable to the FBT year ended 31 March 2019 or the income tax year ended 30 June 2019 are outside the scope of this offering of the TAXAU module.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they need to be taken into account.

FBT application

Overview

The following flow chart provides a format to follow when determining whether FBT applies to a benefit. The various parts of the flow chart are explained below.



FBT is described by some commentators as a 'dragnet' tax. The scope of the tax is potentially very broad (i.e. you start off with the assumption that all benefits are prima facie caught), but there are many exemption and reduction mechanisms in the law that narrow its base.

Step 1 – Is there a benefit?

FBT uses a very broad definition of 'benefit', which includes any 'right …, privilege, service or facility' (s. 136(1) FBTAA 1986). For example, something as trivial as employees' use of tea and coffee-making facilities or a newspaper in the workplace are 'benefits'.

Although FBT seems all-encompassing at first instance, the legislation excludes many types of benefits in various ways, with the result that the FBT imposed eventually falls mainly on benefits that are not work-related (i.e. benefits that confer a private benefit on the employee) – provided that substantiation requirements are met.

The process for identifying these exclusions starts with the definition of 'fringe benefit'.

Step 2 – Is the benefit a 'fringe benefit'?

A 'fringe benefit' is defined in s. 136(1) FBTAA 1986 as a benefit provided to an employee (or an associate of an employee, such as a spouse) by an employer, associate of the employer, or another person (the 'arranger') under an arrangement with the employer **in respect of the employment**. However, a limited number of exemptions apply, which are listed at s. 136(1)(f)–(s).

The definitions in s. 136(1) also assist in determining:

- what a 'benefit' is
- who is an 'employee'
- who is an 'associate' of the employee, and
- who is an 'associate' of the employer.

It is important to note that not every benefit will be provided 'in respect of employment'. The words 'in respect of the employment' in the definition of 'fringe benefit' have been held to require not merely a causal relationship, but a sufficient or material relationship between an employee's employment and the benefit provided: see *J & G Knowles v. FCT*. For example, the repayment of a loan to a director/shareholder was not provided 'in respect of' employment in *Slade Bloodstock v. FCT*. In that case, the material connection was the director/shareholder's entitlement as a creditor, rather than any connection in respect of their employment. In addition, a benefit provided to a shareholder in connection with their ownership of shares would not be a fringe benefit. Employment must be the 'driver' for the benefit. ATO guidance on this issue is contained in MT 2016.

Who is an employee?

An 'employee' under FBT is generally determined according to the same criteria used in the income tax law for determining whether someone is an employee or, for example, an independent contractor. In simple terms, an employee is someone who receives salary or wages that attract PAYG withholding under the TAA 1953.

While an employee includes a current, future or former employee, once an employee dies, any post-death benefits would be outside the FBT net because inherently related to the concept of employee is the continuing existence of an individual. Therefore, if an employer pays for funeral expenses, it will not give rise to a fringe benefit (refer TR 1999/10).

Who is an employer?

The corresponding income tax law definition is also used to identify 'employer' for FBT purposes (i.e. an entity that pays salary or wages).

Some employer categories receive concessional treatment under the FBT law. These concessions create salary packaging opportunities that, to some extent, compensate for the lower salaries typically paid by such employers.

The different categories and a very broad summary of the main employer concessions are summarised in the following table:

Categories of employers for FBT purposes		
Category	**Type of organisation**	**Main concession conditions**
Wholly FBT-exempt	Religious institutions	Employee must be involved in pastoral duties, or be a live-in carer for aged or underprivileged person(s)
Partially FBT-exempt	**Category A employers** Public or not-for-profit hospitals, public ambulance services	**Category A employers** • General exemption cap: $17,000* • Salary packaged meal entertainment and entertainment facility leasing exemption cap: $5,000* (with any excess included in the general exemption cap)
	Category B employers Charities and public benevolent institutions	**Category B employers** • General exemption cap: $30,000* • Salary packaged meal entertainment and entertainment facility leasing exemption cap: $5,000* (with any excess included in the general exemption cap)
Rebateable	Non-government, non-profit organisations (e.g. religious, educational, charitable, scientific or public educational institutions, trade unions and employer associations)	FBT liability is reduced by a rebate equal to 47% of the gross FBT payable, subject to a $30,000 cap threshold. Once the total grossed-up taxable value exceeds the cap, the rebate cannot be claimed for the excess amount
Fully taxable	Private and public sector employers	Not applicable

* Grossed-up taxable value, per employee.

The focus of this unit is on fully taxable employers operating in the private sector.

Specific exclusions

The definition of 'fringe benefit' in s. 136(1) FBTAA 1986 also contains a number of exclusions, which fall into two groups:

- **Benefits outside the scope of FBT –** these are benefits that are dealt with (and generally made assessable) under specific income tax rules.
- **Exempt benefits –** these are benefits that fall within the FBT regime but are exempt. Exempt benefits are not 'fringe benefits' as defined in s. 136(1) FBTAA 1986. This may have implications when considering the interactions between FBT and income tax.

Benefits outside the scope of FBT

The most important of the 'out-of-scope' benefits are summarised in the following table.

Benefits outside the scope of FBT and dealt with under the income tax law
Salary or wages
Benefits under employee share schemes
Employer-provided complying superannuation fund contributions
Employment termination payments (e.g. a lump sum paid on retirement) and payments for unused leave
Benefits that are deemed dividends under the ITAA 1936, including Division 7A ITAA 1936
Payments of a capital nature for a legally enforceable contract for restraint of trade, or for personal injury to a person

In broad terms, these out-of-scope benefits narrow the application of FBT to benefits 'in kind', or non-cash benefits. However, there is an exception for the payment of a living-away-from-home allowance (a cash payment) and for most expense reimbursements, which are dealt with in the FBT (not income tax) law.

> **Required reading**
>
> Section 136(1) FBTAA 1986 – definition of 'fringe benefit'.

Exempt benefits

Each separate fringe benefit category may contain a specific exemption, or a mechanism to reduce the taxable value of a fringe benefit (e.g. the otherwise deductible rule for expense payment fringe benefits).

In addition, the FBT law also contains a range of:

- general exemptions (Division 13 FBTAA 1986), and
- general rules that reduce the taxable value of fringe benefits (Division 14 FBTAA 1986).

Division 13 FBTAA 1986 contains four particular FBT general exemptions that are frequently encountered in practice. These four FBT exemptions are summarised in the following table.

<table>
<tr><th colspan="3">FBT exemptions in Division 13 FBTAA 1986</th></tr>
<tr><th>FBTAA 1986 section</th><th colspan="2">Exemption and income tax outcome for the employer</th></tr>
<tr><td>53</td><td colspan="2">Exemption for running costs associated with a car fringe benefit
Discussed later in this unit under 'car fringe benefits'</td></tr>
<tr><td rowspan="3">58P</td><td colspan="2">Minor benefits exemption
Section 58P provides an exemption for minor benefits that have a taxable value of less than $300 (GST-inclusive) and that are infrequently provided and/or difficult to record and value. The minor benefits exemption does not apply to benefits that are provided under a salary sacrifice arrangement (TR 2007/12) and 'in-house' fringe benefits</td></tr>
<tr><td>Example</td><td>Overall tax outcome</td></tr>
<tr><td>Inexpensive Christmas gifts
(e.g. bottle of wine or perfume)</td><td>• No FBT to the employer (exempt benefit)
• Deductible to the employer (s. 8-1 ITAA 1997) – gifts are generally not the provision of entertainment, so Division 32 ITAA 1997 does not apply</td></tr>
<tr><td rowspan="3">58X</td><td colspan="2">Work-related items exemption
Section 58X broadly provides an FBT exemption for the following eligible work-related items that are used primarily for use in the employee's employment (i.e. used more than 50% for the employee's employment)</td></tr>
<tr><td>Examples</td><td>Overall tax outcome</td></tr>
<tr><td>• Portable electronic device (definition of a portable electronic device is considered in ATO ID 2008/133) – for example, laptops and mobile phones
• Computer software
• Protective clothing
• Briefcase
• 'Tools of trade'</td><td>• No FBT to the employer (exempt benefit)
• Deductible to the employer as business labour costs (s. 8-1 ITAA 1997)
Note: The combination of no FBT and income tax deductibility for the employer means that these work-related items (particularly laptops and mobile phones) offer attractive salary packaging opportunities provided the item is primarily for use in the course of an employee's employment</td></tr>
</table>

<table>
<tr><th colspan="3">FBT exemptions in Division 13 FBTAA 1986</th></tr>
<tr><th>FBTAA 1986 section</th><th colspan="2">Exemption and income tax outcome for the employer</th></tr>
<tr><td rowspan="3">58Z</td><td colspan="2">Taxi travel exemption
Section 58Z provides an exemption for taxi travel that is:
• A single trip beginning or ending at the employee’s place of work
• A result of sickness or injury to the employee and that is between an employee’s place of work, place of residence or other appropriate place
Note: ’Taxi’ is defined in s. 136(1) FBTAA 1986 to mean a motor vehicle that is licenced to operate as a taxi. The ATO’s view prior to Uber v. CoT (where the ordinary meaning of ‘taxi’ was adopted for GST purposes) was that a taxi did not include ‘ride-sharing’ services or other for hire services. The Government has released draft legislation to amend the definition of taxi for FBT purposes to resolve this issue</td></tr>
<tr><td>Example</td><td>Overall tax outcome</td></tr>
<tr><td>Taxi home after extended work hours</td><td>• No FBT to the employer (exempt benefit)
• Deductible to the employer as business labour costs (s. 8-1 ITAA 1997)</td></tr>
</table>

There are many other exemptions in Division 13 FBTAA 1986 that are too numerous to canvass in detail. The table below highlights only the most commonly used exemptions – note that each exemption only applies if the employer satisfies the specific requirements of the relevant section. (To assist you to categorise the concessions, they are grouped under subject headings not used in the FBTAA 1986.)

Miscellaneous FBT-exempt benefits – Division 13 FBTAA 1986	
Benefit	**FBTAA 1986 reference**
Work-related items – other	
Attendance at an employment interview or selection test (e.g. airfare)	s. 58A
Newspapers and periodicals related to employment	s. 58H
Medical tests, preventative health care, counselling	s. 58M
Subscription to a professional or trade journal, entitlement to use a corporate credit card or airport lounge membership	s. 58Y
Compassionate travel	
Compassionate travel (i.e. for an employee or their close relative to attend a family funeral or visit a sick relative)	s. 58LA
Employee relocation benefits	
Services of a relocation consultant	s. 58AA
Removal and storage of household effects	s. 58B
Incidental costs of selling or acquiring a dwelling	s. 58C
Costs of connecting or reconnecting utilities (e.g. gas)	s. 58D
Leasing of household goods while living away from home	s. 58E
Relocation transport	s. 58F
Remote area housing (some employers, such as hospitals, may be eligible for this exemption even if located in regional areas)	s. 58ZC
Work-related items – health benefits	
Benefits relating to work-related trauma that is covered by workers’ compensation arrangements	s. 58J
First aid facility, clinic, etc. on or near an employer’s premises	s. 58K

Miscellaneous FBT-exempt benefits – Division 13 FBTAA 1986	
Benefit	**FBTAA 1986 reference**
Medical transport or evacuation while working overseas	s. 58L
Emergency assistance to obtain health care	s. 58N

Other specific exemptions and FBT reduction mechanisms will be identified in the discussion relating to the various types of benefit categories (e.g. car fringe benefits or expense payment fringe benefits) below.

Required reading

Sections 58P, 58X and 58Z FBTAA 1986.

Benefits provided overseas

Where an employee who is a resident of Australia for income tax purposes is working overseas and paid by an overseas employer with no connection with Australia (e.g. no branch in Australia), the Australian FBT law does not apply to any benefits provided to the employee (see TD 2011/1). This is because such payments are considered 'extra-territorial' (i.e. outside the scope of Australian law).

However, this means that an employee in this situation is exposed to Australian income tax on both:

- assessable foreign-sourced employment income (s. 6-5 ITAA 1997), and
- the value of benefits received (s. 15-2 ITAA 1997), because s. 23L(1) ITAA 1936 does not exempt these benefits from income tax.

Therefore, an employee seconded overseas could pay tax on their airfares and accommodation under s. 21A ITAA 1936 and s. 6-5 ITAA 1997. The government is currently considering this anomaly.

Example – Benefits provided overseas

Maryann is an Australian resident taxpayer whose main source of employment income is her work as a ski instructor.

Maryann has accepted an offer of employment from a New Zealand-based company to work in New Zealand during the ski season. As part of Maryann's short-term employment contract, her employer provides her with free accommodation near the ski slopes.

The New Zealand employer has no staff or operations in Australia and therefore has no connection with Australia. Although Maryann's wages are assessable income in Australia because she is a resident, her non-resident employer has no obligation to withhold Australian PAYG tax from her wages.

As there is no obligation to withhold Australian PAYG tax, no obligations under the FBTAA 1986 arise for the New Zealand employer.

Maryann will be required to include her foreign employment income (and possibly the value of the benefits received) in her Australian assessable income under s. 21A ITAA 1936 and s. 6-5 ITAA 1997.

Step 3 – Determine the category

Divisions 2–12 in Part III FBTAA 1986 list the categories of fringe benefits, tabled below.

FBTAA 1986 fringe benefit categories	
FBTAA 1986 Division	**Fringe benefit category**
2	Car fringe benefits
3	Debt waiver fringe benefits
4	Loan fringe benefits
5	Expense payment fringe benefits
7	Living-away-from-home allowance (LAFHA) fringe benefits
9A	Meal entertainment fringe benefits (only applies if employer elects to apply Division 9A)
10A	Car parking fringe benefits
11	Property fringe benefits (title passes, e.g. giving an employee a tool kit to keep)
12	Residual fringe benefits (providing a service or right to use, e.g. allowing an employee to use a tool kit)

These are the most common fringe benefits provided by employers. There are some additional categories that are outside the scope of the TAXAU module.

Most of the above divisions are divided into two parts, which outline:

- What the benefit is or how it arises.
- How to calculate the taxable value of the benefit.

In some cases (e.g. Divisions 9A and 10A FBTAA 1986), additional Subdivisions provide alternative methods of calculating the taxable value of the fringe benefit.

Step 4 – Does the benefit qualify as an exemption?

Each fringe benefit category usually contains exemptions that are specific to that category. These exemptions should be considered to determine whether they apply to the facts of a particular benefit.

As discussed above under Step 2, the FBT exemptions found in Division 13 FBTAA 1986 may also be applicable.

Step 5 – Determine the taxable value and reductions

Each benefit category contains formulas for calculating the taxable value of the particular type of benefit.

Having calculated taxable value, the amount may be reduced because of:

- Specific reduction provisions contained within the particular fringe benefit category.
- Miscellaneous reduction provisions contained in Division 14 FBTAA 1986.

Before understanding how the taxable value of each fringe benefit category is aggregated and the final FBT liability ascertained, it is essential to understand the specific fringe benefit categories (Divisions 2–12 Part III FBTAA 1986), tabled above.

FBT taxable value

Car fringe benefits

Scope

A car fringe benefit arises when a **car**, typically **owned or leased by an employer**, is made **available for private use** by an employee or an associate of an employee (s. 7(1) FBTAA 1986). For example, an employer makes a car available to an employee for a home to work journey. A car fringe benefit is often referred to as a 'company car'.

A car is also **deemed to be available for private use** when the car either is:

- Not at the business premises and the employee is allowed to use it for private purposes.
- Garaged at the employee's home.

The following arrangements **do not** give rise to a car fringe benefit:

- Taxi hire and short-term rental car arrangements.
- When a vehicle owned by an employee is used for work-related travel. However, where the employer reimburses the employee for running costs, this may give rise to an expense payment fringe benefit (see later in this unit).

A **car** is defined in s. 136(1) FBTAA 1986 (using the meaning from s. 995-1 ITAA 1997) as a motor-powered **road vehicle** (except a motor cycle or similar vehicle) designed to carry a load of **less than one tonne** and **fewer than nine passengers**. Therefore, the following types of vehicles (including four-wheel drive vehicles) are cars:

- Motor cars, station wagons, panel vans and utility trucks (excluding panel vans and utility trucks designed to carry a load of one tonne or more).
- All other goods-carrying vehicles designed to carry less than one tonne.
- All other passenger-carrying vehicles designed to carry fewer than nine occupants.

Exemptions

Particular types of cars

Under s. 8 FBTAA 1986, specific exemptions apply for:

- Cars that are taxis, panel vans, utility trucks and other non-passenger road vehicles, and are designed to carry a load of less than one tonne **and** where there is no private use other than:
  - Work-related travel of the employee, which as defined under s. 136(1) FBTAA 1986 includes home-to-work travel, and travel that is incidental to travel in the course of performing the duties of employment.
  - Other private use by the employee or their associates that is minor, infrequent and irregular (e.g. going to a rubbish collection site a few times a year).
- Unregistered cars used in business operations.
- Car fringe benefits where the entity providing the car cannot claim an income tax deduction due to the application of the personal services income (PSI) rules (see Unit 7).

The ATO has released guidance on what constitutes **minor, infrequent and irregular private use** of a vehicle provided for business purposes in PCG 2018/3. The guide sets out a safe harbour methodology for employers. The requirements include the following:

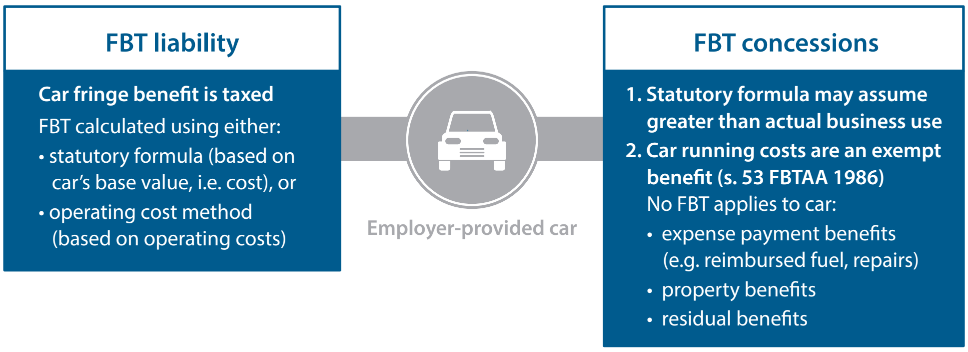
- The employer takes reasonable steps to limit and monitor private use.
- The vehicle is not provided as part of a salary package.

- The vehicle has a GST-inclusive value of less than the luxury car tax threshold. For the 2018–2019 income year this threshold is $75,526 for fuel-efficient cars and $66,331 for other vehicles (for the 2019–2020 income year it is $75,726 and $67,525 respectively).
- In respect of the use:
  - Any diversion between home and work adds no more than two kilometres to the journey.
  - Wholly private travel (excluding home-to-work) cannot exceed 1,000 kilometres in total for the FBT year, and each return journey cannot exceed 200 kilometres.

Running costs

Under s. 53 FBTAA 1986, where a car fringe benefit is provided, the associated running costs (e.g. fuel, repairs) are treated as an exempt fringe benefit. This is because the costs are already covered by the valuation rules for car fringe benefits (e.g. the operating cost method). This means that car fringe benefits are often provided on a 'fully maintained' basis, with a vehicle's running costs being packaged in such a way that they are reimbursed by the employer from the employee's pre-tax salary (salary packaging is discussed later in this unit).

Why a 'fully maintained' car remains an attractive fringe benefit



Note: Where car expenses like fuel, repairs, etc. are not provided in connection with a car fringe benefit and **are** provided as an expense payment fringe benefit (e.g. the employer simply reimburses an employee's monthly car lease payments or expenses related to an employee owned car), the s. 53 exemption does not apply. In this situation, the substantiation requirements for car expenses must be satisfied in order for the taxable value of the benefit to be reduced.

> **Required reading**
>
> Sections 7, 8 and 136(1) FBTAA 1986 – definition of 'car'.
>
> Section 995-1 ITAA 1997 – definition of 'car' (this definition applies for FBT purposes, as well as for income tax purposes).

Calculation method

The taxable value of a car fringe benefit is determined under either the:

- **Statutory formula method** (default method).
- **Operating cost method** (applies only if an employer elects to use this method).

The method used applies on a car-by-car basis, thus allowing employers to select the method that produces the lowest tax outcome based on the particular employee's car usage. Furthermore, the method used for a particular car may differ from year to year.

Statutory formula method

Under the statutory formula method (s. 9(1) FBTAA 1986), the taxable value is calculated as follows:

$$\text{Taxable value} = \text{Statutory fraction} \times \text{Base value of car} \times \frac{\text{Number of days car fringe benefit provided in FBT year}}{\text{Number of days in FBT year}} - \text{Recipient's payment}$$

Each element of the statutory formula is explained below.

Statutory fraction

The statutory fraction is 0.20 (i.e. 20%) (s. 9(1) FBTAA 1986).

Base value

If an employer **owns** the car (including hire-purchase arrangements), its base value equals its cost price (s. 9(2)(a)(i) FBTAA 1986).

The term 'cost price' is defined in s. 136(1) FBTAA 1986 to mean those costs that are directly attributable to the acquisition or delivery of the car. The cost price includes the following:

- Purchase price (including GST and any luxury car tax) net of any discounts, **employee** trade-ins and employee payments that reduce the purchase price. However, if an **employer** provides a trade-in to reduce the cash payable, the base value includes the trade-in value because the trade-in of a car is akin to the payment of cash (TR 2011/3).
- Delivery charges.
- Customs duty (but not registration and stamp duty).
- Cost of fitted non-business accessories.

Base value is **reduced by one-third** if the car has been held for four complete FBT years – that is, when completing the fifth FBT return (s. 9(2)(a)(i) FBTAA 1986). This reduction does not apply to non-business accessories fitted after the car was acquired (TD 94/28).

If an employer **leases** the car, its base value equals the 'leased car value' (s. 9(2)(a)(ii) FBTAA 1986) (i.e. the cost to the employer to buy the car from the lessor, or, if leased as a new car, the cost price to the lessor (s. 136 FBTAA 1986)).

Days that a car fringe benefit is provided

As noted above, a car fringe benefit arises on **any day where there is actual or deemed private use** of a vehicle by an employee or associate of an employee.

In practical terms, private use is deemed to occur on any day the employee (or their associate) has custody and control of the car.

To reduce the FBT exposure, some employees and employers keep detailed records of days when **no car fringe benefit** arises, such as when the car is:

- Kept wholly on the business premises, with no private use permitted.
- Being repaired and off the road for more than a day.
- Garaged away from the employee's residence and the keys not held by, or available to, the employee or their associate.

Recipient's payment

Under s. 9(2)(e) FBTAA 1986, a recipient's payment is the payment (if any), evidenced in documentary form, made either:

- directly to the employer by the employee for use of the car (contributions must be made from the employee's after-tax income and included in the employer's assessable income), or
- by the employee to a third party for the car's operating costs (e.g. fuel, car washes etc.). **Note**: Contributions from the employee are not included in the employer's assessable income (i.e. they are not taken to be constructive receipts).

Operating cost method

Under the operating cost method (s. 10 FBTAA 1986), the taxable value is calculated as follows:

Taxable value	=	Operating cost	×	(100% – business use percentage)	–	Recipient's payment

Each element of the operating cost formula is explained below.

Operating cost

If an employer **owns** the car, the operating costs are the:

- Actual operating costs regardless of who paid for them (e.g. fuel, service and repairs, but not repairs covered by insurance) (s. 10(3)(a)(i) FBTAA 1986).
- Registration and insurance, which are apportioned if the car is a fringe benefit for part of the year (s. 10(3)(a)(ii) FBTAA 1986).
- Deemed interest and deemed depreciation (s. 10(3)(a)(iii) FBTAA 1986), which is apportioned if the car is a fringe benefit for part of the year (TR 2011/3):

Deemed depreciation (s. 11(1) FBTAA 1986)	=	(FBT) undepreciated value[1]	×	25%	×	Number of days in FBT year car was owned/Number of days in FBT year
Deemed interest (s. 11(2) FBTAA 1986)	=	Opening (FBT) undepreciated value + value of non-business accessory	×	Statutory rate[2]	×	Number of days in FBT year car was owned/Number of days in FBT year

Notes

1. Cost price – accumulated FBT depreciation. FBT depreciation is not income tax depreciation, so the car limit does not apply (see ATO's *Fringe benefits tax – a guide for employers*).
2. Statutory rate for the FBT year commencing 1 April 2018 is the benchmark interest rate of 5.20% under TD 2018/2 (commencing 1 April 2019 it is 5.37% under TD 2019/6).

If an employer **leases** the car, the operating costs are the lease payments (s. 10(3)(a)(v) FBTAA 1986) rather than the deemed interest and deemed depreciation.

If an employer purchases the car on a **hire-purchase basis**, the employer is deemed to own the car (s. 7(6)). Therefore, the 'own' car rules above are applied.

Business use percentage

The 'business use percentage' of a company car is defined in s. 136(1) FBTAA 1986 and calculated as:

Business kilometres	÷	Total kilometres

The percentage is calculated by reference to a logbook (kept for a 12-week period) and odometer records.

Recipient's payment

See 'recipient's payment' under 'statutory formula method' above (s. 10(3)(c) FBTAA 1986).

Required reading

Sections 9 and 10 FBTAA 1986.

Activity 3.1: Car fringe benefit – statutory formula method

[Available online in myLearning]

Debt waiver fringe benefits

Scope

Where an obligation to pay or repay an amount is waived, the waiver is taken to be a benefit provided at the time of waiving the obligation or debt (s. 14 FBTAA 1986).

Calculation method

The taxable value of the debt waiver, calculated in accordance with s. 15 FBTAA 1986, is the amount of payment or repayment waived.

Example – Debt waiver fringe benefit

XYZ Pty Ltd (XYZ) lends $5,000 to one of its employees, John. John encounters financial difficulties. In exchange for a partial repayment of $1,000, XYZ agrees to release John from any further obligations in relation to the debt.

In this case, a debt waiver fringe benefit arises. The taxable value of that benefit is $4,000.

Note: If XYZ is in the business of lending money, it may obtain a bad debt deduction under s. 25-35 ITAA 1997. Alternatively, a deduction may be available under s. 8-1 ITAA 1997 as an employment expense.

Loan fringe benefits

Scope

A loan fringe benefit arises where an employee receives a loan from their employer and the rate of interest charged on that loan is less than the statutory rate of interest set each year by the ATO (s. 16 FBTAA 1986).

A loan is broadly defined in s. 136(1) as:

(a) an advance of money;

(b) the provision of credit or any other form of financial accommodation;

(c) the payment of an amount for, on account of, on behalf of or at the request of a person where there is an obligation (whether expressed or implied) to repay the amount; and

(d) a transaction (whatever its terms or form) which in substance effects a loan of money.

Exemptions

Section 17 FBTAA 1986 exempts certain loan benefits from FBT where the employer:

- Is in the business of lending money (e.g. a bank) and makes fixed or variable rate loans to employees on the same terms as loans it makes to the public.
- Provides short-term (up to six months) advances to cover employment-related expenses.
- Provides temporary (up to 12 months) advances to cover security deposits.

A loan provided by an employer that is a company to an employee who is a shareholder in the company is also exempt from FBT under s. 10ZB ITAA 1936 (see Unit 8).

Calculation method

The taxable value of a loan fringe benefit is calculated in accordance with s. 18 FBTAA 1986. The taxable value may be further **reduced by** otherwise deductible amounts.

Statutory interest rate method

Under s. 18 FBTAA 1986, the taxable value of a loan fringe benefit is calculated as the difference between the interest that would have accrued during the FBT year if the statutory interest rate had applied to the outstanding daily balance of the loan, and the interest that actually accrued.

The statutory interest rate for the FBT year commencing 1 April 2018 is the benchmark interest rate of 5.20% under TD 2018/2 (commencing 1 April 2019 it is 5.37% under TD 2019/6).

In TD 2008/10, the Commissioner considers that where an employee is given time to repay their mistakenly overpaid salary, a loan fringe benefit arises. Recovering overpaid salary payments by instalments can also qualify as a minor exempt benefit, as set out in TR 2007/12.

Example – Loan fringe benefit

Assume ABC Accountants lends one of its employees $100,000 at an interest rate of 2% per annum on 1 July 2018. The employee uses that money for non-income-producing purposes.

The loan fringe benefit has been provided for 274 days of the FBT year. Therefore, the taxable value of the loan fringe benefit would be calculated as:

$100,000	×	(5.20% – 2%)	×	274 / 365	=	$2,402

Otherwise deductible rule

The loan fringe benefit category contains a specific provision that enables the taxable value of these fringe benefits to be reduced. The reduction mechanism is known as the 'otherwise deductible rule' (s. 19 FBTAA 1986).

The otherwise deductible rule requires the employer to answer this **hypothetical question**: 'Assuming the loan was interest-bearing, would the employee have been entitled to an income tax deduction if they had been required to pay interest on the loan?' To the extent that a deduction would have been available, the taxable value of the loan fringe benefit is reduced by the deductible percentage.

In most cases, the employer must obtain a **written declaration** from the employee to substantiate the extent to which the interest would have been 'otherwise deductible'. No declaration is required for employee share scheme loans or credit relating to goods or services used exclusively in the course of an employee's employment (e.g. a loan to an apprentice to purchase a tool kit).

The otherwise deductible rule **only applies to loans to employees** and not to a spouse or other associates of the employee. Where an interest-free or low-interest loan is provided jointly to an employee and their associate to acquire an income-producing asset (e.g. a rental property), reducing its taxable value under the otherwise deductible rule is limited to the employee's share of the loan. The otherwise deductible rule cannot be applied to the associate's share. For planning purposes, loans should be made only to employees, not their spouses.

Example – Loan fringe benefit: Otherwise deductible amounts

Assume ABC Accountants lends one of its employees $100,000 at an interest rate of 2% per annum on 1 July 2018.

As per the previous example, the taxable value of the fringe loan benefit is $2,402. The formula for calculating this amount takes into account the 2% interest actually paid by the employee.

However, assume that the employee in this case is a director of ABC Accountants, who uses the loan to undertake a Master of Business Administration course at university. The director works in the firm's management consulting practice and the course content is directly relevant to her work.

The otherwise deductible rule in s. 19 FBTAA 1986 can be invoked by ABC Accountants, by asking this hypothetical question: 'Assuming the loan was interest-bearing, would the director have been entitled to an income tax deduction if she had been required to pay interest on the loan?'

Looking at this from the employee's (i.e. the director's) perspective, a s. 8-1 ITAA 1997 deduction would be allowed for self-education expenses (including the interest on funds she borrowed to undertake self-education) if the study leads to, or is likely to lead to, an increase in the employee's income from current income-earning activities (*FCT v. Hatchett*; TR 98/9).

The $250 limit on the amount that can be claimed for self-education costs (s. 82A ITAA 1936) is ignored when applying the otherwise deductible rule (s. 19(1)(ba) FBTAA 1986).

In response to the hypothetical question, therefore, the director would be entitled to a 100% deduction.

Assuming ABC Accountants obtains a declaration from the director by the time it lodges the annual FBT return, the taxable value of this loan fringe benefit will be further reduced by 100% under the otherwise deductible rule.

The result is that the taxable value will be reduced to $nil and no FBT will be payable on the loan fringe benefit.

Required reading

Section 18 FBTAA 1986.

Expense payment fringe benefits

Scope

The most commonly encountered fringe benefit is the expense payment fringe benefit. Businesses typically incur a wide range of expenses through their employees' activities (e.g. client entertainment, travel costs, phone calls, parking) and have arrangements in place to reimburse their employees for authorised expenditure. These arrangements sometimes involve corporate credit cards. They may also reimburse non-business benefits like school fees and mortgage payments.

Section 20 FBTAA 1986 states that an expense payment fringe benefit may arise in either of two ways:

- Where an employer pays a third party for expenses incurred by one of its employees.
- Where an employer reimburses one of its employees for expenses incurred by the employee.

In either case, the expenses may be business expenses or private expenses, or a combination of the two.

An employee whose expenditure has been paid or reimbursed by the employer is denied a personal income tax deduction in order to prevent a 'double dip' (s. 51AH ITAA 1936).

Expenses incurred on credit cards

Where an expense is incurred on a credit card, it is important to first establish whether the employer or employee is legally responsible for ultimately paying the credit card statement:

- If the **employee** is responsible, the employer's reimbursement of an amount charged to the employee's credit card will be an expense payment fringe benefit.
- If the **employer** is responsible, the employer could be providing a property or residual fringe benefit (discussed later in this unit), but not an expense payment fringe benefit.

Allowances versus reimbursements (TR 92/15)

Some employers choose to provide allowances to their employees, instead of reimbursing actual expenditure. Other employers use a combination of the two.

An allowance paid to an employee by an employer will typically not give rise to an expense payment benefit.

The distinction between an allowance and a reimbursement (TR 92/15) and whether a deduction can be claimed is summarised in the following table.

Deduction and reimbursement summary	
Allowance	**Reimbursement**
An **allowance** is an arrangement whereby the employee is paid a predetermined amount to cover an estimated expense. Allowances are ordinary income and form part of an employee's assessable income (s. 6-5 and s. 15-2 ITAA 1997)	A payment is a **reimbursement** when: • the recipient is compensated exactly (typically on presentation of a receipt or invoice) for an expense that has already been incurred but not necessarily disbursed, or • where the employee is required to refund the unexpended portion of an allowance to the employer A reimbursement is an **expense payment fringe benefit** under the FBT law

Deduction and reimbursement summary	
Allowance	**Reimbursement**
Exception A LAFHA, which is dealt with under the FBT law (see below)	**Exception** A cents-per-kilometre car expense reimbursement – although this is an exempt car expense payment benefit (s. 22 FBTAA 1986), it is nonetheless included in an employee's assessable income as statutory income (s. 15-70 ITAA 1997)
Deductions With the exception of LAFHAs, an employee can claim a deduction against an allowance if the requirements of s. 8-1 ITAA 1997 or a specific deduction provision are satisfied. Consider whether the following provisions apply: • Income tax substantiation rules in ITAA 1997 • Restrictions on deductions for entertainment (Division 32 ITAA 1997)	**Deductions** With the exception of cents-per-kilometre car expense reimbursements, s. 51AH ITAA 1936 specifically denies a deduction to employees for expenditure that has been paid or reimbursed in circumstances that give rise to either a fringe benefit or an exempt fringe benefit

Exemptions

The expense payment fringe benefit category contains the following specific exemptions:

- Benefits covered by a '**no-private-use declaration**' (s. 20A FBTAA 1986). This is an annual declaration by an employer that covers all expense payment fringe benefits for an FBT year, and states that the employer's policy is to only pay or reimburse work-related expenses.
- Exempt accommodation expense payment benefits (s. 21 FBTAA 1986). This exemption is available where the employee satisfies the living-away-from-home allowance (LAFHA) requirements relating to maintaining an Australian home and for a period of 12 months or less, or the requirements relating to fly-in-fly-out/drive-in-drive-out employees (see later in this unit under LAFHA).
- Per-kilometres car expense reimbursements (s. 22 FBTAA 1986).

Calculation method

The **taxable value** of an expense payment benefit depends on whether it is an 'in-house' or 'external' benefit (see below). The taxable value may be further **reduced by**:

- Otherwise deductible amounts.
- $1,000 concession for in-house benefits.

In-house and external benefits

In-house expense payment benefits can be either:

- in-house **property** expense payment fringe benefits, or
- in-house **residual** expense payment fringe benefits.

An **in-house** (property or residual) expense payment fringe benefit arises where the expenditure paid for, or reimbursed by, an employer was incurred in the purchase of goods or services **that the employer or an associate of the employer sells to customers or clients** in the ordinary course of business.

An **external** expense payment fringe benefit arises where there is an expense payment fringe benefit that does not meet the definition of an in-house expense payment fringe benefit. This typically occurs where the employer reimburses an employee for an expense incurred from **purchasing goods or services from a third party provider**.

Example – Expense payment fringe benefit: External versus in-house

The rules for determining the taxable value of an external versus in-house expense payment fringe benefit are as follows.

Type of expense payment fringe benefit	Example	Taxable value = Value - Recipient contributions Where value equals:
External expense payment benefit	Aussie Furniture and Interior Design Pty Ltd (Aussie Furniture) reimburses its employees who incur taxi fares while travelling between stores for work-related purposes	The amount reimbursed
In-house expense payment – property benefit	Aussie Furniture manufactures furniture, which it sells through independent retailers. It reimburses its employees 20% of the amount they pay for Aussie Furniture products from retailers at the full retail price	The amount that would be the taxable value under the property fringe benefit rules (see later in unit) if the sale of the goods to the employee by the retailer had constituted an in-house property fringe benefit
In-house expense payment – residual benefit	Aussie Furniture also runs a franchise home decorating advice business. It reimburses its employees 20% of the amount they pay to engage the services of the franchisees	The amount that would be the taxable value under the residual fringe benefit rules (see later in unit) if the service had constituted an in-house residual fringe benefit

Otherwise deductible rule

The taxable value of an expense payment fringe benefit may be reduced in accordance with the otherwise deductible rule if the recipient of the benefit is an employee (but not a spouse of the employee) (s. 24 FBTAA 1986).

The taxable value of the benefit is reduced by the amount that the employee would have otherwise been entitled to claim as an income tax deduction if the employee had incurred the expenditure themselves and had not been reimbursed by the employer.

A common example of an otherwise deductible expense payment benefit is when work-related travel is reimbursed by the employer. Where the travel expenditure would have otherwise been deductible for the employee, the taxable value of the expense payment benefit is reduced by the extent to which the employee would have been entitled to a deduction.

The key requirements for applying the otherwise deductible rule are:

Key requirements – otherwise deductible rule
The otherwise deductible rule only applies if the expense payment fringe benefit is provided **to an employee** (not to an associate such as a spouse)
The deduction that would otherwise have been available to the **employee** must have been a '**once-only** deduction' (i.e. 100% deductible in year 1) (s. 24(1)(b) FBTAA 1986) This means that the otherwise deductible rule does not apply where the deduction would be for the decline in value of depreciating assets over a period of time, except where 100% of the cost would have been deductible to the employee in a single income year (e.g. the cost is no more than $300 (s. 40-80(2) ITAA 1997) or where the effective life is one year
FBT substantiation rules may apply (see below)

FBT substantiation for otherwise deductible amounts

For practical business reasons and (where applicable) to obtain GST input tax credits, employers almost invariably require employees to provide **tax invoices** as evidence to support their expense claims. However, the FBT law also specifically requires employers who invoke the otherwise deductible rule to obtain certain types of documentation to substantiate the extent to which an expense payment would be 'otherwise deductible' for the employee.

A **travel diary** (or detailed itinerary) is required where the employee's expense relates to:

- travel within Australia for more than five consecutive nights and which is not exclusively for performing work-related duties, or
- travel outside Australia for more than five consecutive nights.

An employee expense payment benefit **declaration** is also required where an employee's expense (other than an expense incurred regarding a car they own or lease) is not incurred exclusively in the course of performing work-related duties; for example, **home telephone or internet costs** that have part-business and part-private components. The ATO has introduced a $50 threshold for these costs. Where the threshold (per employee per FBT year) is not exceeded, obtaining the declaration should be sufficient. However, where it is exceeded the employer must also keep records of the actual use.

Car expenses (e.g. petrol, oil, registration, insurance and maintenance) which are **not** connected to a car fringe benefit require more **extensive substantiation**, including log books, odometer readings, special declarations, etc. Simply obtaining a declaration is not sufficient.

An ATO pro forma employee expense payment benefit declaration is shown below.

Expense payment fringe benefit declaration

Australian Government
Australian Taxation Office

I, ______ (name of the employee)

declare that

______ (show nature of expense eg. telephone rental and/or calls)

were provided to me by or on behalf of my employer during the period from

Day / Month / Year 20__ *to* Day / Month / Year 20__

and the expenses were incurred by me for the following purpose(s)

(Please give sufficient information to demonstrate the extent to which the expenses were incurred by you for the purpose of earning your assessable income.)

______

______

I also declare that the percentage of those expenses incurred in earning my assessable income was ____ *%.*

I understand that any work expenses reimbursed by my employer are not deductible in my personal income tax return.

Signature

Date
Day / Month / Year

$1,000 concession for in-house benefits

Section 62 FBTAA 1986 provides a reduction of **$1,000 per employee per FBT year** in respect of the **total taxable value of all** in-house benefits (i.e. expense payment, property and residual). However, under s. 62(2), this concession does **not apply** if the benefit is given under a salary sacrifice arrangement.

Required reading

Section 20 FBTAA 1986.

Worked example 3.1: Expense payment fringe benefits

[Available online in myLearning]

Living-away-from-home allowance (LAFHA) fringe benefits

Scope

Living-away-from-home allowances are unique in the sense that they are the only cash fringe benefit that is specifically dealt with under the FBT law, instead of being treated as salary or wages and subject to PAYG withholding tax.

A LAFHA benefit arises where an employer pays an allowance to an employee to either partly or wholly compensate the employee for additional non-deductible expenses they incur (and other additional disadvantages) during periods when their duties of employment require them to **live away from their normal residence** (s. 30(1) FBTAA 1986).

Under s. 136(1) FBTAA 1986, 'normal residence' means:

- the employee's usual place of residence in Australia, or
- if the usual place of residence is not Australia, the employee's:
  - usual place of residence, or
  - the place in Australia where the employee usually resides when in Australia.

Note: The special LAFHA rules applicable to offshore oil and gas rig workers are outside the scope of the TAXAU module.

Travelling allowance versus a LAFHA

Some employers provide a travelling allowance to their employees in circumstances similar to those in which a LAFHA is provided. It is important to distinguish between the two allowances, because, unlike a LAFHA, a travelling allowance will form part of an employee's salary and wages and attract PAYG withholding tax, rather than FBT. The employees may then be able to claim deductions against their travelling allowance (see Unit 1).

The distinction between a travelling allowance and a LAFHA, and determining whether a deduction can be claimed by an employee, is summarised in the following table.

Travelling allowance and LAFHA summary

Allowance	Description	Deductions
Travelling	Compensation to the employee for additional deductible expenses incurred by the employee. The key considerations for the deductibility of travel expenses related to accommodation and meals, as set out in TR 2017/D6, include the following: • The employee's work activities require them to undertake the travel • The work requires them to sleep away from home overnight • The employee has a permanent home elsewhere • The employee does not incur the expense in the course of relocation or living away from home	A deduction under s. 8-1 ITAA 1997 would typically be available to the employee for work-related travel expenses (including travel, food, accommodation and incidentals) claimed against the allowance Consider whether the following provisions apply: • Income tax substantiation rules in Subdivisions 900-B and 900-F ITAA 1997 (see Unit 1) • Restrictions on deductions for entertainment (Division 32 ITAA 1997)
LAFHA	Compensation to the employee for additional non-deductible expenses incurred by the employee by reason that the employee's duties require them to live away from home	• No deduction would be available to the employee against the LAFHA • The employee's expenditure on accommodation and food is inherently private in nature (s. 8-1(2)(b) ITAA 1997)

Note: The decision in *John Holland Group Pty Ltd v. FCT* showed that home-to-work travel is work related and 'otherwise deductible' where employees are travelling (and getting paid) from the airport to a remote work location and returning from there.

Exemptions

There are no exemptions specific to the LAFHA fringe benefit category. However, various concessions are available when calculating taxable value (see below).

Calculation method

The taxable value of a LAFHA is the amount of the allowance (s. 31B FBTAA 1986). However, it may in limited circumstances be **reduced by** (ss 31(2)):

- The exempt accommodation component (i.e. actual accommodation costs incurred).
- Any exempt food component (i.e. additional food costs incurred over a statutory amount).

A reduction in the taxable value of a LAFHA (for arrangements that are not 'fly-in fly-out' or 'drive-in drive-out') is only available for:

- A maximum of **12 months** (s. 31D FBTAA 1986).
- An **employee who** (s. 31C FBTAA 1986):
  - is living away from their normal residence in Australia, and
  - maintains their normal residence for their immediate use and enjoyment at all times, and
  - of whom it is reasonable to expect the employee will return to that residence at the end of the assignment.

Thus, there is no reduction in the taxable value of a LAFHA (for arrangements that are **not** 'fly-in fly-out' or 'drive-in drive-out') where an employee rents their normal residence to a third party, or an employee's normal residence is located outside Australia.

For example, an employee with a home in Australia goes on a secondment to the United Kingdom for six months. If the employee does not rent the home for the period of their secondment, the taxable value of any LAFHA can be reduced. However, as an Australian home generally has to be maintained, it is very difficult for an expatriate who is coming to Australia to get a reduction in the taxable value of a LAFHA.

'Fly-in fly-out' or' drive-in drive-out' employee rules

A reduction in the taxable value of a LAFHA is available for an employee working in Australia under a 'fly-in fly-out' or 'drive-in drive-out' arrangement where their normal residence is in Australia or overseas (s. 31E FBTAA 1986).

Such employees:

- do not have to maintain a home in Australia for their own use and enjoyment, and
- continue to receive concessional tax treatment on the LAFHAs they receive beyond a 12-month period.

This concession recognises the important economic role such workers play in sectors with operations in remote locations or regions where there is a shortage of skills (e.g. on oil rigs).

'Fly-in fly-out' and 'drive-in drive-out' status arises where **all** of the following requirements are satisfied:

- The employee works for a number of days on a regular and rotational basis and has a number of days off that are not the same days in consecutive weeks.
- The employee returns to their normal residence during their days off.
- Such arrangements are customary for employees performing similar duties in that industry.
- It is unreasonable to expect an employee to travel to and from work while living at their normal residence on a daily basis given the locations of the employment and their home.
- It is reasonable to expect that an employee will resume living at their normal residence when their employment duties no longer require them to live away from home.

Exempt accommodation and food components

As noted above, there is a reduction in the taxable value of a LAFHA that may be available for any exempt accommodation and food components.

This reduced taxable value is the amount of the LAFHA paid after subtracting:

- the exempt accommodation component, which is the component of the allowance that is reasonable compensation for the cost of the accommodation of the employee and their family members (typically, this is the actual cost of the accommodation while living away from home), and
- the exempt food component, which is the component of the allowance that is **reasonable** compensation for the employee's increased expenditure on food. This is calculated by taking the amount provided by the employer, reducing this to the amount of the reasonable food component (if no substantiation of expenditure held) and then reducing this further by the statutory food component (currently $42 per adult as defined under s. 136(1) FBTAA 1986). The reasonable food component figures released by the Commissioner annually provide estimates of food costs that an employee would incur if they were living at home. For the FBT year commencing 1 April 2018, the reasonable food component for one adult within Australia is $265 under TD 2018/3 (commencing 1 April 2019 it is $269 under TD 2019/7).

Example – LAFHA

Assume an employee who qualifies for the LAFHA concessions receives a food allowance of $265 per week for 26 weeks while they are required to live away from their usual place of residence. The employee does not hold receipts for all of their expenditure on food during this time. However, they have some receipts and also kept a list of their food expenditure which shows that they spent at least their allowance on food each week.

Their exempt food component is calculated as:

$265 allowance × 26 weeks	–	$42 statutory food component × 26 weeks	=	$5,798

Therefore, the taxable value of the LAFHA is calculated as:

$265 allowance × 26 weeks	–	$5,798	=	$1,092

Worked example 3.2: LAFHA fringe benefits

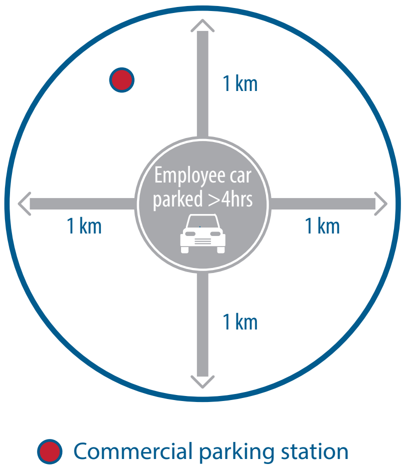
[Available online in myLearning]

Car parking fringe benefits

Scope

A series of steps is applied to determine whether, on a particular day, a car parking fringe benefit arises under s. 39A FBTAA 1986.

These steps are summarised in the following diagram:



Step 1 Is the employee's (or associate's) car parked in a parking facility on the employer's business premises for more than four hours in total between 7am and 7pm?

Yes

Step 2 Is there a **commercial** parking station within 1km of the parking facility that charges a fee greater than the car parking threshold per day?

Yes

Step 3 Is the car parked in the vicinity of the place of employment?

Yes

Step 4 Is the car used to travel from home to work?

The **car parking threshold** for the FBT year commencing 1 April 2018 is $8.83 under TD 2018/7 (commencing 1 April 2019, it is $8.95 under TD 2019/9).

The legislation uses the proximity (within a one-kilometre radius) of an employer to a commercial car parking station to establish whether a liability arises. The one kilometre is measured according to the shortest practicable route (by foot, car, train, etc.) from the parking station to the employer's premises (TR 96/26). In practical terms, this means that only employer-provided parking in the CBD areas of larger cities attracts FBT. The one-kilometre test is a 'black-line' test. If the car parking station is 999 metres away, the employer is subject to car parking fringe benefits rules.

The decision in *FCT v. Qantas Airways Limited* demonstrated that an airport car park that is open to the public is a commercial car park. Therefore, car spots provided to Qantas employees are subject to FBT.

Exemptions

Although there are no specific exemptions in the car parking fringe benefit category, a number of miscellaneous exemptions may apply. The most relevant of these are the exemptions for:

- Employees of religious, charitable or public education institutions and not-for-profit scientific institutions (s. 58G FBTAA 1986).
- Employees of **small business entities**, where an employee's car is not parked at a commercial parking station (s. 58GA FBTAA 1986). To be eligible, the employer cannot be a public company (i.e. a listed company) or a government body and:
  - the employer must be a small business entity in the preceding year (see Unit 6), or
  - the employer's ordinary and statutory income for the income year preceding the start of the FBT year must be less than $10 million.

Employees who have a disabled persons parking permit are also eligible (r. 3A Fringe Benefits Tax Regulations 1992).

Calculation method

An employer can elect to apply any one of the following methods:

- For each **actual car parking benefit** provided on a particular day:
  - **Commercial parking station method** – determine the lowest fee charged by a commercial parking station operator within a one-kilometre radius reduced by recipient contributions (s. 39C FBTAA 1986).
  - **Market value method** – determine the arm's-length amount the employee could be expected to have paid reduced by recipient contributions (s. 39D FBTAA 1986).
  - **Average cost method** – determine the average of the lowest fees charged by any operator of a commercial car parking station within a one-kilometre radius on the first and last days of the FBT year reduced by recipient contributions (s. 39DA FBTAA 1986).
- For each **car parking space** for which there is at least one car parking benefit:
  - **Statutory formula method** (s. 39FA FBTAA 1986):

$$\text{Taxable value} = \left(\text{Daily rate amount} \times \frac{\text{Number of days in availability period in relation to the space}}{366} \times 228\right) - \text{Recipient contributions}$$

  - **12-week record-keeping method** (s. 39GB FBTAA 1986):

$$\text{Taxable value} = \left(\text{Total value of car parking benefits (register)} \times \frac{52}{12} \times \frac{\text{Number of days of car parking benefits}}{366}\right) - \text{Recipient contributions}$$

The '**daily rate amount**' and the '**total value of car parking benefits**' for a space are amounts worked out using the commercial parking station method, the market value method, or the average cost method (as if there were no recipient contributions).

Both methods can only be used if the taxpayer elects to do so. The taxpayer can elect for either method to apply to all employees, a specific class of employees or specified employees.

Note: The above formulas use 366 days, rather than referring to the number of days in the FBT year, as this drafting anomaly is what is specifically included in the FBT legislation.

Example – Car parking fringe benefits

ABC Accountants has an office in Melbourne. ABC provides on-site parking to 20 employees. The nearest commercial parking station is 500 metres away, which charges the public a flat fee of $10 per day.

A 12-week register is kept and this reveals that 900 car parking benefits were provided during this time, the results of which can be used for the whole FBT year.

Assuming that no FBT exemption applies, the taxable value of the car parking fringe benefits using the two methods would be calculated as follows:

12-week record-keeping method

$$900 \times \$10 \times \frac{52}{12} \times \frac{366}{366} = \$39{,}000$$

Statutory method

$$20 \times \$10 \times \frac{366}{366} \times 228 = \$45{,}600$$

Choosing the 12-week record-keeping method will result in a lower taxable value of the benefits.

In practice most companies use the statutory formula method and find the lowest car parking rate in the vicinity.

Property fringe benefits

Scope

Where an employer provides an employee with property free or at a discount, a property fringe benefit arises under s. 40 FBTAA 1986.

'Property' is defined in s. 136(1) FBTAA 1986 as both tangible and intangible property. It includes food and drinks (TR 97/17), goods, real property (e.g. land and buildings) and choses in action (e.g. shares or bonds).

Property also includes any other kind of property and has been held to include money *(Essenbourne v. FCT*; *Caelli Constructions v. FCT).* The case of *Caelli Constructions v. FCT* involved payments to an employee redundancy fund. These were found to be property fringe benefits paid in relation to employment, as they were paid under an industrial agreement and based on the salary of the employee. This clarifies the scope of the earlier case, *Essenbourne v. FCT*, where payments to an employee benefit fund were found to have no link to employment and, therefore, were not fringe benefits. However, note that certain payments to approved worker entitlement funds are now an exempt benefit (ss 58PA and 58PB FBTAA 1986).

Exemptions

Section 41 FBTAA 1986 states that an exempt benefit arises where all property, including food or drink, is provided to, and consumed by, **current employees** (not by an associate, such as a spouse) on working days at an **employer's premises** (e.g. a working lunch, morning tea, stationery, office supplies, etc.).

The exemption does not apply if food and drink is provided under a packaging arrangement as defined in s. 136(1) FBTAA 1986 (s. 41(2) FBTAA 1986).

Calculation method

The taxable value of a property fringe benefit depends on whether it is an 'in-house' or 'external' benefit (see below). The taxable value may be further **reduced by**:

- Otherwise deductible amounts.
- $1,000 concession for in-house benefits.

External benefits

All property fringe benefits other than in-house property fringe benefits (see below) are 'external' property fringe benefits.

The taxable value of a property fringe benefit where the property provided is an external property fringe benefit under s. 43 FBTAA 1986 is summarised in the following table.

External property fringe benefits – taxable value under s. 43 FBTAA 1986	
Situation	**Taxable value = Value - Recipient's contribution** **Where value equals:**
1. The **provider is the employer** who purchased the property in an arm's-length transaction	Cost price of the property
2. The **provider is not the employer** and the employer has incurred expenditure through payment to the provider in an arm's-length transaction	Expenditure incurred
3. Any **other** case	Arm's-length value

In-house benefits

Broadly, in-house property fringe benefits arise where the employer carries on a business that consists of, or includes, the provision of identical or similar goods principally to outsiders. The most common examples of such benefits are staff discounts provided to employees working in the retail, wholesale or manufacturing sectors.

The taxable value of a property fringe benefit where the property provided is an in-house property fringe benefit under s. 42 FBTAA 1986 is summarised in the following table.

In-house property fringe benefits – taxable value under s. 42 FBTAA 1986	
Situation	**Taxable value = Value – Recipient contributions** **Where value equals:**
1. A benefit given under a **salary sacrifice arrangement**	Arm's-length price employee could expect to pay (has priority over all other categories)
2. Where the employer **manufactures, produces, processes or treats** the property provided, and the property is:	
– Identical to goods normally sold by the employer to manufacturers, wholesalers or retailers	Lowest arm's-length selling price
– Identical to goods sold to the public	75% of the arm's-length selling price
– Any other case (i.e. where similar but not identical goods sold by the employer)	75% of the arm's-length price employee could be expected to pay
3. Where the employer **purchases** property for resale in the normal course of business	Lesser of: – Arm's-length purchase price paid by employer – Lowest arm's-length price employee could expect to pay
4. Any **other** case	75% of arm's-length price employee could expect to pay

Company cars acquired at end of lease

Where a car fringe benefit has been provided to an employee by way of a lease arrangement, the lessor (e.g. a finance company) will usually give the employer the right of first offer on the car at the end of the lease period. The employer typically communicates this offer to the employee, which in effect provides the employee with an opportunity to purchase the car for its lease residual value.

No property fringe benefit arises in such situations. The court in *Granby Pty Ltd v. FCT* indicated that such transactions are generally of an arm's-length nature because both parties are acting in their own best interests, and the ATO accepts the outcome of this case where the lease complies with ATO guidelines (TD 95/63).

Otherwise deductible rule

Section 44 FBTAA 1986 provides an otherwise deductible rule in respect of property fringe benefits. (This rule was discussed earlier in relation to the fringe benefit categories covered above.)

For the otherwise deductible rule to apply, the deduction that would otherwise have been available to the employee must be a '**once only**' deduction (i.e. 100% deductible in year 1) (s. 44(1)(b) FBTAA 1986).

This means that the otherwise deductible rule **does not** apply where the deduction would be for the decline in value of depreciating assets over a period of time, except where 100% of the cost would have been deductible to the employee in a single income year (e.g. the cost is no more than $300 (s. 40-80(2) ITAA 1997) or where the effective life is one year).

For example, the otherwise deductible rule does not apply when an employer gives an employee a $3,000 desktop computer, even where the employee uses the computer solely for work-related purposes. The otherwise deductible rule also does not apply when an employer gives an employee a $3,000 laptop computer. However, laptop computers and other portable electronic devices that are primarily work-related are exempt benefits under s. 58X FBTAA 1986 (see earlier in unit).

$1,000 concession for in-house benefits

Section 62 FBTAA 1986 provides a reduction of **$1,000 per employee per FBT year** in respect of the **total taxable value** of all in-house fringe benefits (i.e. expense payment, property and residual).

However, under s. 62(2), this concession does not apply if the benefit is given under a salary packaging arrangement.

Link between FBT and income tax for entertainment

The FBT exemption under s. 41 FBTAA 1986 often needs to be considered in tandem with the income tax treatment of entertainment expenditure, as illustrated by the following example (see also later in this unit 'Meal entertainment fringe benefits').

Example – Food and drink consumed on employer's premises

ABC Accountants provides a range of food and drink to current employees at various functions that are held on its business premises. The provision of food and drink to employees involves the provision of property to the employees.

ABC Accountants uses the 'actual method' for determining the taxable value of its property fringe benefit (i.e. it has not elected to apply the meal entertainment fringe benefit category). Therefore, where the property is consumed on business premises, ABC Accountants is able to apply the FBT exemption in s. 41 FBTAA 1986.

However, an exempt property benefit (under s. 41 FBTAA 1986) is **not** a fringe benefit as defined in s. 136(1) FBTAA 1986. Therefore, the exclusion from the income tax rules for entertainment that is a fringe benefit (s. 32-20 ITAA 1997) does **not** apply where ABC Accountants provides entertainment by way of food and drink to employees on business premises (i.e. the entertainment will be non-deductible for income tax purposes under s. 32-5 ITAA 1997).

It is important to remember that entertainment generally only arises where the food or drink is provided at a social function (TR 97/17).

Circumstances in which food and drink is provided to current employees during a working day	**Entertainment context?**	**FBT applicable?**	**Employer's expenditure tax deductible?**
Morning tea and cake to celebrate employee's birthday	No	No (s. 41 FBTAA 1986)	Yes (s. 8-1 ITAA 1997)
Celebratory champagne lunch in firm's in-house dining facility for employees who make the Merit List in the Chartered Accountants Program	Yes	No (s. 41 FBTAA 1986)	No (s. 32-5, and Item 1.1 in s. 32-30 ITAA 1997)
Friday night drinks (e.g. beer, wine, soft drinks) and snacks consumed on premises	Yes	No (s. 41 FBTAA 1986)	No (s. 32-5 ITAA 1997)

Required reading

Sections 40–43 FBTAA 1986.

Residual fringe benefits

Scope

Any benefit not covered by a more specific category (i.e. Divisions 2 to 11 FBTAA 1986) is a residual benefit (s. 45 FBTAA 1986). In practical terms, the residual fringe benefit category usually covers employer-provided services or entitlements to use (but not acquire) an employer's property. Such benefits can be:

- In-house – For example:
  - ABC Accountants (ABC), a registered tax agent, offers every employee a 50% discount on income tax return preparation fees.
- External – For example:
  - ABC arranges for a third-party law firm to grant a 50% discount on legal fees to all ABC's employees drawing up a will.
  - ABC allows an employee to use a motor vehicle other than a car for private purposes (e.g. a utility truck with a carrying capacity of one tonne, or a motorcycle).

Exemptions

Section 47 FBTAA 1986 contains the following specific exemptions:

- Employee transport provided by employers who are public transport providers.
- Recreational or childcare facilities located on business premises (e.g. company gym).
- Use of property (but not a motor vehicle) that is usually located on business premises, principally in connection with the employer's business operations (e.g. toilet and bathroom facilities, vending machines, tea and coffee making facilities).
- Accommodation for eligible family members where an employee is living away from (and maintaining for their ongoing use) their usual residence for a period of 12 months or less (where provided as part of a LAFHA fringe benefit – see discussion earlier in this unit).
- Use of a motor vehicle where there is **no** private use other than:
  - Work-related travel of the employee, which as defined under s. 136(1) FBTAA 1986, includes home-to-work travel, and travel that is incidental to travel in the course of performing the duties of employment.
  - Other private use by the employee or their associates that was minor, infrequent and irregular.

  However, the above exemption does not apply if a motor vehicle is a taxi or a 'car', unless it is a car which is a panel van, utility truck or non-passenger road vehicle.

  Note: See earlier in this unit under car fringe benefits for the definitions of a motor vehicle and a car, and for guidance on what constitutes minor, infrequent and irregular private use.

  Use of a motor vehicle that is a car may give rise to a car fringe benefit or an exempt car fringe benefit. It generally will not give rise to a residual fringe benefit or an exempt residual fringe benefit. Motor vehicles that may give rise to a residual fringe benefit or an exempt residual fringe benefit include (but are not limited to) a utility truck with a carrying capacity of one tonne or more, and a motor cycle.
- Unregistered motor vehicles (but not cars that are an exempt car fringe benefit) used in business operations.
- Transport to and from work for employees on oil rigs or in remote areas.
- Priority access to childcare facilities.

Employers can also consider making a no-private-use declaration under s. 47A FBTAA 1986 to the effect that all residual benefits provided attract the otherwise deductible rule and have a taxable value of nil. Residual benefits covered by such a declaration are exempt benefits.

Calculation method

The taxable value of a residual fringe benefit depends on whether it is an 'in-house' or 'external' benefit (see below). The taxable value may be further **reduced by**:

- Otherwise deductible amounts.
- $1,000 concession for in-house benefits.

External benefits

For external residual fringe benefits, the taxable value under s. 50 and s. 51 FBTAA 1986 is determined in a similar way as for external property fringe benefits (see earlier in this unit). For example, where an employee is provided with the use of an employer's property for private purposes, the taxable value is the notional value (i.e. arm's length value) of the benefit **reduced by** recipient contributions.

Where the employer's property is a motor vehicle other than a car, one method that would be acceptable to determine the notional value is a cents per kilometre basis (MT 2034). For the FBT year commencing 1 April 2018 refer TD 2018/4 (commencing 1 April 2019 refer TD 2019/3).

In-house benefits

For in-house residual fringe benefits, the taxable value under s. 48 and s. 49 FBTAA 1986 is determined in a similar way as for in-house property fringe benefits (see earlier in this unit). For example, where the benefit is not provided under a salary sacrifice arrangement, the taxable value of the in-house residual benefit is generally 75% of the lowest price charged to the public for the same type of benefit **reduced by** any recipient contributions.

Otherwise deductible amount

Section 52 FBTAA 1986 provides an otherwise deductible rule for residual fringe benefits. The key requirements for its application are consistent with those for other categories of benefits. For example, it is only applicable for employees (not associates), and it must relate to a 'once-only deduction'.

$1,000 concession for in-house benefits

Section 62 FBTAA 1986 provides a reduction of **$1,000 per employee per FBT year** in respect of the **total taxable value** of all in-house fringe benefits (i.e. expense payment, property and residual). However, under s. 62(2), this concession does not apply if the benefit is given under a salary sacrifice arrangement.

Example – Residual fringe benefits

ABC Accountants, a registered tax agent, offers to prepare the income tax return of an employee, Bill Smith, whose return will cost the firm $500. The firm's financial planning division also provides a free one-hour consultation to Bill valued at $700 to help him develop an initial investment strategy. The benefits do not form part of Bill's salary package.

Both benefits are services and give rise to residual fringe benefits.

- For the tax return preparation service, the otherwise deductible rule will apply to reduce the taxable value of this benefit to $nil (s. 52 FBTAA 1986) as the tax return preparation fees would have been deductible to Bill under s. 25-5 ITAA 1997.
- For the initial investment advice, the otherwise deductible rule is not available for this benefit because costs connected to the setup of the investment portfolio are capital in nature. Bill would not have been eligible to claim a deduction had he personally incurred the $700 cost. The outlay would have been incurred prior to the derivation of investment income and would also have been of a capital nature (TD 95/60). However, the $1,000 in-house benefit concession in s. 62 FBTAA 1986 will apply to reduce the taxable value of the benefit to $nil.

Meal entertainment fringe benefits

Scope

Entertainment is probably the most difficult area of fringe benefits for identifying and calculating taxable values, as there are so many different types of benefits and ways in which to calculate their taxable values.

There is no single entertainment fringe benefit category. Numerous fringe benefits categories may be relevant and the entertainment must fit into one of these. These types of fringe benefits include:

- Meal entertainment fringe benefits (i.e. benefits provided by way of food or drink, but only if the employer elects to treat these benefits as meal entertainment fringe benefits – discussed below).
- Expense payment fringe benefits (e.g. the cost of a ticket to a cricket match purchased by the employee and reimbursed by the employer – see Worked example 3.1: Expense payment fringe benefits).
- Property fringe benefits (e.g. employer provided food and drink at a staff family picnic day held at a local park, but not if the employer has elected to treat these benefits as meal entertainment fringe benefits – discussed below).
- Residual fringe benefits (e.g. provision of accommodation or transport for a staff social event).
- Tax-exempt body entertainment fringe benefit (e.g. entertainment provided by an employer that is exempt from income tax).

Division 9A (ss 37A–37CF FBTAA 1986) applies to meal entertainment fringe benefits. It only applies if an employer elects to use it for calculating the taxable value of meal entertainment that would otherwise fall within another FBT benefit category (e.g. expense payments, property and residual fringe benefits).

Once an employer elects to apply Division 9A FBTAA 1986, it must classify **all** fringe benefits arising from the 'provision of meal entertainment' during the FBT year as meal entertainment fringe benefits. To avoid duplication, no other fringe benefit category can apply (s. 37AF FBTAA 1986).

What is entertainment?

The provision of entertainment includes entertainment by way of food, drink or recreation; or accommodation or travel in connection with, or to facilitate, the provision of entertainment. The FBT law definition of 'entertainment' (s. 136(1) FBTAA 1986) links to the circular definition in the income tax law (i.e. 'entertainment means entertainment …' – see s. 32-10 ITAA 1997).

As noted in the discussion on entertainment expenses in Unit 1 and the discussion above on property fringe benefits, it is necessary to determine when food and drink is provided in an entertainment context.

In an employment context, entertainment includes staff social functions, amusements, sport and similar leisure-time pursuits, business lunches and drinks and cocktail parties.

However, employers commonly make the mistake of treating gifts of products (e.g. wine, hampers or television sets) to employees as entertainment. Such gifts no doubt bring the employee much joy, but they are not necessarily provided in an entertainment context.

The ATO's TD 94/55 suggests two references for determining whether gifts have been provided in an entertainment context:

- **Timeliness –** does entertainment occur soon after the provision of the gift? Does the usefulness of the gift expire after consumption?
- **Direct connection –** is there a direct connection between the gift and the entertainment? Does entertainment arise from the use of the item of property?

What is the 'provision of meal entertainment'?

The 'provision of meal entertainment' is defined in s. 37AD FBTAA 1986 to mean the provision of:

(a) entertainment by way of food or drink; or

(b) accommodation or travel in connection with, or for the purpose of facilitating, entertainment [by way of food or drink]; or

(c) the payment or reimbursement of expenses incurred in providing something covered by paragraph (a) or (b).

The FBT definition of 'meal entertainment' differs from the income tax definition of 'entertainment' (s. 32-10 ITAA 1997). For example, it excludes 'recreation' and makes no reference to the various concessions available under the income tax law, which allow deductions for entertainment in limited circumstances. Therefore, at a single entertainment function or event (e.g. a Christmas party) meal entertainment fringe benefits may be provided with other categories of fringe benefits that are 'entertainment' but not 'meal entertainment'.

The Commissioner has issued a comprehensive ruling, TR 97/17 '*Income tax and fringe benefits tax: entertainment by way of food or drink*', which examines a broad range of circumstances in which food and drink is provided to employees. The ruling includes a helpful test for identifying entertainment scenarios: the 'Why, What, When and Where' test. This test demonstrates that **entertainment does not occur every time** that food, drink or recreation is provided. It is necessary to form a conclusion as to whether the food, drink, etc. was provided in an entertainment context. For example:

- Providing morning or afternoon tea to employees (and associates of employees) on a working day, either on the employer's premises or at a worksite of the employer, does not qualify generally as the provision of entertainment when applying the TR 97/17 test because it is mere sustenance. Therefore, it cannot be treated as a meal entertainment fringe benefit and it is deductible under the general deduction provision for income tax purposes (i.e. it is not excluded from deduction under the entertainment provision).
- TR 97/17 also states that light meals (e.g. sandwiches, finger food, salads and orange juice) are treated in the same way as morning and afternoon tea. However, if alcohol is provided at morning or afternoon tea, or at a light meal at the employer's business premises or worksite, that would constitute the provision of entertainment because an element of festivity would be involved by implication.

Activity 3.2: Entertainment – fringe benefit categories

[Available online in myLearning]

Exemptions

There are **no** specific exemptions in the meal entertainment fringe benefit category.

In respect of the miscellaneous exemptions (discussed earlier in this unit), the following limitations apply:

- Where the employer chooses to apply the meal entertainment fringe benefit category, the **property fringe benefits exemption** for property consumed on business premises on a work day (i.e. s. 41 FBTAA 1986) **cannot be applied** to meal entertainment expenses. This is because s. 37AF FBTAA 1986 states that, when an employer chooses to apply the meal entertainment fringe benefit provisions, no other fringe benefit category can apply (and therefore specific exemptions within those categories cannot apply). However, the property fringe benefit exemption will continue to apply to food and drink consumed on work premises on a work day where it is not entertainment (e.g. morning and afternoon teas).

- Due to differences in the drafting of the two methods for calculating the taxable value of meal entertainment fringe benefits, the **minor and infrequent benefits exemption** in s. 58P FBTAA 1986 is:
  - **Available** to an employer who uses the 12-week register method. However, as noted earlier in this unit, this exemption cannot be applied to in-house benefits.
  - **Not** available to an employer who uses the 50:50 split method.

Calculation method

Division 9A FBTAA 1986 allows an employer to elect to calculate the taxable value of the provision of meal entertainment fringe benefits in one of two ways:

- **50:50 split method** – the taxable value is 50% of the employer's total meal entertainment expenditure (s. 37BA FBTAA 1986).
- **12-week register method** – the taxable value is a percentage of the employer's total meal entertainment expenditure, with the percentage ascertained from keeping a 12-week register of meal entertainment benefits (s. 37CB FBTAA 1986). The 12-week register is valid for the FBT year in which the register is set up and for the next four FBT years, unless expenses in providing meal entertainment are 20% higher in a year other than the year in which the register was kept (s. 37CD(3) FBTAA 1986).

For tax purposes, both methods provide the employer with some relief from the need to create detailed expense coding procedures and obtain relevant receipts from employees. However, the apparent simplicity of the 50:50 split method in particular should not be allowed to mask the obvious point that, for most employers, this method usually overstates the extent to which meal entertainment is provided to employees (i.e. a business owner typically spends more on entertaining clients than employees).

Note: Meal entertainment benefits provided by a non-employer (e.g. associate, third party, etc.) or via a salary packaging arrangement, must be calculated using the actual method (i.e. the 50:50 split method and the 12-week register method are not available).

Link between FBT and income tax

Unlike other fringe benefits, there is a direct link between the treatment of entertainment expenditure for FBT purposes and its income tax treatment.

Meal entertainment fringe benefits

An employer who **elects to apply** Division 9A FBTAA 1986 to meal entertainment expenditure must use the same method for claiming income tax deductions. Therefore, income tax deductions for meal entertainment expenditure will be claimed on **either** the 50:50 split method (s. 51AEA ITAA 1936), or 12-week register method (s. 51AEB ITAA 1936).

Example – Meal entertainment: Division 9A

ABC Accountants chooses to apply the 50:50 method under the meal entertainment fringe benefit category. It incurs $2,200 (including GST of $200) in meal entertainment at a local restaurant for one employee and three clients. The following are the FBT, GST and income tax consequences for the deemed employee portion:

- The taxable value of the fringe benefit is $1,100 (i.e. 50% × $2,200).
- The GST input tax credit entitlement is $100 (i.e. $1,100 × $^{1}/_{11}$).
- The income tax deduction is $1,000 (i.e. $1,100 – $100) (s. 32-20 and s. 27-5 ITAA 1997).

The deemed client portion of $1,100 is not a fringe benefit, is not income tax deductible (s. 32-5 ITAA 1997), and there is no entitlement to a GST input tax credit (Division 69 GST Act).

As noted above under exemptions, if an employer elects to apply the meal entertainment fringe benefit category, the FBT and income treatment of certain benefits may change.

Example – Meal entertainment: Excluded exemptions

ABC Accountants has chosen to apply the 50:50 method under the meal entertainment fringe benefit category. As a consequence, the following meal entertainment expenses would be subject to FBT:

- 50% of any infrequent employee restaurant meals costing less than $300 (i.e. benefits that would otherwise be an exempt minor and infrequent benefit under s. 58P).
- 50% of the cost of any Friday night drinks (i.e. benefits that would otherwise be an exempt property fringe benefit as it is consumed on business premises on a work day under s. 41).

The portion that is subject to FBT would be deductible for income tax purposes under s. 32-20 ITAA 1997. However, the portion that is not subject to FBT would continue to be not deductible for income tax purposes.

Note: For morning and afternoon tea (i.e. mere sustenance and not entertainment) the FBT treatment as an exempt property fringe benefit under s. 41 FBTAA 1986 and the income tax treatment as a deductible expenditure under s. 8-1 ITAA 1997 would not change where a meal entertainment fringe benefit election is made.

Other fringe benefits

Where Division 9A FBTAA 1986 does not apply (i.e. where an employer has **not chosen to apply** the meal entertainment fringe benefit category), the taxable value of the fringe benefit will be based on actual meals (and associated travel and accommodation) provided to employees and their associates. This is commonly referred to as the 'actual method'.

In the usual case, where an employee takes a business client to a business lunch and the employer reimburses the employee for the cost of both meals, the tax consequences are as follows:

- The cost of the **employee's** meal is subject to FBT as an expense payment fringe benefit (subject to the minor benefit exemption in s. 58P) and is deductible for the employer (ss 8-1 and 32-20 ITAA 1997). Where s. 58P applies, the meal would be an exempt benefit and would not be deductible.
- The cost of the **client's** meal is not deductible for the employer and is not a fringe benefit (ss 32-5 and 32-20 ITAA 1997, and s. 63A FBTAA 1986).

For practical reasons, the Commissioner allows the cost of the meal entertainment for both the employee and client to be split on a 'per head' basis (TD 94/25).

Example – Meal entertainment: Expense payment benefit

ABC Accountants incurs $2,200 (including GST of $200) in meal entertainment at a local restaurant for one employee and three clients. It has **not** chosen to apply Division 9A FBTAA 1986. The following are the FBT, GST and income tax consequences of the employee portion:

- The taxable value of the expense payment fringe benefit is $550 (i.e. $\frac{1}{4}$ × $2,200).
- The GST input tax credit entitlement is $50 (i.e. $550 × $^1/_{11}$)
- The income tax deduction is $500 (i.e. $550 – $50) (s. 32-20 and s. 27-5 ITAA 1997).

The $1,650 client portion is not a fringe benefit, is not income tax deductible, and there is no GST input tax credit entitlement.

Worked example 3.3: Meal entertainment fringe benefits
[Available online in myLearning]

Entertainment facility leasing

Scope

'Entertainment facility leasing expenses' is defined in s. 136(1) FBTAA 1986 to mean:

> Expenses incurred by the person in hiring or leasing:
>
> (a) a corporate box;
>
> (b) boats, or planes, for the purpose of the provision of entertainment; or
>
> (c) other premises, or facilities, for the purpose of the provision of entertainment;
>
> but does not include so much of any of such expenses that:
>
> (d) is attributable to the provision of food or drink; or
>
> (e) is attributable to advertising and is an allowable deduction …

Calculation method

Under s. 152B FBTAA 1986, an employer can elect that the taxable value of benefits provided by entertainment facilities that are hired or leased is 50% of all the expenses (50:50 split method). This is a compliance-cost-saving measure that alleviates the practical problem of keeping an actual employee and non-employee headcount of those who use the facilities.

Recipient contributions

If an employee pays an amount to the employer for the benefit, this amount will be a recipient's contribution or employee contribution. The taxable value of that fringe benefit is reduced by the gross amount of the payment (including GST). The amount must be paid from the after-tax income of the employee.

To qualify as a recipient contribution, the amount would generally be paid within the FBT year. However, there is no actual time frame stipulated in the legislation. Provided the employee agrees to pay the contribution by the end of the FBT year, the ATO will accept it as a contribution for the year that has just ended even where it is received after the FBT return is lodged.

In ATO ID 2005/210, the ATO accepts that **excess recipient contributions** in a particular FBT year can be carried forward and used to reduce the taxable value of benefits in a later FBT year.

In the case of **car fringe benefits**, the recipient contribution can be made either by making a payment to the employer from after-tax pay (usually done by payroll deduction) or by the employee (or an associate of the employee) paying the packaged car expenses (e.g. fuel, repairs, insurance and registration). Other costs paid by the recipient, such as bridge and road tolls, will not be treated as a recipient's contribution.

FBT payable

Overview

Up until now, the focus of this unit has been on identifying and (if necessary) calculating the taxable value of particular fringe benefits.

The next step is to calculate the actual amount of FBT that is payable by the employer.

Building on the flow chart methodology used in Steps 1–5 earlier in this unit, the next two steps are depicted below.

Step 6 Calculate taxable amount
= (Taxable value Type 1 benefits × Type 1 gross-up factor) +
(Taxable value Type 2 benefits × Type 2 gross-up factor)

Step 7 Calculate FBT liability
= Taxable amount × FBT rate

Step 6 – Calculate taxable amount

To calculate the taxable amount under s. 5B:

- Identify each fringe benefit as either a Type 1 or Type 2 benefit.
- Multiply the taxable value of each fringe benefit by the applicable gross-up factor.

Type 1 and Type 2 benefits

The entitlement to a GST input tax credit in relation to the fringe benefit determines whether a fringe benefit is a Type 1 or Type 2 benefit:

- Type 1 benefit – employer is entitled to an input tax credit for GST paid on benefits provided.
- Type 2 benefit – employer is **not** entitled to an input tax credit for GST paid on benefits provided.

Section 149A FBTAA 1986 states a benefit provided in respect of an employee's employment is a GST-creditable benefit, where an entitlement to a GST input tax credit arises under Division 111 of the GST Act because of the provision of the benefit. Where the benefit is a 'thing' within the GST Act, it must have been acquired or imported within the meaning of the GST Act.

In interpreting the above requirement, para. 5 TR 2001/2 states that a benefit that has been manufactured cannot be a Type 1 benefit and will be a Type 2 benefit as outlined in the following example.

Example – Manufactured goods: Type 2 benefits

On 5 August, Archimedes Limited provides a bathtub it manufactured to Riccardo. The bathtub is identical to those normally sold to retailers and had an in-house property fringe benefit taxable value of $1,500.

Archimedes Limited would treat the provision of the bathtub as a Type 2 benefit, as it was not 'acquired' for the purposes of s. 149A.

Source: TR 2001/2 para. 53.

Gross-up factors

Gross-up factors are used in calculating an FBT liability for **two** reasons:

1. To make employers and employees indifferent to either packaging fully taxable FBT benefits or paying cash salaries sufficient for employees to acquire the benefits from their after-tax salaries. This assumes that employees are in the top marginal tax bracket.
2. To acknowledge the GST input tax credit that employers sometimes obtain when purchasing benefits that are provided to their employees.

The **Type 1 gross-up factor** is calculated as follows:

$$\frac{\text{FBT rate} + \text{GST rate}}{(1 - \text{FBT rate}) \times (1 + \text{GST rate}) \times \text{FBT rate}}$$

The **Type 2 gross-up factor** is calculated as follows:

$$\frac{1}{1 - \text{FBT rate}}$$

The following table summarises the FBT rate and gross-up factors for particular FBT year ends.

Fringe benefits tax			
Year end 31 March	**Rate**	**Type 1 gross-up factor**	**Type 2 gross-up factor**
2016 and 2017	49%	2.1463	1.9608
2018 and later	47%	2.0802	1.8868

Note: The FBT year end covered in this offering of the TAXAU module is 31 March 2019.

Step 7 – Calculate FBT payable

FBT payable is calculated by multiplying the taxable amount by the applicable FBT rate.

The following example illustrates the calculation of FBT payable and how the use of gross-up factors ensure there is no benefit to employees from salary packaging private expenses (i.e. that are fully taxable fringe benefits) rather than receiving an equivalent amount as cash salary.

Example – Employer paying for employee's private expenses

A senior executive asks his corporate employer to pay private expenses of $110 (including $10 of GST). The corporate employer is willing to do so and is eligible for full GST input tax credits on this expense benefit. As the employer is entitled to a GST input tax credit, the benefit is a Type 1 benefit.

The comparative calculations are set out below. (Amounts have been rounded up to the nearest dollar for simplicity.)

Details	Salary $	Fringe benefit $
Tax impact for employer		
Salary	208[1]	
Benefit		110
Benefit of input tax credit		(10)
Tax deduction for cost of providing salary or GST-exclusive cost of benefit at 30%	(62)	(30)
FBT		108[2]
Tax deduction for FBT at 30%		(32)[3]
After-tax cost to employer	**146**	**146**
Tax impact for employee		
Salary	208	–
Income tax at 47%[4]	(98)	–
After-tax benefit	**110**	**110.00**

Notes

1. This amount is the sum of the GST-exclusive cost of the benefit to the employer plus the FBT ($100 + $108 = $208).
2. Taxable value is calculated on a GST-inclusive basis ($110 in this example) (TR 2001/2). The GST-inclusive taxable value ($110) is grossed up by 2.0802 and then FBT at 47% is levied on the grossed-up amount:

   $110 × 2.0802 = $229

   $229 × 47% = $108
3. FBT is deductible for income tax purposes.
4. Assume all taxable at the top marginal rate of 47%.

Activity 3.3: FBT payable

[Available online in myLearning]

FBT administration

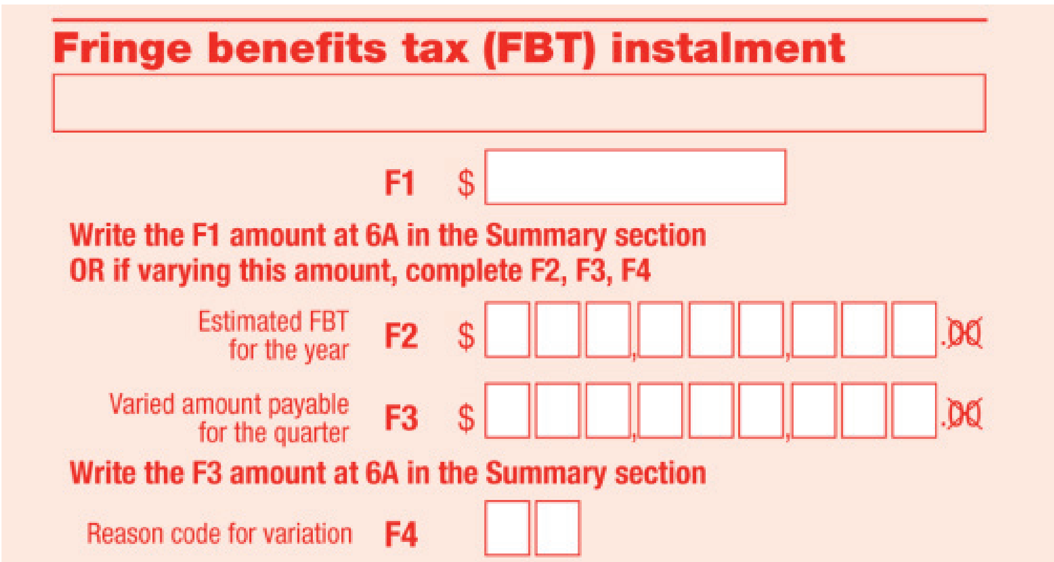
Collecting FBT

FBT is assessed each year when employers' annual FBT returns for the FBT year (1 April to 31 March) are lodged.

FBT is a self-assessment tax, for which employers are liable to lodge an annual FBT return and pay any tax liability by 21 May. The ATO usually gives tax agents a short extension of time to lodge their clients' FBT returns.

Where an employer's first FBT annual return shows a tax liability of $3,000 or more, the ATO will notify the employer of its obligation to pay quarterly FBT instalments for the next FBT year (i.e. for the quarters ending 30 June, 30 September, 31 December and 31 March).

These quarterly FBT instalments are paid using the business activity statement (BAS) (see extract below) on a date advised by the ATO on the BAS. The payments are credited towards the employer's final FBT liability for the year. The BAS enables employers to vary each FBT instalment by estimating their final tax liability. Penalties apply if the variation is later found to be excessive. Once the instalment system applies, the annual FBT return effectively becomes a 'true-up' mechanism that enables employers to pay any remaining amount of FBT (or obtain a refund of FBT that has been overpaid).



Fringe benefits tax (FBT) instalment

F1 $

Write the F1 amount at 6A in the Summary section
OR if varying this amount, complete F2, F3, F4

Estimated FBT for the year **F2** $ .00

Varied amount payable for the quarter **F3** $ .00

Write the F3 amount at 6A in the Summary section

Reason code for variation **F4**

Source: ATO, www.ato.gov.au.

Reportable fringe benefits

Where the total taxable value of certain fringe benefits provided to an employee exceeds $2,000 in the FBT year (i.e. year ended 31 March), employers are required to record the grossed-up taxable value of those benefits on the employee's PAYG payment summary for the corresponding income year (i.e. year ended 30 June). Employers must also record the value of certain types of exempt benefits. These are known as the reportable fringe benefits rules.

The gross-up factor used for reportable fringe benefit purposes is the Type 2 (i.e. the lower gross-up rate) irrespective of the actual type of benefit and the actual gross-up rate that is required to be used by the employer to calculate FBT payable.

An employee does not pay income tax on the reported amount of their fringe benefits. It is, however, included in a number of income tests relating to government benefits and obligations, such as:

- Medicare levy surcharge.
- Deduction for personal superannuation contributions.
- Superannuation co-contributions.
- Higher Education Loan Program (HELP) and Financial Supplement repayments.
- Child support obligations.
- Entitlement to certain income-tested government benefits.

The main benefits excluded from the reporting requirements under s. 5E FBTAA 1986 are:

- Car parking fringe benefits (excluding car parking expense payment fringe benefits).
- Meal entertainment fringe benefits.
- Exempt fringe benefits.
- Otherwise deductible fringe benefits.

Interaction between income tax, GST and FBT

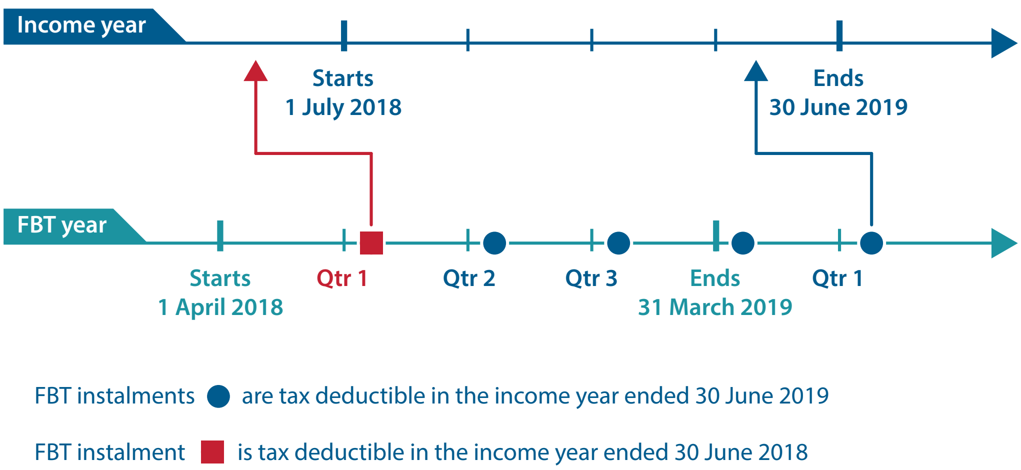
Deduction for FBT

An employer treats FBT as a tax-deductible expense under s. 8-1 ITAA 1997 because it has a clear connection with the cost of labour used in the employer's business.

The lack of alignment between the income year for income tax purposes (typically 1 July to 30 June) and the FBT year (see 'Collecting FBT' above) creates a timing issue when claiming a deduction for income tax purposes.

The ATO accepts that the FBT instalment relating to the June 2019 quarter (paid in July 2019) is incurred by the employer in the income tax year ended 30 June 2019 (i.e. the deduction is 'back-dated'). The result is that the June quarter instalment is deductible in the year ended 30 June 2019, even though it is paid after the end of the income year (TR 95/24). Correspondingly, the FBT instalment relating to the June 2018 quarter (paid in July 2018) must be excluded from the income tax calculation for the income year ended 30 June 2019.

This timing issue is illustrated by the following diagram.



FBT and income tax

A **fringe benefit** is deemed to be non-assessable, non-exempt (NANE) income in the employee's hands for income tax purposes (s. 23L(1) ITAA 1936). However, exempt benefits are not 'fringe benefits' as defined in s. 136(1) FBTAA 1986.

With one exception, an **exempt benefit** is deemed to be exempt income in the employee's hands for income tax purposes (s. 23L(1A) ITAA 1936). Therefore exempt benefits would, technically, waste (i.e. use up) any income tax losses the employee may have (see Unit 1).

For example, the provision of a company car (where it is a car fringe benefit) is NANE income and will not waste an employee's tax losses. However, attending a Christmas party (where it is an exempt benefit under s. 58P) is exempt income and would waste the employee's tax losses.

The exception is employer-reimbursed car expenses (typically paid on a per-kilometre basis), which are:

- An exempt benefit under the expense payment fringe benefit category (s. 22 FBTAA 1986).
- Included in assessable income for income tax purposes (s. 15-70 ITAA 1997).

Unlike other fringe benefits, there is a direct link between the treatment of entertainment expenditure for FBT purposes and its income tax treatment. See discussion above under meal entertainment fringe benefits and property fringe benefits.

FBT and GST

The above discussion on calculating FBT payable illustrates the way in which GST is taken into account for Type 1 benefits.

Other aspects of the interaction between GST and FBT are summarised in the following table.

Interaction of FBT, GST and income tax

Situation	Tax	Consequences
Employer provides benefit (assume employer is registered for GST)	GST	Although an employer makes a taxable supply when providing a fringe benefit, the employer is only liable for GST to the extent of the consideration payable on the supply in the form of a recipient's payment or contribution (s. 9-75(3) GST Act) The employer will be entitled to GST input tax credits for most expense payment fringe benefits (e.g. reimbursement of taxi fares incurred by an employee while travelling for work) (Division 111 GST Act). Tax invoices need to be obtained from the employee, although not for minor amounts However, no GST input tax credit entitlement arises where the employer reimburses non-deductible expenses (e.g. the client portion of a restaurant meal, or the cost of beer and wine etc. consumed at a social function held on business premises during a work day: Division 69 GST Act)
	FBT	Taxable value of the benefit for FBT purposes is calculated on a GST-inclusive basis (TR 2001/2 paras 21, 22, 23 and 26)
	Income tax	• Any amount assessable to employer does not include GST (s. 17-5 ITAA 1997) • GST component of the cost of a fringe benefit is not deductible if the employer is eligible for an input tax credit (s. 27-5 ITAA 1997) • An employer can deduct FBT as a labour cost (s. 8-1 ITAA 1997) • GST paid by employer (e.g. on an employee contribution) is not deductible (s. 27-15 ITAA 1997)
Employee makes contribution to employer	GST	Employee contribution can affect the GST payable by the employer on the taxable supply it makes (see above)
	FBT	Employee's contribution towards the benefit (if any) reduces the taxable value of the fringe benefit and hence, the employer's FBT liability
	Income tax	• Employer perspective – the employee contribution will typically be income according to ordinary concepts in the hands of the employer (s. 6-5 ITAA 1997) • Employee perspective – contribution towards private component of a fringe benefit is not deductible for an employee (s. 51AJ ITAA 1936)
Employee makes contribution, but not to employer	GST	No consequences for the employer or employee
	FBT	Employee's contribution reduces the taxable value of the fringe benefit and, hence, the employer's FBT liability
	Income tax	• No consequences for the employer or employee (there is no constructive receipt under s. 6-5(4) ITAA 1997) • Employee contribution towards private component of a fringe benefit is not deductible to employee (s. 51AJ ITAA 1936)

Example – Interaction between FBT and GST: Employee contribution

ABC Accountants has provided Peter, an employee, with a new television with a GST-inclusive cost of $1,100. Peter has made an employee contribution of $110 to his employer, ABC Accountants.

For FBT purposes:

The taxable value of the benefit is $990 (i.e. $1,100 GST-inclusive cost to ABC Accountants less the employee contribution of $110).

The FBT payable by ABC Accountants is $990 × 2.0802 × 47% = $1,009.

For GST purposes:

ABC Accountants has made a creditable acquisition and is entitled to a GST input tax credit of $100 (i.e. $1,100 × $^{1}/_{11}$).

Peter's employee contribution is consideration for a taxable supply. ABC Accountants has a GST liability of $10 (i.e. $110 × $^{1}/_{11}$).

The net GST refundable to ABC Accountants is $90.

Worked example 3.4: Interaction between FBT, GST and income tax – company car

[Available online in myLearning]

Salary packaging

Salary packaging (or salary sacrifice arrangements) describes arrangements between employers and employees whereby employees agree to forego part of their future entitlement to salary or wages in return for the employer providing them with benefits.

Under an **effective** salary sacrifice arrangement:

- The employee pays income tax on the reduced salary or wages.
- The employer may be liable to pay FBT on the fringe benefits it provides to the employee.

The precise details of such an arrangement are subject to agreement between the employee and the employer. This will usually be governed by a written salary packaging policy. A 'standard' policy might include the following:

- Total cost of employment (TCE) cap – that is, the total amount of remuneration that the employer is willing to pay (including cash salary, superannuation contributions, payroll tax, workers' compensation cover, cost of benefits and any FBT payable by the employer).
- GST credits added back to the employee's package.

Benefits – employer perspective

An employer who is prepared to bear no more than the TCE cap is usually indifferent as to whether cash salary or benefits are provided to an employee unless the administration of the benefits is prohibitive. Benefits that attract FBT are treated as falling within the TCE and the employer will adjust the cash salary accordingly to take account of the tax.

Some employers are reluctant to enter into salary sacrifice arrangements because of the extra administrative costs involved, or may require the employee to bear some of these costs via an administration charge that forms part of the TCE (these costs do not give rise to an FBT liability regardless of whether or not the costs are passed onto the employee – ATO ID 2001/333).

In practice, apart from cars, salary packaging is becoming less common because there is very little benefit for the administration costs incurred (except for rebateable employers such as hospitals, charities, etc.).

Benefits – employee perspective

Whether salary packaging is attractive to an employee depends firstly on the individual's personal circumstances. Relevant considerations include the employee's:

- Pre-tax salary – typically, salary sacrifice arrangements are more attractive to those on higher incomes (i.e. over $180,000).
- Need for cash salary to meet day-to-day needs and financial commitments.

Secondly, the gross-up formulas used to calculate FBT are designed, in part, to make employers and employees indifferent to either packaging a **fully taxable** fringe benefit or paying a cash salary that is sufficient for an employee to acquire the benefit from their after-tax salary. This means that it is usually beneficial to salary package only those benefits that receive **concessional** FBT treatment, such as:

- Benefits outside the scope of FBT (e.g. additional superannuation contributions).
- Exempt benefits (e.g. a laptop computer that is used mainly for work).
- Benefits whose taxable value is calculated using a concessional formula (e.g. a car fringe benefit, for which the statutory gross-up formula used assumes a higher level of business use than is actually the case).
- Benefits whose taxable value can be reduced, either because of:
  - a specific reduction mechanism in the FBT law (e.g. LAFHA fringe benefits for an Australian employee who is living away from their normal residence for a period of 12 months or less), or
  - the otherwise deductible rule (particularly for loan, expense payment, property and residual fringe benefits). Examples include an employer's payment of an employee's self-education expenses, professional association membership fees, income protection insurance and tax agent fees.

The other benefit of salary packaging concessionally taxed benefits is that the employer may receive GST input tax credits, whereas the employee does not. Therefore, the cost of such benefits – for example, professional association membership subscriptions – is 10% cheaper if they are packaged.

Effective arrangements

Salary sacrifice arrangements must be effective. The ATO's opinion of what constitutes an effective salary sacrifice arrangement is stated in paras 21–22 of TR 2001/10:

- An **effective** salary package involves an employee agreeing to receive part of their remuneration as a benefit **before** they have an entitlement to receive that part of their remuneration as salary or wages.
- An **ineffective** salary package involves an employee directing that an existing entitlement to receive salary or wages be provided as a benefit.

Payments made as part of an ineffective salary sacrifice arrangement will be treated as assessable income of the employee under ordinary concepts.

Example – Cash bonus to employee

Big Pty Ltd (Big) pays bonuses to its employees at the end of each financial year. On 30 June, the company informs its receptionist, Beryl Barnes, that she is legally entitled to a $3,000 cash bonus, which will be paid to her in the next payroll cycle. Beryl phones her human resources (HR) manager and asks that the $3,000 bonus not be paid to her in cash, but rather directed into her superannuation fund as an additional employer (pre-tax) contribution.

The HR manager should advise Beryl that it is too late to salary sacrifice the $3,000 as Beryl has already been advised that she is legally entitled to the $3,000. She has earned it and is now trying to direct how it should be dealt with. The amount will be treated as derived ordinary income for income tax purposes (s. 6-5(4) ITAA 1997).

To avoid such a problem occurring the following year, the HR manager should recommend that Big changes its bonus procedure as follows:

- Prior to notifying employees of their annual bonus (if any), Big should ask its employees to notify the company in writing of how they wish to be paid their bonus: as a cash salary, an additional superannuation contribution, or another benefit.
- Once Big decides on each employee's bonus entitlement amount, it should then apply that amount in accordance with the employee's pre-existing instructions.

Payments on termination of employment

Employment termination payment

Scope

An employment termination payment (ETP) is a payment received as a consequence of the termination of:

- employment (a **life benefit** termination payment (s. 82-130(2) ITAA 1997)), or
- another's employment because of death (a **death benefit** termination payment (s. 82-130(3) ITAA 1997)).

ETPs dealt with in this unit are life benefit termination payments. Death benefit termination payments are beyond the scope of this unit.

An ETP must generally be received no later than 12 months after termination of the employment. However, the 12-month rule does not apply:

- To the taxable component of genuine redundancy payments and early retirement scheme payments.
- Where the Commissioner has made a determination under s. 82-130(7) ITAA 1997.

A person who receives an ETP is **not** taxed on the tax-free component of the lifetime benefit and may have a capped rate of tax applied to the taxable component of the lifetime benefit.

Note: ETPs cannot be rolled over to a superannuation fund (refer s. 80-20 ITAA 1997). Also, under s. 80-15 ITAA 1997, the transfer of property is deemed to be a payment for ETP purposes at market value (less any consideration paid by the employee). Such a transfer is an exempt fringe benefit (refer s. 136(1) – definition of 'fringe benefit', subsection (lc) FBTAA 1986).

Exclusions

Various payments are excluded from the ETP definition in s. 82-135 ITAA 1997, including:

- Superannuation benefits.
- Payments for unused annual leave or unused long service leave.
- The tax-free part of a **genuine** redundancy payment or an early retirement scheme payment.

These payments are covered by specific tax rules, which are discussed below.

Required reading

Sections 82-130 and 82-135 ITAA 1997.

Calculation method

Tax-free component

The tax-free component of a life benefit termination payment is NANE income (s. 82-10(1) ITAA 1997). It consists of the following (s. 82-140 ITAA 1997):

- **Invalidity segment** (defined in s. 82-150 ITAA 1997) – applicable where an employee is terminated from their employment due to invalidity that has been certified by two medical practitioners. This component is calculated by reference to the employee's normal retirement date and is not taxed.

- **Pre-July 1983 segment** (defined in s. 82-155 ITAA 1997) – applicable where the taxpayer's eligible service period commenced before 1 July 1983. It is calculated by deducting any invalidity segment and apportioning the balance according to the days in the service period that were before 1 July 1983.

Taxable component

The life benefit termination payment's taxable component is equal to the ETP less the tax-free component (s. 82-145 ITAA 1997).

The taxable component is assessable and its tax treatment is determined by reference to a 'cap' under s. 82-10 ITAA 1997, being the **lesser** of either the:

- ETP cap of $205,000 for the 2018–2019 income year ($210,000 for the 2019–2020 income year) reduced by certain earlier termination payments received in the same income year. The ETP cap is indexed annually in line with average weekly ordinary times earning (AWOTE), in increments of $5,000.
- 'Whole-of-income' cap of $180,000 (not indexed) reduced by the taxpayer's non-ETP taxable income.

The purpose of having two methods for calculating the cap is to make the ETP concession more accessible to lower-paid workers.

The whole-of-income cap only applies to certain ETPs, which are called 'non-excluded ETPs'. Non-excluded ETPs include:

- Payments that do not meet the genuine redundancy rules.
- 'Golden handshakes'.
- Payment for rostered days off.
- Payment for unused sick leave.
- Gratuities.

Maximum rate of tax

Assuming the taxable component is within the lower of the ETP or whole-of-income caps, the tax treatment is as tabled below.

Treatment of taxable component of ETP within the cap		
Employee	**Up to ETP cap[2]**	**Over the cap**
Under preservation age[1]	No more than 30% (plus Medicare levy)	Top marginal rate (plus Medicare levy)
Preservation age[1] or over	No more than 15% (plus Medicare levy)	Top marginal rate (plus Medicare levy)

Notes

1. Ascertain the ETP recipient's age on 30 June. For those born before 1 July 1960, the preservation age is 55. For those born after 30 June 1960, the preservation age is phased up from 55 to 60. For those born after 30 June 1964, the preservation age is 60.
2. The concession is implemented by way of a tax offset.

Example – ETP concessions

Small Limited (Small) is the subject of a takeover by Big Limited (Big). As a result, Small terminates the contracts of its two employees, both of whom receive a 'golden handshake' payment (an ETP). One of the terminated employees is on a high income, while the other is on a lower income.

Employee on a lower income

Mark Burns is 45 years old and his taxable income for the year ended 30 June 2019 is $100,000 (excluding any ETP).

Mark receives an ETP of $20,000 on 30 June. The ETP has no tax-free component.

Mark's ETP cap is the **lesser** of the:

- lifetime benefit cap of $205,000 (2018–2019), and
- whole-of-income cap of $180,000 less Mark's non-ETP taxable income for the year (i.e. $180,000 – $100,000 = $80,000).

Thus, the whole-of-income cap of $80,000 is the lesser of the two cap amounts.

Mark's $20,000 ETP is within the $80,000 cap and eligible for the ETP tax offset. Small therefore will withhold pay-as-you-go (PAYG) tax on the $20,000 at 30% plus 2.0% Medicare levy (i.e. $6,400).

Employee on a high income

Cheryl Spence is the chief financial officer (CFO) and is 50 years old. Her taxable income for the year ended 30 June (excluding any ETP) is $250,000.

Cheryl receives an ETP of $100,000 on 30 June. The ETP has no tax-free component.

Cheryl's ETP cap is the **lesser** of the:

- lifetime benefit cap of $205,000 (2018–2019), and
- whole-of-income cap of $180,000 less Cheryl's non-ETP taxable income for the year (i.e. $180,000 – $250,000 = $0, because negative amounts are not recognised).

Thus, the whole-of-income cap of $0 is the lesser of the two cap amounts.

Cheryl's $100,000 ETP is ineligible for the ETP tax offset. Small therefore will withhold PAYG tax at the normal withholding rates specified by the ATO.

Note: Employers face the practical difficulty of not having all the data necessary to ascertain an employee's taxable income (e.g. the employee may have investment income).

Unused annual and long service leave payments

Scope

The income tax provisions for unused leave balances are:

- Unused annual leave payments (Subdivision 83-A ITAA 1997).
- Unused long service leave payments (Subdivision 83-B ITAA 1997).

Calculation method

In general terms, a person receiving annual leave and long service leave payments accrued after 18 August 1993 is taxed at the normal marginal tax rates for individuals (see Unit 7).

However, where such payments are part of a genuine redundancy payment, the income tax payable is capped **at 30%** (plus Medicare levy). Where the income tax payable would otherwise exceed this cap, the taxpayer is entitled to a tax offset.

Required reading

Sections 83-10, 83-15, 83-75 and 83-85 ITAA 1997.

Genuine redundancy and early retirement scheme payments

Scope

Genuine redundancy and early retirement scheme payments are dealt with under Subdivision 83-C ITAA 1997. A person who receives a genuine redundancy payment or a payment under an early retirement scheme is **not** taxed on the tax-free component of the payment.

The differences between the two types of payments are clarified in the following table.

Differences between genuine redundancy and early retirement scheme payments	
Genuine redundancy payment	**Early retirement scheme payment**
A genuine redundancy payment is a payment made because: • the employee's position has been abolished, and • employment is terminated before the employee turns 65 years old The payment must not exceed an arm's-length amount and there must be no arrangement to re-hire the employee	An early retirement scheme payment results from the rationalisation or reorganisation of an employer's operations, which is approved by the Commissioner. The employee must retire before they turn 65 years old (or normal retirement date) The payment must not exceed an arm's-length amount, and there must be no arrangement to re-hire the employee

Note: From 1 July 2019, the employee age requirement has changed from 65 years to the pension age (as defined under s. 23(1) *Social Security Act 1991*). On 1 July 2019, the pension age will be 66 years and by 1 July 2023, it will rise to 67 years.

Calculation method

Tax-free component

The **tax-free component** on both types of payments depends on the employee's period of employment. The tax-free component's limit is:

- $10,399 **plus** $5,200 for each completed year of service for the 2018–2019 income year.
- $10,638 **plus** $5,320 for each completed year of service for the 2019–2020 income year.

Excess component

Any amount received in excess of the tax-free amount is assessable as an ETP (see above).

Example – Genuine redundancy: Tax-free component

Bill Small has worked for Aussie Pty Ltd for 10 years. As a result of an economic downturn, Bill's position is abolished and his employment terminated. Bill receives a $70,000 genuine redundancy payout.

For the income year ended 30 June 2019 the tax-free component of Bill's payout is:

$10,399 + ($5,200 × 10) = $10,399 + $52,000 = $62,399

Therefore, of the $70,000 payout, $62,399 is tax-free. The excess ($7,601) will be treated as the taxable component of an ETP. Because Bill's payout is a genuine redundancy payment, it is not subject to the whole-of-income ETP cap.

For ATO guidance on genuine redundancy payments, refer to TR 2009/2.

Employee share schemes

Overview

An employee share scheme (ESS) allows an employer to offer its employees equity in the company. Such schemes aim to attract, motivate and retain employees.

Division 83A ITAA 1997 deals with employees who receive a beneficial interest in the shares of a company, or receive a right (including an option) to acquire such beneficial interests, under an ESS at a **discount.** 'Discount' in this context is the difference between the market value of the shares or rights (at acquisition) and the consideration paid (if any) by an employee for those shares or rights.

An employee who acquires shares or rights under an ESS at a discount must include that discount amount in their assessable income in the **year of acquisition** – known as 'upfront' taxation (s. 83A-25 ITAA 1997).

If ESS interests have not been granted at a discount, then the shares and rights are taxed as normal under the other provisions of the tax law, such as capital gains tax.

Concessions

There are three concessions available to an employee (where the ESS interest was acquired on or after 1 July 2015):

- Reduction concession — start-ups: where the assessable discount amount is reduced to nil.
- Reduction concession — other cases (i.e. where the start-up concession does not apply): where the assessable discount amount is reduced by $1,000.
- Deferral concession: where the inclusion of the discount amount in assessable income is deferred until the earlier of prescribed events. For example, an employee will include the discount amount in respect of a right (including an option) in assessable income when it is exercised (rather than at the earlier time of when it vests as applied for ESS interests acquired from 1 July 2009 to 30 June 2015).

Details of the above three concessions are set out in the following table.

Concessions for employees acquiring ESS interests on or after 1 July 2015

	Reduction concession – start-ups	Reduction concession – other cases	Deferral concession
Concession	The assessable discount amount is reduced to **nil** (s. 83A-33)	The assessable discount is **reduced by $1,000** (s. 83A-35(1) and (2))	The assessable discount can be **deferred** until whichever time occurs earliest: • When there is no longer a real risk of an employee losing the shares or rights **and** any restrictions on sale are lifted (ss 83A-115(4), 83A-120(4)) • When an employee ceases employment (ss 83A-115(5), 83A-120(5)) • **15** years after the employee acquired the shares or rights (ss 83A-115(6), 83A-120(6)) • For rights (but not shares), when an employee **exercises** the right, **and** after exercise there is no real risk of an employee losing the underlying share **and** the restrictions on sale are lifted (s. 83A-120(7)) The assessable discount is equal to the market value of the share or rights at the ESS deferred taxing point reduced by the cost base of the interest (s. 83A-110(1))
Conditions to qualify	All of the following requirements must be satisfied: • Under s. 83A-33(1)(a), the start-up conditions are satisfied if: – No equity interests (e.g. shares) in the company are listed on a stock exchange (s. 83A-33(2)) – The company has been incorporated for less than 10 years (s. 83A-33(3)) – The company has aggregated turnover not exceeding $50 million (s. 83A-33(4)) – For shares, the discount on the share is no more than 15% of its market value when the employee acquired it (s. 83A-33(5)(a)) – For rights, the amount that must be paid to exercise the right is greater than, or equal to, the market value of an ordinary share in the company when the employee acquired the right (s. 83A-33(5)(b)) – The employer is an Australian resident company (s. 83A-33(6))	All of the following requirements must be satisfied: • The reduction concession for start-ups does not apply (s. 83A-35(2)(c)) • The **employee's** taxable income, reportable fringe benefits, reportable superannuation contributions and total net investment losses for the income year are **less than $180,000** (s. 83A-35(2)(b))	The following requirement must be satisfied: • The reduction concession for start-ups does not apply (s. 83A-105(1)(ab))

Concessions for employees acquiring ESS interests on or after 1 July 2015

	Reduction concession – start-ups	Reduction concession – other cases	Deferral concession
Conditions to qualify (cont.)	• Under s. 83A-33(1)(b), the further conditions are satisfied if: – The employee is employed by the company (or its subsidiary) to which the shares or rights relate (s. 83A-45(1)) – The shares or rights relate to ordinary shares (s. 83A-45(2)) – The employer must not be in the business of share trading or investment and the employee must not be a dual employee of the company issuing the ESS interest and its subsidiary (s. 83A-45(3)) – The employee is only allowed to dispose of the shares or rights after three years from the time of acquisition, or when the employee ceases employment with the employer (ss 83A-45(4) and (5)) – The employee must not hold more than **10%** ownership of the company, or control more than **10%** of the voting rights in the company, after acquiring the ESS interests (s. 83A-45(6))	• Under s. 83A-35(1)(b): – ss 83A-45(1), (2), (3), (4), (5) and (6) are satisfied	• Under s. 83A-105(1)(b): – ss 83A-45(1), (2), (3) and (6) are satisfied
Broad availability condition	• Under s. 83A-33(1)(c), for **shares** (but not rights), the broad availability condition is satisfied if: – The ESS is available to 75% of permanent employees who are residents and have completed three years of service (s. 83A-105(2))	• Under s. 83A-35(1)(a), the broad availability condition is satisfied if: – The ESS is available on a non-discriminatory basis to 75% of permanent employees who are residents and have completed three years of service (s. 83A-35(6)) • Under s. 83A-35(1) (a): – There is **no real risk** of losing the shares or rights (s. 83A-35(7))	• Under s. 83A-105(1)(c)(i), for **shares** (but not rights), the broad availability condition is satisfied if: – The ESS is available to 75% of permanent employees who are residents and have completed three years of service (s. 83A-105(2)) • Under s. 83A-105(1)(c)(ii), for **shares** (but not rights), either: – There is a **real risk** of losing the shares (s. 83A-105(3)), or – The employee acquires the shares as **part of a salary sacrifice arrangement** that does not exceed $5,000 (s. 83A-105(4)) • Under s. 83A-105(1)(d), for **rights** (but not shares), either: – There is a **real risk** of losing the right (s. 83A-105(3)), or – There is **no real risk** of losing the right but the ESS genuinely **restricts the employee immediately disposing** of those rights and the ESS expressly states that it is subject to deferral taxation (s. 83A-105(6))

Capital gains tax (CGT) treatment

An ESS interest that is a **share or a right** (other than a right to which the start-up concession applies) is deemed to have been acquired for its market value under s. 83A-30(1).

For an ESS interest that is taxed upfront, the ESS interest is taken to have been acquired for CGT purposes at its market value at the point when the employee initially acquired the interest.

For tax-deferred ESS interests, the ESS interest is taken to have been acquired for CGT purposes at its market value immediately after the deferred taxing point. This means the shares have to be held for at least 12 months after this time for the 50% CGT general discount to apply (see Unit 4).

An ESS interest that is a **right to which the start-up concessions apply** has a CGT cost base equal to the employee's cost of acquiring the right (s. 130-80(4)). However, there will be no CGT on exercise or on the acquisition of the resulting shares (due to CGT rollover being available). The exercise price of the rights will form part of the cost base of the resulting shares. For the purposes of applying the 50% CGT general discount, the time of acquisition of the resulting shares is deemed to be the time at which the right was acquired (s. 115-30(1)).

Lost ESS interests

A refund of income tax is available where discounted ESS interests are lost and the employee has already been taxed on this discount. Where the conditions for refund are satisfied, the lost ESS interest is treated as having never been acquired. This means the employee must go back and amend the income tax return in which the discount was included in assessable income.

To qualify for a refund under s. 83A-310, the scheme must not be constructed to protect the employee from market risk and one of the following must apply:

- the employee had no choice but to forfeit the ESS interest, or
- the employee chose to cease employment, or
- the employee chose not to exercise a right before it lapsed, or
- the employee chose to allow a right to be cancelled.

Where an employee is not eligible for a refund, the employee would instead have a capital loss under the capital gains tax provisions.

Employer reporting obligations

Employers are required to provide an employee share statement (similar to a PAYG summary) to any employees who are provided with an interest in an ESS at a discount and who had a taxing point during the income year. An annual ESS annual report must also be provided to the ATO to facilitate data-matching with employees' tax returns.

Activity 3.4: Employee share schemes
[Available online in myLearning]

Other key resources

Quick reference guides
3.1: How to calculate fringe benefits tax (FBT) liability – general taxpayers
3.2: How to calculate the taxable value of car fringe benefits
3.3: FBT and entertainment
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 4: Capital gains tax (CGT)

Contents

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Learning outcomes

At the end of this unit you will be able to:

1. Outline the background to the CGT regime.
2. Explain, calculate and advise on a taxpayer's capital gain or capital loss.
3. Analyse and apply the provisions relating to CGT exemptions and the rollover relief provisions.
4. Explain and apply the CGT rules related to death.
5. Explain and apply the CGT integrity measures.

Introduction

This unit covers the fundamentals of capital gains tax (CGT). It then builds on that knowledge by examining the exemptions, concessions and other special topics that are relevant to CGT. The operation of small business CGT concessions is considered in Unit 6.

Completing this unit should provide a clear understanding of how the CGT rules fit together, as well as the ability to apply this understanding to resolve complex, practical CGT problems.

Under the general taxation provisions, capital expenditure is not deductible under s. 8-1 ITAA 1997 and capital receipts are not assessable as ordinary income under s. 6-5 ITAA 1997. The taxation provisions instead specifically provide that:

- Capital expenditure may sometimes (but not always) be treated as:
  - Deductible over a specified time frame in the form of capital allowances (i.e. tax depreciation for plant and equipment) or capital works (i.e. tax amortisation for buildings and structural improvements) or under the blackhole provision (see Unit 5).
  - In rare situations, immediately deductible (see Unit 5).
  - Part of an asset's cost base for CGT purposes.
- The CGT provisions may operate to assess profits and losses made on the sale of some capital assets and on the happening of other specified taxing events.

Note:

- The income tax year end covered in this offering of the TAXAU module is 30 June 2019. Therefore, the amendments to the CGT provisions that are applicable from 1 July 2019 are outside of the scope of the module. The details provided in this unit are for reference purposes only.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

CGT application

Overview

The CGT regime was introduced from 20 September 1985. Prior to this date, most capital receipts were not taxed in Australia. This resulted in a large number of legal cases needing to distinguish between capital and revenue receipts. Despite the introduction of the CGT regime, the capital/revenue distinction remains important as capital gains are taxed differently to income (see Unit 1).

Since the introduction of the CGT regime, most capital receipts are taxed under the regime. The CGT regime applies **prospectively** – that is, assets acquired before 20 September 1985 remain outside the CGT net. However, there are some circumstances in which a pre-CGT asset may be subject to taxation.

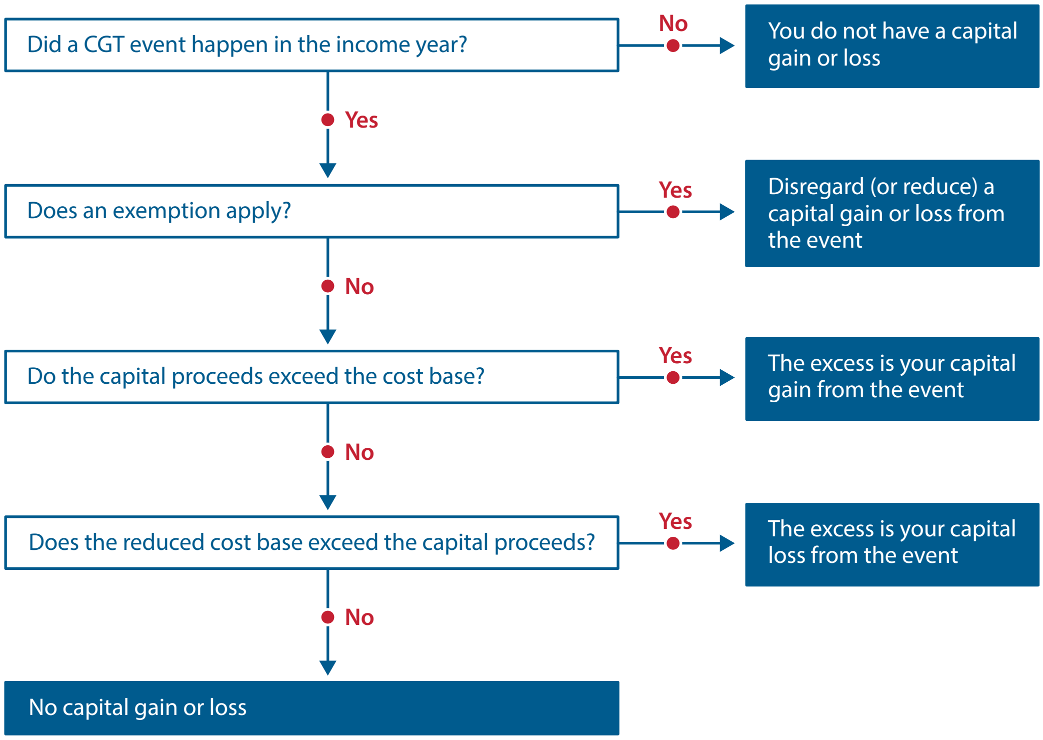
Some key points to understand, before getting into the specific details, are the following:

- The CGT rules are contained in the ITAA 1997 in Part 3-1 (general rules) and Part 3-2 (special rules) – they do not make up a separate taxing Act in their own right.
- While referred to as a capital gains 'tax', the CGT rules do not actually impose a tax. The income tax legislation simply includes a net capital gain in the assessable income of a taxpayer under s. 102-5. That is, a net capital gain is statutory income under s. 6-10.
- The CGT rules are generally a residual taxing mechanism. Where an amount has been included as part of calculation of assessable income under another provision of the income tax legislation the related capital gain or capital loss is disregarded.
- **Australian residents** are taxed in Australia on their worldwide income, which includes a net capital gain (s. 6-10(4) and s. 102-5) (see Unit 1).

  Foreign residents are taxed in Australia on their Australian sourced income (s. 6-5 and s. 6-10). However, a further restriction applies under the CGT rules. A foreign resident is only taxable in Australia on capital gains (and losses) where a CGT event happens to a CGT asset that is 'taxable Australian property' (see later in this unit).
- Taxpayers must calculate their net capital gain or loss for an income year following the steps prescribed in the CGT rules. Broadly, these steps require the taxpayer to:
  - Determine which CGT events have affected them in an income year and calculate a separate capital gain or loss for each event. Some, but not all, CGT events involve CGT assets. The CGT rules:
    - Generally apply to CGT assets when a gain or loss is realised, not accrued. However, some CGT events deem a gain or loss to be realised (e.g. on a change in residency), or deem there to be market value capital proceeds.
    - Disregard the capital gain or loss for certain assets (e.g. pre-CGT assets, collectables or personal use assets acquired for less than specified amounts, etc.).
  - All the capital gains and losses for an income year (excluding those that are disregarded) must be offset against each other, and then reduced by capital losses carried forward.
  - Any remaining capital gain balance is then reduced by available concessions (e.g. CGT general discount and small business entity CGT concessions – see Unit 6).
- Where:
  - A **net capital gain** arises for the income year, it is included in assessable income.
  - A **net capital loss** arises for the income year (i.e. if capital losses exceed capital gains), it is quarantined (i.e. it is **not** included as a deduction in the calculation of taxable income). However, it is carried forward and may be used to offset capital gains derived in future income years (subject to loss recoupment tests where the taxpayer is a company – see Unit 8).

Methodology

Division 100 provides a guide to the fundamentals of CGT. The diagram below is taken from s. 100-15 and illustrates the process involved in determining whether a capital gain or a capital loss has been made and the amount of the capital gain or capital loss.



CGT events

Division 104 sets out all the CGT events for which a taxpayer can make a capital gain or loss. A capital gain or loss can only be made if a CGT event occurs (s. 102-20). If there is no CGT event, there is no exposure to CGT. A CGT event still happens even if the capital gain or loss arising is disregarded.

Each CGT event contains its own rules on how the CGT event occurs, the timing of the CGT event and, broadly, how a capital gain or loss is calculated. The most common CGT event that arises in practice is CGT event A1 – the disposal of a CGT asset to another entity (i.e. sale).

A list of CGT events is contained in s. 104-5 and are categorised by Subdivisions as tabled below.

CGT events			
Subdivision	**Category**	**CGT events**	**Description**
104-A	Disposals	A1	Disposal of a CGT asset (i.e. sales)
104-B	Use and enjoyment before title passes	B1	Where the right to use and enjoy an asset passes to another entity without a contemporaneous passing of title to that entity. For example, under a hire purchase contract, use and enjoyment of an asset might be transferred before the actual title is transferred
104-C	End of a CGT asset	C1–C3	Where a CGT asset is lost or destroyed, an option to acquire shares expires, a right is cancelled, or an intangible CGT asset ends

CGT events			
Subdivision	**Category**	**CGT events**	**Description**
104-D	Bringing into existence a CGT asset	D1–D4	Creating contractual, legal or equitable rights, granting options or mining rights, and entering into a conservation covenant
104-E	Trusts	E1–E10	A range of situations regarding trusts (see Unit 10)
104-F	Leases	F1–F5	Granting a lease, and payments in relation to changes in a lease
104-G	Shares	G1 and G3	A number of situations concerning shares
104-H	Special capital receipts	H1 and H2	Event H1 deals with forfeited deposits. Event H2 is a special 'catch all' provision
104- I	Australian residency ends	I1 and I2	Where an individual, company or trust ceases to be resident in Australia for tax purposes
104-J	CGT events relating to rollovers	J1, J2 and J4–J6	Event J1 deals with the situation where a company ceases to be part of a group after an intragroup rollover. The other events deal with the change in status of rollover assets
104-K	Other CGT events	K1–K12	A range of other situations, such as foreign exchange gains and losses and taxation on the sale of pre-CGT shares in some circumstances
104-L	Consolidated groups and multiple entry consolidated (MEC) groups	L1–L6 and L8	Various tax consolidation issues (see Unit 12)

Required reading

Section 104-5 ITAA 1997 – high level overview only.

Ordering rule

Where more than one CGT event is applicable in a particular situation, the application of the **more specific** CGT event usually **takes priority** over the more general CGT event (s. 102-25). It is therefore necessary to review the complete list of CGT events to determine which might apply in any given situation.

Example – Order of application: CGT events A1 and E2

Consider CGT event A1 (which applies to the disposal of a CGT asset to another entity) and event E2 (which applies when a CGT asset is transferred to an existing trust).

The time of the event under CGT event A1 is when a contract is entered into; while the time of the event under CGT event E2 is when the asset is transferred (which may differ from the contract date).

In *Healey v. FCT*, the court held that CGT event E2 (rather than CGT event A1) was applicable in this circumstance. The timing for CGT event E2 (which pre-dated the actual contract date) meant that the taxpayer was not eligible for the 50% CGT general discount (as discussed later in this unit).

Note: The Australian Taxation Office (ATO) has tried to narrow the principle adopted in *Healey v. FCT* to non-arm's length situations where there is no contract (e.g. where an asset is vested in a related family trust), as compared with a sale of an asset by a company to a trust under a contract on an arm's-length basis.

CGT event A1

The rules for the application of CGT event A1 are contained in s. 104-10 and are set out below.

CGT event A1			
Event description	**Time of event**	**Capital gain**	**Capital loss**
Disposal of a CGT asset	When a contract is entered into or, if there is no contract, when the entity stops being the owner	Capital proceeds from disposal less the asset's cost base	Asset's reduced cost base less capital proceeds

How event occurs

CGT event A1 applies where there is a change of ownership from one entity to another with or without consideration (e.g. the sale of land to another entity). A change of ownership requires a change of beneficial ownership, as opposed to a change of legal ownership. For example, appointing a new trustee of a trust does not trigger CGT event A1 (s. 104-10(2)).

Time of event

For the purposes of CGT event A1, the time when a contract is entered into is the time when it **comes into existence** for general law purposes. If a contract is subject to a condition:

- Where the condition is a condition precedent to its **formation**, the contract does not come into existence until the condition is met.
- Where the condition is a condition precedent to the **performance** of the contract, the condition does not prevent the creation of the contract and non-fulfilment of the condition merely entitles a party to terminate the contract.

A good understanding of contract law is therefore critical to understanding the timing of CGT events. Often legal advice is required to determine the precise time a contract is formed.

In the ATO's view, binding heads of agreement or memorandums of understanding create a contract, even if the actual contracting terms are detailed later in a formal contract. It is therefore critical to determine what is the real contract (which may not be the document called 'contract').

The timing of CGT event A1 differs from when ordinary income is derived (i.e. not until there is a recoverable debt for an accrual-basis taxpayer – see Unit 1).

Example – Time when included in assessable income

ABC Ltd sold land that it held on revenue account. Any gain (or loss) on sale would be included in ABC's assessable income on settlement of the contract. However, if that same piece of land is sold on capital account, any capital gain (or loss) would be included in assessable income when the contract is entered into.

Other CGT events

Other examples of CGT events and when they occur are set out below.

Example – CGT events and timing		
Situation	**CGT event and timing**	**Section**
UnluckyCo had a warehouse damaged by fire on 1 August 2018. The damage is discovered on 2 August 2018. The insurance proceeds are received on 12 December 2018	CGT event C1 occurs when compensation is first received, not when the damage is done **Note:** The taxpayer may choose rollover relief (see later in this unit)	104-20
A commercial fishing licence expires	CGT event C2 occurs when the licence expires	104-25
Shares in a liquidated company are cancelled within 18 months of the liquidator's distribution	CGT event C2 occurs when the company is deregistered (see later in this unit)	104-25

Example – CGT events and timing		
Situation	**CGT event and timing**	**Section**
Bob Pty Ltd acquired a trade debtor balance that it subsequently wrote off as uncollectible	CGT event C2 occurs when the debt is written off / disposed of **Note:** It is not deductible under s. 25-35 as a bad debt as it has not previously been brought to account as assessable income (see Unit 1)	104-25
SmithCo granted an option to a shareholder for $1,000 to purchase additional **shares** in SmithCo. The option lapses unexercised	CGT event C3 occurs when the option ends	104-30
Mr Jones enters into a contract with the purchaser of his business not to operate a similar business in the same town (i.e. a restrictive covenant) and was paid $20,000	CGT event D1 occurs when the contract is entered into	104-35
SmithCo granted an option to ChipCo for $10,000 to purchase **an asset** owned by SmithCo. The option has not expired in the income year	CGT event D2 occurs when the option is granted **Note:** If exercised in a later income year, CGT event D2 is disregarded and SmithCo recognises the amount received on granting the option as part of the asset's capital proceeds (see later in this unit)	104-40
A company makes a capital payment (i.e. non-assessable distribution) to its shareholder (e.g. return of share capital). The cost base of the shares is reduced to $nil	CGT event G1 occurs when the payment is made (subject to exceptions, see later in this unit)	104-135
Liquidator declares shares to be worthless	CGT event G3 happens when declaration is made (see later in this unit)	104-145
Tim decides to sell his land. Before entering into a contract, the prospective purchaser pays Tim a holding deposit of $1,000. The negotiations fail and the deposit is forfeited	CGT event H1 occurs when the deposit is forfeited (see Activity 4.1)	104-150
An individual taxpayer leaves Australia and becomes a foreign resident for tax purposes	CGT event I1 occurs when the individual stops being a resident (see later in this unit)	104-160
A deceased's asset (that is not taxable Australian property) passes to a non-resident	CGT event K3 occurs just before the date of death (see later in this unit)	104-215
A farmer starts a new business of subdividing and selling land (i.e. CGT asset becomes trading stock). The farmer chooses under s. 70-30 to use market value	CGT event K4 occurs when the land starts being held as trading stock (see later in this unit and Unit 1)	104-220
A taxpayer sells shares it acquired in SmallCo in 1983. SmallCo's only asset is land acquired in 2005 (i.e. at least 75% post-CGT)	CGT event K6 occurs when CGT event A1 occurs, that is at date of contract, or change in ownership if no contract (see later in this unit)	104-230
An individual taxpayer disposes of a depreciating asset that is predominantly, but not exclusively, used for income-producing purposes (i.e. it is not a personal use asset)	CGT event K7 occurs when the balancing adjustment event happens (see later in this unit and Unit 5)	104-235

Required reading

Sections 104-10, 104-20, 104-25, 104-40 ITAA 1997.

Activity 4.1: CGT event A1 and a forfeited deposit

[Available online in myLearning]

CGT assets

Division 108 deals with the categories of CGT assets and explains the special rules that apply. As discussed earlier, most (but not all) CGT events involve a CGT asset.

CGT assets		
Subdivision	**Category**	**Provision**
108-A	CGT assets	Defines the term 'CGT asset'
108-B and 108-C	Collectables and personal use assets	Explains when capital losses on collectables and personal use assets can be reflected in the calculation of a net capital gain or loss (see exemptions and anti-avoidance provisions later in this unit)
108-D	Separate CGT assets	Sets out the circumstances when land, buildings and capital improvements are treated as separate CGT assets (see pre-CGT asset integrity provisions later in this unit)

Inclusions

A 'CGT asset' is defined in s. 108-5 as **any kind of property, or a legal or equitable right that is not property**.

Section 108-5 also provides examples of CGT assets, including **goodwill, land and buildings, shares and options, debts owed to the taxpayer, rights to enforce contractual obligations, foreign currency, and an interest (or a part interest) in an asset**.

A 'legal or equitable right' is one that can be protected by the law, that is, where a court is able to enforce the right. This excludes personal liberties and freedoms.

Where individuals own a CGT asset as joint tenants, they are treated as though they each own a separate but equal interest in the CGT asset (s. 108-7).

Exemptions and anti-overlap provisions

The breadth of the definition of CGT asset means that most assets fall within the definition. Therefore, the CGT law restricts the scope through:

- **Specific anti-overlap exemptions** in Division 118 that effectively result in CGT 'giving way' to the other specific tax rules (e.g. trading stock and depreciating assets) or the ordinary income treatment (see later in this unit).
- **Specifically exempting or disregarding** the gains or losses on certain assets (e.g. cars and personal use assets and collectables below certain thresholds) (see later in this unit).

Exception for pre-CGT assets

A capital gain or a capital loss that is made in respect of a CGT asset acquired **before 20 September 1985** (i.e. a pre-CGT asset) is generally disregarded. For example:

- CGT event A1 – s. 104-10(5) disregards the disposal of a pre-CGT asset.
- CGT event C1 – s. 104-20(4) disregards the loss or destruction of a pre-CGT asset.
- CGT event I1 – s. 104-160(5) disregards the deemed disposal of a pre-CGT asset when an individual taxpayer becomes a foreign resident for tax purposes.

However, the exception for pre-CGT assets is subject to the application of the pre-CGT asset integrity provisions, including CGT event K6 and Division 149 (see later in this unit).

Required reading

Sections 108-5 ITAA 1997.

Acquisitions

A CGT asset is usually acquired by a new owner when a CGT event for the other party occurs – for example, when land is sold, the sale triggers both CGT event A1 for the existing owner and the land's acquisition by the new owner. A CGT asset can also be acquired without there being a CGT event for another party – for example, when a taxpayer constructs an asset or a company issues shares to a shareholder under a dividend reinvestment plan.

The CGT provisions contain rules for determining when an acquisition occurs, even though there is no taxing point for the taxpayer who acquires the asset. An example of a situation in which an acquisition time is needed is where the taxpayer is a resident individual or complying superannuation fund. These taxpayers are eligible for the CGT discount, **provided** the asset is held for 12 months. In this instance, an acquisition time is required to start the 12-month clock.

General rules

The table in s. 109-5(2) sets out the general rules for determining the acquisition time. These rules **mirror the operation of the CGT event rules** summarised in s. 104-5. Tabled below are some examples of the general acquisition rules aligned to CGT events.

Examples of general acquisition rules aligned to CGT events (s. 109-5(2))		
Situation	**CGT event and timing**	**Acquisition time**
Taxpayer acquires real estate from vendor	CGT event A1 happens for the vendor	Taxpayer acquires the real estate when the contract is entered into
Trustee receives a CGT asset from settlor	CGT event E2 happens for the settlor	Trustee acquires the CGT asset when it is transferred (see *Healey v. FCT*)

Specific rules

Specific acquisition rules cater for situations where an **asset is acquired without there being a CGT event** (s. 109-10), as set out in the table below.

Specific acquisition rules when no CGT event occurs (s. 109-10)	
Situation	**Acquisition time**
Taxpayer constructs asset	When construction started
Shareholder receives shares issued on initial float of a company	With contract – when contract is entered into No contract – when shares are issued

Section 109-55 contains a summary of **other specific acquisition rules** catering for situations where assets are acquired, including as a result of:

- Death of another person (Division 128).
- CGT main residence exemption (Division 118).
- CGT rollover (Divisions 122 to 126).
- Changes to investments in shares or units (Division 130).
- Change in majority underlying interest in a pre-CGT asset (Division 149).
- Becoming an Australian resident (Subdivision 855B).

Capital gains and discount capital gains

Overview

Once it has been established that a CGT event has occurred, it is necessary to calculate the capital gain or capital loss arising from **that event**. For each CGT event, there are particular rules in determining how to calculate whether a capital gain or loss has arisen. There are separate formulas for calculating a capital gain or a capital loss.

The general method of calculating a capital gain is set out in the following table.

	$
Capital proceeds	x
Less: Cost base (or Indexed cost base where applicable)	(x)
Capital gain	x

The calculations use several concepts, which are discussed in more detail below.

Capital proceeds

General rule

Generally, the capital proceeds from a CGT event are the sum of any money received and/or the market value of any property received (s. 116-20).

Example – Capital proceeds where property is received

Bob Smith agrees to sell his business to XYZ Ltd (XYZ), a listed company, in return for 100,000 shares in XYZ. The transaction gives rise to CGT event A1. At the time CGT event A1 occurs (the date of contract), the market value of the shares is $10 each.

The capital proceeds for the sale of the business will be $1,000,000 ($10 × 100,000 shares).

Capital proceeds include the entitlement to receive money or property – hence, capital proceeds may include amounts not yet received. For example, if land is sold on a deferred settlement basis (e.g. payment is to be received in two years), the full capital gain arises when the sale contract is entered into, even though the money has not yet been received.

Note that, in certain circumstances, the tax treatment of the deferred settlements may be altered by Division 230 in respect of the taxation of financial arrangements (TOFA). (The application of Division 230 to deferred settlements is beyond the scope of the TAXAU module.)

Modifications and special rules

There are modifications to the general rule and a number of special rules that may be relevant in determining the capital proceeds in relation to a CGT event. Section s. 116-25 provides guidance on when these modifications and special rules apply:

- **Market value substitution rule (s. 116-30)**. This modification generally applies to replace the actual capital proceeds with the market value where:
  - No capital proceeds are received. (In practice, you should be very careful before allocating a $nil consideration to the sale of an asset. Allocating $1 automatically stops this modification from applying.)
  - Some or all of the capital proceeds cannot be valued.
  - A non-arm's-length dealing takes place in relation to an event (e.g. an asset is given to a family member at more or less than market value). To be acting at arm's length, each party must act in their own best interests – see *Granby Pty Ltd v. FCT*. Just because an asset is transferred for more or less than market value does not automatically mean that the parties are not dealing at arm's length.

  Note: If an asset is given away for $nil in an arm's-length transaction, the market value will automatically be substituted. To prevent this, some consideration (even if only $1) should be received.

Example – Market value substitution rule for capital proceeds

Bob Smith transfers a two-bedroom apartment to an existing family trust for $nil consideration.

The transaction gives rise to CGT event E2 (see *Healey v. FCT*). At the time CGT event E2 occurs (the date of transfer), the market value of the apartment is $500,000.

The capital proceeds for the transfer will be $500,000.

- **Apportionment rule (s. 116-40)**. This rule applies to apportion the proceeds where the taxpayer receives a composite amount covering more than one CGT event, or a CGT event and some other transaction. The capital proceeds from each event are so much of the payment as is reasonably attributable to that event.

  Where a business is sold and the sale agreement **dissects** the sale price between the various assets, it is generally considered that s. 116-40 would **not** apply because this section is only intended to apply to **undissected** amounts.

Example – Apportionment rule for capital proceeds

Bob Smith sells three separate CGT assets for an undissected total of $100,000. The $100,000 consideration was arrived at through arm's-length bargaining.

Bob uses his independent valuation, obtained for insurance purposes, that shows the following market value of each asset, to determine a reasonable apportionment of the undissected proceeds.

Title	Insurance value $
Asset 1	20,000
Asset 2	30,000
Asset 3	70,000
Total	120,000

The total capital proceeds of $100,000 are apportioned as follows:

Title	Apportionment	$
Asset 1	20,000 ÷ 120,000	16,666.66
Asset 2	30,000 ÷ 120,000	25,000.00
Asset 3	70,000 ÷ 120,000	58,333.34
Total		100,000.00

- **Non-receipt rule (s. 116-45)**. As noted earlier, the definition of 'capital proceeds' in s. 116-20 includes amounts to be received in the future. This modification rule applies where it has become clear that the full amount of the capital proceeds will not be received and this is beyond the taxpayer's control. The proceeds are reduced by the unpaid amount.

Example – Non-receipt rule for capital proceeds

Bob Smith sells an asset for $250,000. He allows the purchaser to pay $200,000 in Year 1, with the balance to be paid in Year 2. The transaction triggers CGT event A1 in Year 1 and Bob lodges his Year 1 tax return disclosing the capital proceeds of $250,000 (i.e. the total amount he has received and is entitled to receive (s. 116-20)).

The purchaser declares bankruptcy in Year 2 and does not pay the remaining $50,000.

Bob seeks an amended assessment for Year 1 (s. 170 ITAA 1936) and invokes the non-receipt rule by recalculating the gain or loss using capital proceeds of $200,000.

- **Repaid rule (s. 116-50)**. This rule applies where some or all of the capital proceeds have to be paid back to the purchaser, or the purchaser is compensated in a way that can reasonably be regarded as a repayment. The proceeds are reduced by the amount repaid. This generally includes amounts payable under a warranty clause.

Example – Repaid rule for capital proceeds

Bob Smith sells a parcel of land for $200,000. The purchaser later discovers that Bob misrepresented a term of the contract and sues Bob. The court orders Bob to pay the purchaser $20,000 in damages.

The capital proceeds for the sale of land will be reduced to $180,000.

- **Assumption of liability rule (s. 116-55).** This rule applies where, in acquiring an asset, another party assumes responsibility for a liability secured over the asset.

Example – Assumption of liability rule for capital proceeds

Bob Smith sells a parcel of land for $100,000 in cash, with the purchaser also agreeing to become responsible for Bob's $200,000 liability to Big Bank for an outstanding mortgage over the land.

The capital proceeds for the sale of land will be increased to $300,000.

- **Misappropriation rule (s. 116-60).** This rule applies where the capital proceeds from a CGT event are misappropriated by an agent or employee. The proceeds are reduced by the amount misappropriated.

Example – Misappropriation rule for capital proceeds

Bob Smith sells a parcel of land for $1,000,000. All arrangements relating to the sale are entrusted to Bob's employee, Sue Brown. Sue arranges for the proceeds of sale to be deposited into her personal bank account and flees with the money to South America. Bob is not insured for such a situation.

The capital proceeds for the sale of land will be decreased to $nil.

- **Assets subject to an option (s. 116-65).** This rule applies where another entity exercises an option granted by the taxpayer and as a result the taxpayer disposes of a CGT asset. The capital proceeds are increased by any payment received for granting the option. (Note: The capital gain or loss made on granting the option under CGT event D2 is disregarded.)
- **Look-through earnout rights special rule (s. 116-120).** This rule includes the financial benefits received under an indeterminate earnout right in the capital proceeds on disposal of a business (or its active assets). Therefore, prior year net capital gain/loss calculations in respect of the sale of the business (or its active assets) will need to be amended each time a payment (i.e. financial benefit) under the earnout right is received.

Example – Look-through earnout rights special rule for capital proceeds

Anna sells her business for $1,000,000 in Year 1. The business has a cost base of $600,000. Anna therefore has a capital gain of $400,000. However, under a look-through earnout right that could not be reasonably determined at the time of disposal, Anna receives a payment of $100,000 in Year 2 (i.e. the first year after disposal) and a final payment of $50,000 in Year 3 (i.e. the second year after disposal).

As a result of the payment in Year 2, Anna's capital proceeds are adjusted to $1,100,000 and in Year 3 are further adjusted to $1,150,000. Anna's final capital gain on disposal of her business is amended to $550,000, and is considered to have arisen in Year 1 at the time of the original CGT event.

Interaction with GST

Goods and services tax (GST) does not differentiate between transactions on revenue or capital account. Accordingly, the CGT event that gives rise to the capital proceeds may be a taxable supply for GST purposes, such that the capital proceeds include a GST component collected on behalf of the Government. In such cases, the capital proceeds will be the GST-exclusive amount (s. 116-20(5)) (see Unit 2).

Required reading

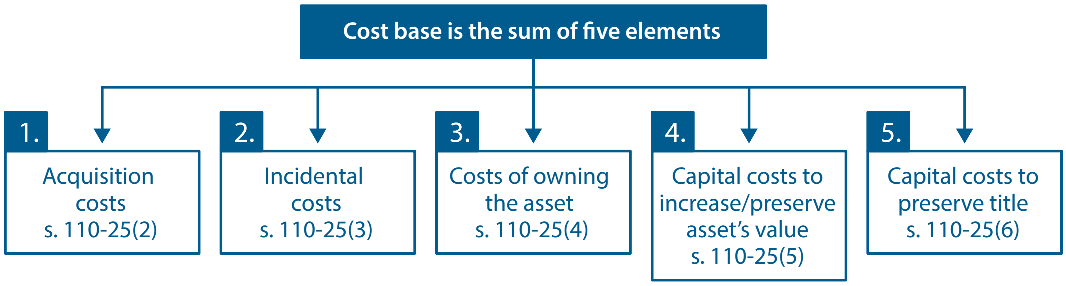
Section 116-20 ITAA 1997.

Cost base

'Cost base' is, broadly, the amount paid to acquire a CGT asset. The cost base rules are contained in Division 110.

Inclusions

An amount can only be included in the cost base of a CGT asset if it falls within one of the five elements of cost base, as listed in s. 110-25 (see diagram below). For tax planning purposes, maximising the cost base reduces a capital gain or increases a capital loss.



1. **Acquisition costs**. This is money paid and/or the market value of property given to acquire the CGT asset. It includes amounts required to be paid at some stage in the future.
2. **Incidental costs**. These are incidental costs incurred in acquiring the CGT asset and those that relate to the CGT event (i.e. incidental costs that relate to both the acquisition and disposal of the asset). Costs incurred after a CGT event happens can 'relate to' the CGT event for the purpose of working out incidental costs (TD 2017/10).

   Incidental costs are defined in s. 110-35 and include:

   - Professional advice.
   - Stamp duty.
   - Advertising.
   - Valuation costs.
   - Search fees.
   - Cost of a conveyancing kit.
   - Borrowing expenses (e.g. loan application fees and mortgage discharge fees, but only where they are not otherwise deductible: refer to s. 110-45(1B)).
   - Certain expenditure incurred by the head company of a consolidated group (e.g. stamp duty, legal fees and GST advice (which is not deductible under s. 25-5) paid on the transfer of land between members of the group). Costs of moving shares in a subsidiary would not be included because the shares in the subsidiary do not exist under the single entity rule (see Unit 12). Such costs would be deductible under s. 40-880 over five years (see Unit 5).

3. **Costs of owning the asset**. This cost base element is only relevant if the asset was acquired after 20 August 1991. Examples of such costs include non-deductible:

   - interest or other financing costs (except non-deductible interest under the thin capitalisation rules – see s. 110-54)
   - repairs or maintenance costs, and
   - rates and land tax.

   This element does not apply to collectables and personal-use assets (ss 108-17 and 108-30), (e.g. if a taxpayer acquires a boat for private purposes and sells it for a capital gain, ownership costs such as interest would not go into the cost base of the boat because it is a personal use asset).

4. **Capital costs to increase or preserve the asset's value** (or that relate to installing or moving the asset). These include:
   - Capital expenditure incurred for the purpose, or for the expected effect, of increasing or preserving the asset's value – for example, the cost of constructing a building on land, and payment to remove or extinguish an obligation relating to an asset.
   - Capital expenditure incurred that relates to installing or moving the asset.
5. **Capital costs to establish, preserve or defend title to the asset**. An example of this would be an amount paid by a landowner to a solicitor to deal with a neighbour's allegation that the boundary between their two adjoining blocks of land has been incorrectly measured.

Exclusions

The following rules apply to exclude certain expenditure from the cost base of a CGT asset:

- Where the CGT asset was **acquired on or before 13 May 1997**, expenditure otherwise falling within the second or third element (but not the first element) is excluded to the extent that it is deductible (s. 110-40(2)). On the other hand, if the expenditure falls within the first element of cost base and is an allowable deduction, no adjustment is required.

  For example, a capital works deduction under Division 43 relates to expenditure that is included in the first element of cost base of a building or structural improvement. Where the building or structural improvement is acquired on or before 13 May 1997, its cost base **is not** reduced by the amount the taxpayer is entitled to claim as a capital works deduction.
- Where the CGT asset was **acquired after 13 May 1997, any expenditure** that would otherwise be included in the cost base (including the first element) is excluded to the extent that it is deductible (s. 110-45). Where the effect of the deduction is reversed and included in assessable income (e.g. a balancing adjustment), the amount may be included in the cost base (s. 110-45(2)).

  For example, where a building or structural improvement is acquired after 13 May 1997, its cost base **is** reduced by the amount the taxpayer is entitled to claim as a capital works deduction under Division 43.
- Expenditure that is recouped cannot form part of the cost base unless it is included in assessable income (ss 110-40(3) and 110-45(3)).
- Expenditure is excluded to the extent that it is, in respect of the following (s. 110-38):
  - Entertainment that is not deductible under s. 32-5.
  - Penalties that are not deductible under s. 26-5.
  - Travel related to a residential rental property that is not deductible under s. 26-31 (see Unit 7).

Example – Cost base reduction: Division 43 capital works

Bob Smith buys an office building for $1 million in Year 1 (i.e. after 13 May 1997) and rents it to a tenant on arm's-length terms. The original construction costs of the office building were $600,000 and the Division 43 capital works deduction of 2.5% is $15,000 per year. Five years later, Bob sells the building for $1 million (i.e. equal to its cost price).

Ignoring all other elements of cost base, a common mistake is to think that Bob has made neither a capital gain nor a loss. However, the original $1 million cost base is reduced by the total Division 43 deductions claimed of $75,000 (i.e. 5 years × $15,000). Bob's cost base is actually $925,000. Therefore, a capital gain of $75,000 would arise. This 'claws back' the $75,000 of building deductions. However, Bob is still better off overall (assuming he is in the same tax bracket the whole time) because of the CGT general discount (see discussion later in this unit).

Required reading

Sections 110-25, 110-35 and 110-45 ITAA 1997.

Modifications and special rules

As with capital proceeds, the general cost base rule may be modified by Division 112. Where Division 112 applies, the taxpayer is treated as if they had paid the modified amount (s. 112-15).

Modifications and special cost base rules include the following:

- **Market value substitution rule (s. 112-20)**. This modification generally applies to replace market value as the cost base where:
  - No expenditure was incurred to acquire the CGT asset (if an asset is acquired for $nil consideration, there is an automatic uplift to market value).
  - Some or all of the expenditure cannot be valued.
  - A non-arm's-length dealing took place in relation to the acquisition (e.g. an asset is acquired from a family member at more or less than market value). To be acting at arm's length, each party must act in their own best interests – see *Granby Pty Ltd v. FCT*.

  Note: If a holding company lends funds to, or subscribes for shares in, a subsidiary with negative net assets, the loan/shares could be deemed to be acquired at less than their purchase price. This may create a capital gain on repayment/redemption if the value of the subsidiary company subsequently increases.
- **Split, changed or merged assets (s. 112-25)**. The cost base is merged or reasonably apportioned where an asset (the original asset) is:
  - Split into two or more new assets.
  - Changed into a new asset.
  - Merged with another asset into a single new asset.
- **Apportionment rule (s. 112-30)**. This rule applies to apportion the cost base where a taxpayer incurs a composite amount covering more than one CGT asset, or a CGT asset and some other transaction. It also provides a special rule to identify the cost base where a CGT event happens to only part of a CGT asset (a 'part disposal').

  As discussed above, in relation to s. 116-40, the re-apportionment only applies to **undissected** amounts.
- **Assumption of liability rule (s. 112-35)**. This rule provides that the first element of the cost base of a CGT asset includes a liability assumed as part of the acquisition.
- **Look-through earnout rights special rule (s. 112-36).** This rule includes the financial benefits paid under an indeterminate earnout right in the cost base of an acquired business (or its active assets). Therefore, prior year cost base calculations in respect of the acquisition of the business (or its active assets) will need to be amended each time a payment (i.e. financial benefit) under the earnout right is made.

Required reading

Sections 112-20, 112-25, 112-30 and 112-35 ITAA 1997.

Worked example 4.1: Cost base of a CGT asset

[Available online in myLearning]

Reductions

There is a range of situations in which the cost base of an asset will be eroded due to a transaction occurring while the asset is held by the taxpayer. The following are most common situations:

- **Tax-free distributions to shareholders —** the cost base of each share will be reduced by the non-assessable part (s. 104-135(4)). However, disregard any part that is (s. 104-135(1A)):
  - Non-assessable non-exempt (NANE) income (e.g. a payment to a CGT concession stakeholder of the small business CGT retirement exemption amount under s. 152-310).
  - A payment of a small business 15-year exemption amount under s. 152-125 (see Unit 6).

  If the cost base is reduced to $nil, further non-assessable distributions trigger a capital gain under **CGT event G1** (ss 104-135(1)–(3)).

Example – Cost base reduction: Return of share capital

Bob Smith buys 1,000 shares in Big Limited for $10 per share. Shortly after, Big Limited makes a return of share capital to its shareholders of 50 cents per share. This return is not a 'dividend' as defined in s. 6(1) ITAA 1936, and the amount is not assessable under s. 44 ITAA 1936. However, the cost base of each of Bob's shares is reduced from $10.00 to $9.50.

  Note: Whenever a company makes a distribution out of share capital, the potential application of s. 45B ITAA 1936 should be considered. If this provision applies, the capital return could be deemed to be an unfranked (assessable) dividend (see Unit 8).

- **Tax-deferred distributions to unit holders —** the cost base of the unit or interest is reduced by the non-assessable part (s. 104-70(6)). However, the unit holder can disregard certain non-assessable parts. If the cost base is reduced to $nil, further non-assessable distributions trigger a capital gain under **CGT event E4** (ss 104-70(1)–(4)) (see Unit 10).

  The property trust industry (or real estate investment trusts (REITs) industry) commonly refers to the non-assessable component of their trust distributions as the tax deferred component. In broad terms, the tax deferred component represents the difference between the total cash distribution and the assessable amounts in respect of the distribution.

  Note: The ATO accepts that a potential beneficiary in a discretionary trust has no 'interest' in the trust and no cost base to erode (TD 2003/28). Therefore, CGT event E4 does not apply to discretionary trusts.

Example – Cost base reduction: Tax-deferred component of trust distribution

Bob Smith makes a $10,000 investment in a REIT with an 8% per annum yield, of which 40% is tax-deferred (these percentages are assumed to be constant for the purposes of this example).

Each year that Bob holds the REIT:

- $800 is received as a distribution ($10,000 at 8%).
- Income tax is payable on $480 (60% of the distribution).
- The original cost base is reduced by $320 (40% of the distribution).
- After five years, Bob decides to sell the REIT at the market price of $9,500.

Bob might think that he has made a capital loss of $500 on the investment, but the $10,000 original cost base in fact has been eroded by $320 each year for five years (i.e. by $1,600), resulting in a new cost base of $8,400. The sale price of $9,500 less the new cost base of $8,400 actually results in a capital gain of $1,100. Applying the CGT general discount (see below), Bob will pay tax on $550 (50% of $1,100).

Interaction with GST

Any GST input tax credit that the taxpayer is entitled to claim in relation to an amount cannot form part of the cost base (s. 103-30).

Indexed cost base

Application

The indexed cost base is only applicable to CGT assets acquired **before 21 September 1999**. The cost base of these CGT assets can be increased by indexation to adjust for inflation, subject to the following limitations:

- The indexation rate is frozen as at the quarter ending 30 September 1999 (i.e. there is no increase in cost base for inflation after this time).
- The indexed cost base cannot be used where an eligible taxpayer has chosen to apply the CGT general discount (i.e. both concessions cannot be applied to the same asset).
- The CGT asset must be held for 12 months or more.

The indexed cost base is available to **all** taxpayers. Taxpayers that are also eligible for the CGT general discount (i.e. resident individuals, non-resident individuals for capital gains accruing up to 8 May 2012, complying superannuation funds and most trusts), may need to perform alternate calculations to determine the method that gives the best tax outcome. Other taxpayers that are not eligible for the CGT general discount (i.e. mainly companies), should use the indexed cost base (where applicable). As time goes on, indexation is becoming less and less relevant.

Calculation method

When indexation is available to a company, or chosen by a non-corporate taxpayer, the indexed cost base is calculated under Division 114 as:

$$\text{Element of cost base} \times \text{Indexation factor} = \text{Indexed cost base}$$

Under s. 960-275(2), the indexation factor is:

$$\text{Indexation factor} = \frac{\text{Consumer price index (CPI) for quarter ending 30 September 1999}}{\text{CPI for quarter in which expenditure was incurred}}$$

The indexation factor is calculated to three decimal places, rounding up if the fourth decimal place is five or more (e.g. 12.4125 would become 12.413).

Each element of the cost base must be indexed separately from the date on which the expenditure was incurred. The two amounts of the cost base that are not indexed are:

- The third element (non-capital costs of ownership).
- Incidental costs of disposal (note the reference to 'incidental costs of disposal' and not to incidental costs generally) in the second element (incidental costs of disposal will, by definition, now only occur after 21 September 1999 and therefore will not be indexed).

CPI rates

Consumer price index (CPI) rates are published by the Australian Bureau of Statistics (ABS). See Quick reference guide 4.4 for the rates applicable to the indexation of cost base.

Required reading

Sections 110-36, 114-1, 114-5, 114-10 and 960-275(2) ITAA 1997.

Worked example 4.2: Indexed cost base of a CGT asset

[Available online in myLearning]

Discount capital gains

The CGT general discount was introduced to replace cost base indexation. However, it is not available to all taxpayers. Where applicable, a capital gain that is a 'discount capital gain' may be reduced by a discount percentage.

Application

Under s. 115-5, a 'discount capital gain' is a capital gain that meets the following requirements:

- Is made by an **individual**, a complying superannuation entity or a trust (s. 115-10). (Note that where trustees are assessed under provisions such as s. 99A ITAA 1936, no discount is generally available – see s. 115-222 and Unit 10).
- Results from a CGT event happening **after 21 September 1999** (s. 115-15).
- The cost base has **not been indexed** (s. 115-20).
- Results from a CGT event happening in relation to a CGT asset acquired by the taxpayer **at least 12 months** before the CGT event (s. 115-25(1)).
- Is not one of the specified ineligible CGT events in s. 115-25(3).

Despite the above, a capital gain is **not** a discount capital gain where the integrity measures apply (see below).

Eligible individual taxpayers

All **resident** individual taxpayers are entitled to apply the CGT general discount.

Non-resident individual taxpayers are only entitled to apply the CGT general discount for gains accrued up to 8 May 2012 (s. 115-105). For example, where an asset is disposed of in the current income year and that asset was acquired by a non-resident individual taxpayer before 8 May 2012, the non-resident would only be entitled to a partial CGT general discount (s. 115-115).

Measuring '12 months'

The 'at least 12 months' holding requirement in s. 115-25(1) means that the asset must be held for a clear period of 12 months (i.e. a clear year) between the acquisition of the CGT asset and the time the CGT event happens.

The ATO's view is that both the day of acquisition and the day on which the CGT event happens must be excluded in reckoning the 12-month period (TD 2002/10). Some tax practitioners refer to this as the '12 months and two days' requirement. For example, if an asset is acquired on the first day of Year 1, it cannot be sold before the second day of Year 2 if the capital gain is to qualify for discounting (i.e. it cannot be sold of the last day of Year 1).

Ineligible CGT events

Ineligible CGT events are listed in s. 115-25(3) and are events that could never satisfy the 12-month holding requirement in any case (e.g. CGT event F1, which relates to the grant of a lease, or CGT event D1 which relates to the receipt of a restrictive covenant payment are ineligible).

CGT event A1 (i.e. disposal), being the most common CGT event, is not listed as an ineligible CGT event, hence the CGT general discount is available.

Discount percentage

Under s. 115-100, the discount percentage is:

- **50%** for individuals (excluding non-residents) (see Unit 7) and trusts (see Unit 10).
- **33⅓%** for complying superannuation funds (see Unit 11).

Note: For CGT events happening on or after 1 January 2018, the discount percentage is generally 60% for individuals (excluding non-residents) and trusts, where the capital gain is in respect of qualifying affordable housing (subject to specific conditions under s. 115-125). At the time of writing, the legislation to implement this measure has yet to be finalised. It is therefore outside the scope of this offering of the TAXAU module.

Integrity measures

A capital gain is **not** a discount capital gain in the following situations:

- **Agreement within 12 months** – where the CGT event giving rise to the capital gain occurs because of an agreement made within 12 months of the date the CGT asset was acquired, even though the CGT event itself occurs after 12 months (s. 115-40).
- **Entities with newly acquired assets** – where the CGT asset is shares or an interest in a trust and the following three tests are satisfied (s. 115-45):
  - The taxpayer (together with associates) has at least a 10% stake in the company or trust.
  - The cost bases of the assets acquired by the company or trust within the preceding 12 months are more than 50% of the total cost bases of the CGT assets.
  - Assuming the company or trust sold its CGT assets, the net capital gain on the CGT assets acquired by the company or trust within the preceding 12 months would be more than 50% of the net notional capital gain on all the CGT assets (this excludes CGT exempt assets like trading stock, depreciating assets, etc.).

Example – CGT discount: Integrity rule for recently acquired assets

Bob Smith sells his 20% shareholding in Family Company Pty Ltd, making a capital gain of $25,000. Bob has owned the shares for four years. At the time of the sale, Family Company Pty Ltd owns the following assets:

Asset	Period owned	Cost base $	Market value $	Unrealised capital gain $
1	> 12 months	500	1,200	700
2	> 12 months	8,000	13,000	5,000
3	<12 months	2,000	13,000	11,000
4	<12 months	30,000	32,000	2,000
		40,500	59,200	18,700

Applying the three tests in s. 115-45 produces the following results:

- The stakeholder condition is satisfied. Bob owns 20% of the shares in the company.
- The cost base condition is satisfied: $32,000 (cost base of less than 12 months assets) is greater than 50% of $40,500 (cost base of all assets).
- The capital gain condition (assuming underlying assets are sold) is satisfied: $13,000 (notional capital gain of less than 12 months assets) is greater than 50% of $18,700 (capital gain on all assets).

Accordingly, Bob is denied the CGT discount on the sale of his shares.

The obvious tax planning strategy to legitimately avoid s. 115-45 (subject to Part IVA ITAA 1936) would be for Bob to delay the sale of his shares until the necessary proportion of the company's underlying assets had been held for more than 12 months.

In practice, s. 115-45 does not tend to apply very often because it is unusual for assets held for less than 12 months to increase in value materially and also to represent the bulk of the cost base of all assets.

Calculation method

The **discount percentage is not applied until the taxpayer calculates their net capital gain** for an income year under s. 102-5. Note, in this calculation, current and prior year capital losses are offset **before** the CGT general discount is applied. Therefore, the benefit of the CGT general discount may be partially or fully wasted where the taxpayer has capital losses.

Required reading

Sections 115-5, 115-10, 115-15, 115-20,115-25 and 115-105 ITAA 1997.

Worked example 4.3: Capital gain – discount and indexation methods

[Available online in myLearning]

Capital loss

Overview

In a situation where a capital gain calculation actually results in a capital loss, the result of the calculation should be disregarded and the following general method for calculating a capital loss should be used.

	$
Capital proceeds	x
Less: Reduced cost base (s. 110-55)	(x)
Capital loss	x

The calculation uses the concept of reduced cost base, which is discussed in more detail below. Note that capital proceeds are calculated in exactly the same manner as a capital gain (see earlier in this unit).

Reduced cost base

The differences in the calculation of a capital gain and a capital loss arise from the difference between the cost base (used to calculate a capital gain) and the **reduced** cost base (used to calculate a capital loss). These differences are as follows:

- The third element of the **reduced** cost base is not the costs of ownership. Instead, this element is replaced with any amount that is assessable because of a balancing adjustment for the asset, or any amount that would be assessable if balancing adjustment relief was not used.
- No element of the cost base can be indexed (i.e. indexation can never create a capital loss).
- All other elements of reduced cost base and cost base are the same.

Required reading

Section 110-55 ITAA 1997.

'No gain, no loss' outcomes

Where the calculation of a capital gain using cost base results in a loss and the calculation of a capital loss using reduced cost base results in a gain, this is a 'no gain, no loss' situation.

The following rules summarise the possible outcomes:

Capital proceeds	>	Cost base	→	Capital gain
Reduced cost base	>	Capital proceeds	→	Capital loss
Cost base > Capital proceeds	>	Reduced cost base	→	No gain, no loss

Example – No gain, no loss situation

Joel, an Australian resident, acquired an investment property in New Zealand on 1 July 1989 for $400,000 and sold it on 30 June 2019 for $500,000.

Calculating the gain/loss on disposal using the discount method results in a capital gain, while using the indexation method results in a no gain, no loss outcome. Joel would choose to apply the indexation method.

Discount method	
	$
Proceeds	500,000
Less: Cost base	(400,000)
Capital gain	100,000
Less: 50% discount	50,000
Net capital gain	50,000

Indexation method	
	$
Proceeds	500,000
Less: Indexed cost base ($400,000 × 1.268)	(507,200)
Capital gain	0
No capital gain arises as proceeds are less than indexed cost base. No capital loss arises as proceeds are greater than reduced cost base $400,000.	

Net capital gain or loss

Overview

Once a capital gain or loss has been separately calculated for each CGT event occurring in an income year, the taxpayer needs to calculate their net capital gain or loss for the income year. Broadly, the outcome of the net capital gain or loss calculation is as follows:

If capital gains	>	Capital losses	→	Net capital gain to be included in assessable income
If capital losses	>	Capital gains	→	Net capital loss to be carried forward

Calculation method

Section 102-5 includes a **net capital gain** in a taxpayer's **assessable income** (see Unit 1) and sets out the steps that must be followed (i.e. each step must be completed in the prescribed order).

Under these steps:

Step 1 – The **current year capital gains** are reduced by **current year capital losses**. Capital gains or losses that are disregarded are **excluded** from Step 1. For example, exclude:

- Capital gains that qualify for the 15-year small business exemption (see Unit 6).
- Capital gains or losses on motor vehicles (see later in this unit).
- Capital losses on all personal use assets and capital gains on personal use assets costing less than the specified threshold (see later in this unit).
- Capital gains on collectables costing less than the specified threshold (see later in this unit).

Step 2 – If there is an amount remaining (after Step 1), apply any **carry forward net capital losses** to reduce that amount.

Step 3 – If there is an amount remaining (after Step 2) that qualifies for the **CGT general discount** (i.e. discount capital gains), apply the discount percentage to reduce that amount. Non-discount capital gains are not reduced.

Step 4 – If there is an amount remaining (after Step 3, whether or not it is a discount capital gain) that qualifies for the **small business entity CGT concessions**, apply those concessions to reduce that amount. Note, the SBE concessions generally must be applied in a prescribed order (see Unit 6).

Step 5 – Add up remaining capital gains amounts (after Step 4). This amount is the **net capital gain** for the income year. It is included in assessable income.

If the current year capital losses exceed the current year capital gains, the amount remaining after they are offset is the **net capital loss** for the income year (s. 102-10). It is carried forward to offset capital gains in future income years.

Capital loss utilisation rules

Key capital loss utilisation rules include the following:

- Carry forward net capital losses must be offset against capital gains **in the order in which the they were made** (i.e. oldest net capital losses must be used first) (s. 102-15(1)).
- Capital losses (current year and net carry forward) must be offset against capital gains **before the CGT general discount and the CGT small business entity concessions** are applied (i.e. under Step 1 and Step 2 of the net capital gain calculation method). This same restriction does not apply to tax losses. Tax losses are included as an allowable deduction under s. 8-1. Therefore, a **tax loss reduces a net capital gain** after it is included in assessable income (i.e. it is not included in the calculation of a net capital gain).
- A taxpayer can generally **choose which capital gains are reduced by capital losses.** In order to minimise the net capital gain for an income year, taxpayers should choose to prioritise the reduction of capital gains that are **not** eligible for CGT concessions.
- Capital losses on **collectables** can only be used to reduce capital gains on other collectables.
- Capital losses arising from the disposal of a business (or its active assets) involving an **indeterminate look-through earnout right** may not be taken into account in determining a taxpayer's tax liability (i.e. a net capital gain to be included in assessable income) until such time as it cannot be reduced by future financial benefits received (i.e. all additional capital proceeds under the earnout arrangement have been received – see above under modifications and special rules for capital proceeds) (s. 118-580).
- A net capital loss **cannot be offset against other assessable income** (s. 102-10(2)). That is, a net capital loss is quarantined and can only be offset against capital gains in a future income year. A net capital loss may be carried forward indefinitely (s. 102-15), although to use a carry forward a company must satisfy loss carry-forward tests (see Unit 8).

The following example illustrates the application of tax losses and the application of capital losses against capital gains.

Example – Net capital gain and tax losses

Simple Pty Ltd provides the following tax data for the current income year:

- Trading income – $100,000.
- Current year deductions – $40,000.
- Carry forward tax loss – $90,000.
- Capital proceeds from sale of asset A – $80,000 (acquired June 2000).
- Cost base of asset A – $20,000.
- Capital proceeds from sale of asset B – $40,000.
- Reduced cost base of asset B – $50,000.

Calculate the capital gain

Asset A	**$**
Capital proceeds	80,000
Less: Cost base	(20,000)
Capital gain	60,000

Calculate the capital loss

Asset B	**$**
Capital proceeds	40,000
Less: Reduced cost base	(50,000)
Capital loss	(10,000)

Calculate the net capital gain

	$
Capital gain	60,000
Less: Capital loss	(10,000)
Net capital gain	50,000

(Note: A company is not eligible for the CGT general discount)

Calculate the taxable income

	$	$
Assessable income		
Trading income	100,000	
Net capital gain (see above)	50,000	150,000
Deductions		
Current year deductions	40,000	
Carry forward tax losses	90,000	(130,000)
Taxable income		20,000

The calculation of capital gains and losses may be modified in a number of situations, including those that involve collectables and personal use assets. A full list of modifications is set out in s. 102-30.

Required reading

Sections 102-3, 102-5, 102-10 and 102-15 ITAA 1997.

Activity 4.2: Capital losses – ordering and application

[Available online in myLearning]

Tax implications

Under s. 102-5, any net capital gain is included in the taxpayer's assessable income and taxed at the income tax rates applicable to the taxpayer who derived the gain.

A capital gain or loss arises in the **income year in which the CGT event happens**.

Remember, the time at which something happens is also critical to the operation of the CGT provisions for a number of other reasons, including the following:

- In general, the CGT provisions do not apply in relation to assets that were acquired before 20 September 1985.
- Neither indexed cost base nor the CGT general discount is available where a CGT asset has been held for less than 12 months.
- The timing of the asset's acquisition and its subsequent disposal determines whether the taxpayer can choose to use the indexed cost base instead of the CGT general discount in calculating their capital gain.

CGT foreign resident provisions

Overview

Australian residents are generally subject to Australian tax on their worldwide income, including net capital gains. Whereas, foreign residents are only subject to Australian tax on their Australian-sourced income. However, there is a further restriction under which Australia's CGT regime only applies to a non-resident if the asset is taxable Australian property (TAP) or deemed to be TAP (s. 855-10).

Foreign resident individuals:

- Are not entitled to the CGT general discount for capital gains accruing after 8 May 2012 (see earlier in this unit under discount capital gains).
- May not be entitled to the CGT main residence exemption (see later in this unit under 'Main residence exemption').

Foreign residents may also be subject to withholding tax on the disposal of taxable Australian real property (TARP) that has a market value of more than $750,000.

CGT consequences can also arise where an Australian resident taxpayer becomes a foreign resident (i.e. CGT event I1 happens) or a foreign resident taxpayer becomes an Australian resident.

Taxable Australian property

Foreign residents are only subject to Australia's CGT regime if the asset is taxable Australian property (s. 855-10). Under s. 855-15, **taxable Australian property (TAP)** includes:

- **Taxable Australian real property (TARP)** (see s. 855-20). This is essentially real property situated in Australia (i.e. an interest in land equivalent to a freehold interest, including any improvements to land such as buildings, wells, dams, mines, etc.), or a mining, prospecting or quarrying right to minerals, petroleum or quarry materials in Australia.
- **Indirect Australian real property interest** (see s. 855-25). These are essentially indirect interests in real property in Australia held by foreign residents. For example, a foreign resident who owns a 10% shareholding in a foreign or Australian company is subject to CGT on that shareholding if the company owns disproportionately high amounts of real property in Australia (i.e. is a 'land-rich' company). The tracing rules are explained further below.
- A CGT asset used at any time in carrying on a business through a **permanent establishment** in Australia.
- **An option or right to acquire any of the above assets.** (Note that where a company owns an option over real property, but not real property itself, the shares in the company would not be taxable Australian property because the option is one step removed.)
- A CGT asset that the foreign resident has **elected to be taxable Australian property (TAP)** under s. 104-165(3) (choosing to disregard a gain or loss on ceasing to be an Australian resident) when the foreign resident changes residency status from a resident to a foreign resident (see later in the Unit).

Indirect Australian real property interests

Indirect Australian real property interests owned by foreign residents are subject to Australian CGT. That is, a foreign resident is subject to Australian CGT on their interests in Australian real property, whether they are held directly or indirectly.

The tracing rules are complex, but essentially they help to determine whether a company is land-rich (i.e. land represents more than 50% of the market value of the company's assets).

The tracing rules broadly operate in the following manner:

- There is only a need to trace through entities that own real property in Australia if the foreign resident, together with its associates, holds at least a 10% direct participation interest in the entity (the non-portfolio interest test). If the foreign resident holds less than a 10% direct participation interest in the entity, there is no need to trace through that entity to determine if it owns real property in Australia (s. 855-25).
- Where a foreign resident, together with its associates, owns at least a 10% direct participation interest in an entity, the interest that it holds in that entity is subject to CGT if more than 50% of the market value of the entity's total assets comprises TARP (the principal asset test) (s. 855-30).

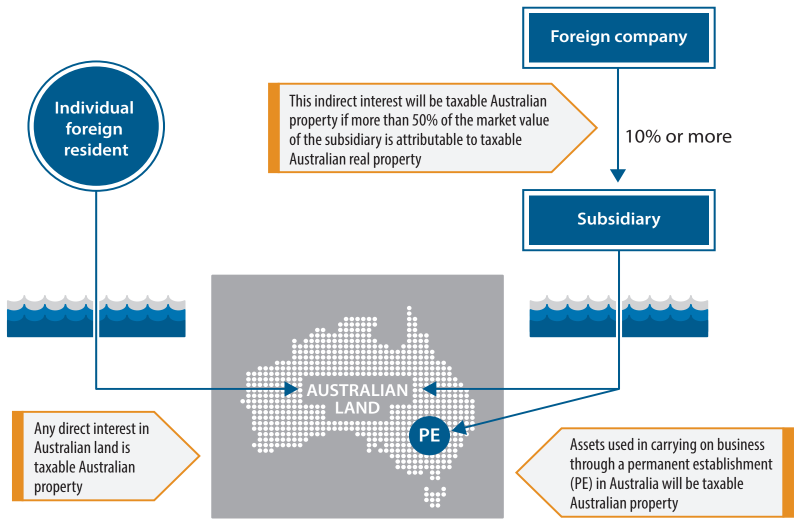
  If that entity (i.e. the first entity) owns a membership interest in a second entity and that membership interest is:

  - At least 10%, then trace through the second entity to determine the actual percentage of the second entity's assets at market value that are TARP and non-TARP, and treat the membership interests that first entity owns in the second entity as those two assets.
  - Less than 10%, then treat the membership interests that the first entity owns in the second entity as a single asset that is non-TARP (i.e. TARP is deemed to be Nil).

  Note: For CGT events happening after 9 May 2017, if the first entity's total participation interests (i.e. the sum of the participation interests held by that entity together with its associates as defined under s. 960-180) is at least 10%, then tracing through the second entity is required. As the legislation to implement this measure had yet to be finalised at the time of writing, it is outside the scope of this offering of the TAXAU module.

In short, an indirect Australian real property interest exists where a foreign resident has a 10% or more interest in an entity and more than 50% of the market value of the entity's assets are attributable to TARP.

The diagram below illustrates CGT assets that are taxable Australian property (TAP):



Note: Where there is a second interposed subsidiary the membership interest is treated as two assets, TARP and non-TARP. However, the TARP asset is deemed to be Nil where that membership interest (together with associate interests from 9 May 2017) is less than 10%.

Worked example 4.4: CGT foreign resident tracing rules

[Available online in myLearning]

Foreign resident withholding tax

Taxable Australian property (TAP) sales are subject to a **non-final** withholding tax at **12.5%** of the **first element of the purchaser's cost base** for CGT purposes (i.e. 12.5% of the total purchase price) (Schedule 1 s. 14-200 TAA 1953). The withholding tax is payable by the purchaser on behalf of the non-resident vendor. The exceptions and exclusions from the requirement to withhold include the following:

- Where the vendor (i.e. seller) is an Australian resident for tax purposes and has provided the purchaser with a **clearance certificate** (i.e. certificate of residency issued by the ATO) (Schedule 1 s. 14-210 TAA 1953). The clearance certificate will remain valid for up to 12 months after the date of issue.
- Taxable Australian real property (TARP) with a market value of **less than $750,000** (e.g. residential property which is sold for less than $750,000) (Schedule 1 s. 14-215 TAA 1953). For parties dealing at arm's length, the market value generally will be the amount paid.
- Transactions on a **stock exchange** (e.g. listed shares) (Schedule 1 s. 14-215 TAA 1953).
- Where an amount is already required to be withheld from payments relating to the transaction (e.g. where the managed investment trust withholding rules apply there will be no further withholding under these rules) (Schedule 1 s. 14-215 TAA 1953).
- Non-TARP (e.g. shares or rights), where:
  - The vendor has provided the purchaser a **vendor declaration** that the purchaser does not know to be false (i.e. declaration that the entity is an Australian resident for tax purposes or the asset is not an indirect real property interest) (Schedule 1 s. 14-210 TAA 1953). A vendor declaration will remain valid for six months.
  - The purchaser does not know or have reasonable grounds to believe the vendor is a foreign resident (i.e. the knowledge condition is satisfied) (Schedule 1 s. 14-210 TAA 1953). For example, it would be reasonable to assume the vendor is a foreign resident where there are no grounds to believe they are an Australian resident and the vendor has a foreign address or is using a foreign bank account for the transaction.

As noted above, the obligation is on the **purchaser** (i.e. the payer of the purchase price) to withhold the tax unless an exclusion applies. The payment must be made to the ATO on or before the date of settlement. The rate of withholding may be reduced where the vendor obtains a variation certificate from the ATO (e.g. where the gain on sale is expected to be minimal or a loss is expected).

The withholding tax rules apply to all TAP sales even where the vendor (i.e. seller) is a property developer holding the property on revenue account (i.e. it is not limited to sales where the proceeds are subject to taxation under the CGT regime).

A non-final withholding tax is collected as an estimate of the non-resident vendor's final income tax liability. The non-resident is still required to lodge an income tax return, **claim a credit** (i.e. tax offset) for the amount withheld (Schedule 1 ss 18-15, 18-20 and 18-25 TAA 1953), and pay any outstanding liability. The non-resident vendor is not entitled to claim the credit until the purchaser has actually **paid** the withholding tax to the ATO.

In practice, the compliance issues associated with this tax are dealt with by the lawyers and are factored into the sale contract.

Ceasing to be a resident – CGT event I1

Application

As noted earlier, CGT event I1 under s. 104-160 deals with situations where a taxpayer ceases to be a resident of Australia (i.e. becomes a foreign resident). 'Residency' is discussed in Unit 1.

To understand the policy rationale behind CGT event I1, remember that an Australian resident is taxable on their worldwide capital gains, but a foreign resident is taxable only on assets that are taxable Australian property (TAP). As such, where a resident becomes a foreign resident, any assets that are non-TAP will generally fall outside the scope of Australian CGT from that time.

Inclusions

Under CGT event I1, when a taxpayer ceases to be a resident, they are **deemed to have disposed of** the following CGT assets at their **market value**:

- Any assets that are non-TAP. For example, a rental property located in a foreign country, shares and other investments in a foreign company, collectables, personal use assets, etc.
- Indirect Australian real property interests (i.e. shares in companies that are TAP). However, as these interests will continue to be subject to Australia's CGT regime when they are actually disposed of, the taxpayer is also deemed to have immediately re-acquired the interests at their market value.

Exclusions

Broadly, all CGT assets held by a taxpayer are deemed to be disposed of under CGT event I1 when a taxpayer ceases to be a resident, **other than**:

- Taxable Australian real property (i.e. land and buildings located in Australia) – for example, an Australian rental property or the taxpayer's main residence prior to departure.
- CGT assets used in a business that is carried on through a permanent establishment in Australia.

Calculation

The deemed capital gain of loss on each CGT asset arises in the **income year of departure**. However, the taxpayer can:

- Apply the normal CGT exemptions and concessions – for example, where applicable:
  - The CGT general discount under s. 115-5 (see earlier in this unit).
  - Disregard the deemed capital gain or loss on a motor vehicle under s. 118-5 and other exemptions (see later in this unit).
  - Disregard the deemed capital gain or loss on a personal use asset or collectable costing less than the specified thresholds under s. 118-10 (see later in this unit).
- Disregard the deemed capital gain or loss on pre-CGT assets (i.e. assets acquired before 20 September 1985) under s. 104-160(5).

Exceptions

Individuals

An exception to CGT event I1 is available where an **individual taxpayer chooses**, under s. 104-165(2), to disregard all deemed capital gains and losses that would otherwise arise upon cessation of residency. Where this choice is made, the relevant assets are to be treated as if they were taxable Australian property (TAP) until the earlier of either of the following:

- A CGT event happening to the assets (e.g. their sale or disposal)
- The taxpayer again becoming an Australian resident.

Note that the choice is made for all assets – it is not made on an asset-by-asset basis.

Temporary residents

CGT event I1 is also disregarded where a person who is a **temporary resident** ceases to be an Australian resident (s. 768-915). The temporary resident rules are designed to encourage the movement of expatriate workers into and out of Australia.

A person is a temporary resident if they:

- Hold a temporary visa granted under the *Migration Act 1958*.
- Are not an Australian resident within the meaning of the *Social Security Act 1991*.
- Do not have a spouse who is an Australian resident within the meaning of the *Social Security Act 1991*.

The *Social Security Act 1991* defines an 'Australian resident' as a person who resides in Australia and is either an Australian citizen, a holder of a permanent visa, or a holder of a protected special category visa.

Temporary residents will, however, be subject to CGT on CGT events that happen to taxable Australian property (see above).

> **Required reading**
>
> Sections 104-160, 104-165, 855-10, 855-15 and 855-20 ITAA 1997.

Becoming a resident

Application

Foreign residents

Subdivision 855-B outlines the CGT consequences of a foreign resident becoming an Australian resident. In general, each CGT asset that is not taxable Australian property is **deemed to have been acquired** at the time the taxpayer becomes an Australian resident, with a cost base or reduced cost base deemed to be its **market value** at that time (s. 855-45). In other words, assets that are not already within the Australian CGT net are brought into the CGT net by deeming the foreign resident to have acquired those assets at their market value at the time they became a resident.

Temporary residents

A person who ceases to be a temporary resident (see definition above), but remains an Australian resident, is taken to have acquired assets (other than assets acquired before 20 September 1985) that are not taxable Australian property for their market value at the time they ceased being a temporary resident (ss 768-950 and 768-955).

Exceptions

CGT assets that are classified as taxable Australian property are excluded from these rules because they are already within the CGT net. Assets acquired before 20 September 1985 are also excluded.

> **Required reading**
>
> Section 855-45 ITAA 1997.

> **Activity 4.3: CGT ramifications of becoming an Australian resident**
>
> [Available online in myLearning]

CGT exemptions and anti-overlap provisions

Overview

The CGT exemptions mean that the capital gains or capital losses that arise from certain CGT events are either disregarded or reduced for tax purposes.

The four categories of **general exemptions**, which are listed in s. 100-30(2), are:

- Exempt assets.
- Anti-overlap provisions.
- Exempt or loss-denying transactions.
- Small business relief (discussed in Unit 6).

These general exemptions are dealt with in detail in Subdivision 118-A. The more common ones are summarised in this unit.

In addition to the above general CGT exemptions, Division 118 contains a number of specific CGT exemptions for (but not limited to):

- Main residence (Subdivision 118-B) – this is the most commonly encountered specific exemption given the significant number of Australian families that own a family home.
- Insurance policies including life and general (Subdivision 118-D).
- Units in pooled superannuation trusts (Subdivision 118-E).
- Look-through earnout rights (Subdivision 118-I).

The main residence exemption is covered in detail in this unit. An awareness of the other specific exemptions covered in this unit is all that is required for the purposes of the TAXAU module.

Exempt assets

The following types of assets are categorised as exempt CGT assets. However, this categorisation does not mean that all capital gains or losses on these assets are disregarded.

- Cars, motorcycles and valour decorations.
- Collectables.
- Personal use assets.

Cars, motorcycles and valour decorations

Capital gains or capital losses made in respect of the disposal of cars, motorcycles and valour or brave conduct decorations are disregarded in **all** situations (s. 118-5).

With regard to cars, this exemption applies regardless of the age of a car. For example, the sale of a vintage car would be exempt under s. 118-5. The reason for this exemption is that most cars are sold for a loss and the Government does not want to provide taxpayers with a tax benefit in this circumstance.

Collectables

A collectable is specifically defined in ss 108-10(2) and (3). To qualify, a collectable must be:

- artwork, jewellery, an antique, or a coin or medallion
- a rare folio, manuscript or book, or
- a postage stamp or first-day cover

that is used or kept mainly for the taxpayer's (or their associate's) personal use or enjoyment. An option or a right to acquire any of the above is also a collectable.

Note that TD 1999/40 describes an antique as 'an object of artistic and historical significance' that is more than 100 years old at the time of the CGT event.

There are three special CGT rules that apply to collectables:

- Capital gains or capital losses made on collectables that were acquired for $500 or less are disregarded (s. 118-10(1)).

  For collectables that comprise an interest in artwork, jewellery, antiques, coins or medallions, rare folios, manuscripts, books, postage stamps or first day covers, the exemption only applies if the market value of the collectable at the time of acquiring the interest (not what the taxpayer paid for it) was $500 or less (s. 118-10(2)). However, where parties are acting at arm's length (i.e. acting in their own best interests – see *Granby v. FCT),* generally the acquisition price would implicitly be its market value.
- The third element of the cost base of a CGT asset (the costs of asset ownership) does not apply to a collectable (s. 108-17).
- Any capital loss on a collectable that is acquired for more than $500 is 'quarantined' and can only be offset against capital gains from collectables (s. 108-10(1)).

  Note: Capital losses arising from non-collectable assets can be offset against gains arising from collectable assets (i.e. the quarantining rule only applies one way).

Personal use assets

A personal use asset is a CGT asset (other than a collectable) that is used or kept mainly for the taxpayer's (or their associate's) personal use or enjoyment (s. 108-20(2)); for example, boats, planes, motor vehicles, etc.

Land and buildings are not personal use assets (s. 108-20(3)).

Certain interest-free loans can be personal use assets (see s. 108-20(2)(d)). For example, it may not be possible to obtain a capital loss if a loan is forgiven when it is a personal use asset (s. 108-20(1)).

There are three special CGT rules that apply to personal use assets:

- Capital gains made on personal use assets are disregarded if the personal use asset was acquired for $10,000 or less (s. 118-10(3)). To prevent manipulation of the $10,000 limit, special rules exist in relation to assets which would ordinarily be disposed of as a set (s. 108-25).
- The third element of the cost base of a CGT asset (the cost of asset ownership) does not apply to a personal use asset (see above and s. 108-30).
- A capital loss cannot be made from the disposal of a personal use asset (s. 108-20(1)).

Required reading

Sections 108-10, 108-20, 118-5, 118-10, 108-17 and 108-30 ITAA 1997.

Anti-overlap provisions

The diagram below summarises the application of the anti-overlap provisions.

Assets

Trading stock Apply Division 70 No CGT: s. 118-25	Division 230 financial arrangements Apply Division 230 No CGT: s. 118-27	CGT assets
Depreciating asset Apply Division 40 No CGT: s. 118-24	Revenue assets (e.g. *Whitfords Beach v. FCT*) Apply s. 6-5 No CGT: s. 118-20	
Foreign currency Apply Division 775 No CGT: s. 118-20	Gain from isolated business transaction entered into with profit-making purpose (e.g. *FCT v. Myer Emporium*) Apply s. 6-5 No CGT: s. 118-20	

Otherwise assessable amounts

A capital gain is reduced if the CGT event that has occurred results in the capital gain, or part of the capital gain, being assessable under another provision of the income tax law (s. 118-20).

Example – Otherwise assessable amount

Risk Limited (Risk), a general insurance company, acquires and disposes of shares in Big Australian Bank Limited. Risk does not carry on a business of trading in shares (so the shares are not trading stock), but the shares it holds are revenue assets: see *Colonial Mutual Life Assurance Society Limited v. FCT*. The $100,000 gain made on the sale of the shares is ordinary income under s. 6-5.

CGT also applies to the transaction (CGT event A1), but the capital gain will be reduced under s. 118-20(1) by the $100,000 included in assessable income. Typically, the capital gain will be reduced to zero (s. 118-20(2)).

Note: If the shares were trading stock, the gain would be reduced under s. 118-25.

Section 118-20 does not apply if there is a loss. Where there is a loss, s. 110-55(9) reduces the cost base of the revenue asset by the amount of the deductible loss so as to prevent a double dip (i.e. s. 8-1 takes precedence over the capital loss provisions).

Depreciating assets

Decline in value fully tax deductible

A capital gain or loss made from a depreciating asset where the decline in value of the asset is fully tax deductible is disregarded under s. 118-24. The capital allowance provisions (see Unit 5 and Unit 6) apply to calculate any assessable gain or deductible loss arising from the disposal of the depreciating asset (or the occurrence of some other type of balancing adjustment event).

Decline in value wholly or partly non-tax deductible – CGT event K7

A partial CGT liability arises under CGT event K7 in s. 104-235 where the decline in value of a depreciating asset is partly non-deductible. This will arise where:

- A depreciating asset that is used wholly or partly for a non-taxable purpose (e.g. private use) is denied a deduction under s. 40-25 (see Unit 5).
- A second-hand depreciating asset that is used in a residential rental property is denied a deduction under s. 40-27(2)(a) and (b) (see Unit 5).

The CGT event K7 capital gain is calculated under s. 104-240 as follows:

$$\text{(Termination value – Cost)} \times \text{Sum of reductions / Total decline}$$

Where:

- Sum of reductions is equal to the reductions in decline in value deductions for the asset under s. 40-25 and s. 40-27.
- Total decline is equal to the decline in value of the depreciating asset since it was first held.

Example – Depreciating asset (CGT event K7)

Bill Brown purchased a digital camera (a depreciating asset) on 1 July 2017 for $5,000 and sold it on 30 June 2019 for $5,500. Bill uses the camera in his business as a wedding photographer, and at the time of the sale, the camera had declined in value to $4,500. For 10% of the time, the camera was also used for private purposes. The camera was not a pooled asset.

The sale of the camera triggers a balancing adjustment event under Division 40. In such cases, CGT event K7 operates to capture the profit or loss on the private use component that is not subject to the capital allowance provisions in Division 40.

The CGT event K7 capital gain is calculated under s. 104-240 as follows:

$$\text{(Termination value – cost)} \times \frac{\text{Sum of reductions}}{\text{Total decline}}$$

$$(\$5{,}500 - \$5{,}000) \times \frac{10\% \times \$500}{\$500}$$

= $500 × 0.1

= $50

Therefore, the capital gain from CGT event K7 is $50 (before applying any discount). The capital gain would not be disregarded under s. 118-10(3) as the asset is not a personal use asset because it is not used or kept 'mainly' for personal use and enjoyment.

There will also be an assessable balancing adjustment of $900 under Division 40 attributed to the business use included in assessable income under s. 40-285(1) and calculated as follows:

$$\text{Balancing adjustment} - \left[\frac{\text{Sum of reductions}}{\text{Total decline}} \times \text{Balancing adjustment}\right]$$

$$(\$5{,}500 - \$4{,}500) - \left[\frac{10\% \times \$500}{\$500} \times \text{Balancing adjustment}\right]$$

= 1,000 – (10% × 1,000)

= $900

This calculation is effectively the sum of:

- A clawback of the capital allowance deductions of $450 (Division 40).
- Taxation on 90% of the profit of $500 ($450) over the original cost of $5,000 attributable to the business use. You should also refer to Unit 5 on capital expenditure, which provides a discussion of the interaction of Division 40 and CGT assets used for a non-taxable purpose.

Trading stock

A capital gain or loss made on the disposal of trading stock is disregarded (s. 118-25). The provisions that are applicable to the disposal of trading stock are set out in Division 70.

It is possible for an asset to change its tax character (i.e. from trading stock to a CGT asset, or vice versa). The s. 70-10 definition of trading stock caters for this by looking at the asset's **current** use, rather than the original purpose of its acquisition.

The income tax treatment is summarised in the table below.

Example – Changing an assets tax character from trading stock to CGT asset		
	Before	**After**
Asset	Land developer selling subdivided land to new home buyers withdraws Block X from sale	Land developer now holds Block X as an investment asset in the hope that this parcel of land may one day be rezoned for 'commercial' use
Tax character	Trading stock	CGT asset
Income tax treatment	**Division 70 treatment** Section 70-110 treats the taxpayer as having both sold the asset at arm's length for its cost and reacquired it for the same amount (see Unit 1)	**CGT treatment** The CGT cost base will be the cost of the asset used in the s. 70-110 calculation (see Unit 1)

Example – Changing an assets tax character from CGT asset to trading stock		
	Before	**After**
Asset	Farmer owning land on the outskirts of town embarks on a new business by subdividing and selling the land as trading stock to new home buyers (TD 92/124)	Farmer, now operating in his new business as a land developer, holds the parcels of land as trading stock
Tax character	CGT asset	Trading stock
Income tax treatment	**CGT treatment** If the taxpayer's s. 70-30 choice is to use: • Cost – the gain or loss is disregarded (s. 118-25(2)) • Market value – CGT event K4 applies (s. 104-220) (see Unit 1)	**Division 70 treatment** Section 70-30 deems the taxpayer to have sold and reacquired the asset at one of the following values (chosen by the taxpayer): • Cost • Market value (see Unit 1)

Financial arrangements

A gain or loss from a financial arrangement that is assessable or deductible under Division 230, or dealt with under the hedging rules in Subdivision 230-E, is disregarded for CGT purposes (s. 118-27).

Required reading

Sections 104-220, 118-20, 118-24 and 118-25 ITAA 1997.

Exempt or loss-denying transactions

Compensation or damages, and windfall gains

Capital gains or losses arising from certain types of compensation or damages, and from gambling winnings or losses, or a game or competition with prizes, are CGT-exempt (s. 118-37).

Compensation or damages are sometimes treated as revenue, assessable under s. 6-5 as ordinary income or under a statutory income provision outside the realm of CGT. Examples of revenue include compensation for the loss or destruction of:

- Trading stock – which is ordinary income and deemed assessable by s. 70-115.
- A depreciating asset – where the compensation is treated as the termination value of the asset for the purposes of calculating the balancing adjustment (s. 40-300(2) item 8).

A 'look-through' approach is typically used to ascertain the CGT impact of compensation or damages that are treated as capital (TR 95/35). This involves 'looking through' the transaction to identify the underlying asset to which the compensation is most directly related. This approach is also commonly called the 'underlying asset' approach.

Example – Compensation and damages

Both example payments provided in the table below give rise to a right to sue the party at fault. However, applying the look-through approach to ascertaining their CGT impact means that this right is not itself treated as a CGT asset. Rather, the underlying asset to which the compensation payment relates needs to be identified and the payment takes its tax character by reference to that underlying asset (the right to sue is ignored).

CGT impact of compensation or damages		
Example	**What does the payment relate to?**	**CGT outcome**
1. A car accident results in an insurance payout of $20,000 for the taxpayer's (written-off) private car	Taxpayer's car ($20,000)	CGT disregards a gain or loss on a car (s. 118-5) There are no CGT implications. Nor is the amount ordinary income Not assessable
2. A newspaper wrongly states that a restaurant has been raided for a breach of health regulations. The restaurateur, who recently paid $300,000 to acquire the restaurant and its associated goodwill, threatens to take legal action. The newspaper's publisher settles the matter by printing an apology and paying the restaurateur $150,000: $50,000 (for loss of profits) and $100,000 (for damage to business goodwill)	• Loss of profits ($50,000) • Business goodwill ($100,000)	• The $50,000 takes the character of the thing compensated for (profits). This amount is assessable as ordinary income (s. 6-5) • The $100,000 is treated as partial recoupment of the amount paid to acquire the goodwill. The CGT cost base is reduced by the compensation received and is therefore not taxable in its own right (TR 95/35)

Required reading

Section 118-37 ITAA 1997.

Activity 4.4: Compensation receipts

[Available online in myLearning]

Main residence exemption

Capital gains or losses from **dwellings** are disregarded under s. 118-110 where the dwelling:

- was owned by an individual, and
- was that individual's main residence (e.g. family home) throughout the ownership period.

A dwelling is a building that provides mainly residential accommodation, but can include a caravan, houseboat or other mobile home (s. 118-115).

The exemption also applies to **adjacent land** used primarily for private or domestic purposes, subject to a total land area of two hectares (s. 118-120). Adjacent land can include:

- Land acquired after the acquisition of the dwelling and on a separate title (TD 92/171).
- Land that is not contiguous (TD 1999/68). The Commissioner gives an example of a block of land bought two streets away as being adjacent.

In contrast, if a taxpayer buys a unit in an apartment block to live in, and then acquires the unit next door also to live in, the two units could not be treated as a single dwelling on sale unless there was an amalgamation of title.

Example – Dwelling and adjacent land: Main residence exemption

Bill Brown, an Australian resident, purchased a home in 2013 and occupied it as his main residence. The home has never been used for income-producing purposes. In 2015, Bill purchased the vacant block of land that is adjacent to the land on which his dwelling is situated and constructed a private swimming pool on it. The total area of the adjacent land and of the land on which the home is located is less than two hectares.

In 2019, Bill, an Australian resident, entered into a contract to sell the home and the adjoining block. A full main residence exemption is available regardless of whether or not Bill amalgamates the titles.

Adapted from: TD 92/171.

Note: For CGT events happening on or after 9 May 2017, the main residence exemption does not apply if, at the time of the CGT event, the taxpayer was an excluded foreign resident or a foreign resident who does not satisfy the life events test. Broadly, the exemption will only be available where an individual has been a foreign resident for a period of six years or less, and during the period of that foreign residency, certain life events occurred. The life events test includes terminal medical conditions, death and family law matters (i.e. divorce or separation). However, under the transitional provision, this amendment does not apply if the CGT event happens on or before 30 June 2020 and the taxpayer had an ownership interest in the dwelling on 9 May 2017. At the time of writing, the legislation to implement this measure has yet to be finalised. It is therefore outside the scope of this offering of the TAXAU module.

Rules that extend the exemption

The following rules **extend** the application of the main residence exemption:

- A dwelling is treated as a taxpayer's main residence if it is **moved into at the time it was first practicable for the taxpayer to do so** after its acquisition (s. 118-135). In this regard:
  - The taxpayer's **intention** to move in is not sufficient. They **must physically move in**. For example, if a taxpayer acquires a house to live in, but is relocated before they do so for work reasons, the exemption will **not** be available (refer *Caller v. FCT* and *Chapman v. FCT*).
  - There are no hard and fast rules about when a house becomes a taxpayer's main residence. It comes down to facts, such as intention and conduct that evidences that intention (e.g. moving in furniture, connecting utilities, changing your address on your driver's licence or on the electoral role).

- Where a taxpayer **acquires a new main residence** before disposing of their previous main residence, they are entitled to claim the main residence exemption on both residences for a period of up to six months (s. 118-140).
- If a residence ceases to be the taxpayer's main residence, the taxpayer may use it for **income-producing purposes** and choose to continue to treat that residence as a main residence **for a period of up to six years**, provided the taxpayer does not treat another residence as the main residence at the same time (s. 118-145).

  The six-year period starts from the time the property is used for income-producing purposes and is reset each time the taxpayer moves back into the premises and uses it again as a main residence. This concession is only available in circumstances where, prior to being used for income-producing purposes, the dwelling was used as a main residence.

  If the dwelling is not used for income-producing purposes, there is no time limit. A taxpayer therefore could leave their home for 10 years and take advantage of this concession, provided no other home becomes their main residence.

Example – Two dwellings: Main residence exemption

Bill Brown, an Australian resident, acquired a dwelling on 1 January 2002, in which he lived until he went overseas on 1 January 2013. Bill did not rent out the home during his absence. Bill acquired a second dwelling on 1 February 2018, which he moved into on his return to Australia on 1 March 2018. Bill disposed of the first dwelling on 1 August 2018. At the time the dwelling was sold, Bill was an Australian resident.

In accordance with s. 118-145, Bill continued to treat the first dwelling as his main residence from 1 January 2013 until its disposal on 1 August 2018 (i.e. for five years and seven months).

In addition, under s. 118-140, Bill also treated the second dwelling as his main residence from the time he acquired it on 1 February 2018 up until the time he ceased to have an ownership interest in the first dwelling (1 August 2018).

Note: The 6-year limitation rule for income-producing use and the deemed acquisition rule at the time of first income-producing use are not relevant for Bill.

Adapted from: TD 1999/43.

- The main residence exemption can be applied to **land for up to four years** where the taxpayer builds a dwelling on the land, or repairs, renovates or finishes building a dwelling on the land (s. 118-150). However, the taxpayer can make this choice only if the dwelling:
  - becomes their main residence as soon as practicable after the dwelling is built, repaired or renovated (s. 118-150(3)(a)), and
  - continues to be their main residence for at least three months (s. 118-150(3)(b)).

Example – Constructing a dwelling: Main residence exemption

Bill Brown, an Australian resident, purchased land in late 2013 and commenced building a dwelling on it in mid-2015. In early 2016, as soon as practicable after construction of the dwelling was completed, Bill moved into the dwelling. He resided in it for approximately two and a half months. Due to a lack of local employment opportunities, Bill moved interstate (i.e. within Australia) and, after moving out, rented the dwelling. The dwelling is still currently rented. Bill now intends to sell the dwelling. He does not own any other dwellings. When the dwelling was eventually sold, Bill was an Australian resident.

Although the dwelling was Bill's actual main residence for a period of less than three months after its construction was completed, this period (i.e. the construction period) was immediately succeeded by a period in which Bill was able to treat it as his main residence under s. 118-145. For the purposes of s. 118-150(3)(b), the latter period extended the time in which the dwelling continued to be the taxpayer's main residence to the requisite period of at least three months.

Adapted from: ATO *Guide to capital gains tax*.

Rules that limit the exemption

The following rules **limit** the main residence exemption:

- The main residence exemption is only available in respect of certain CGT events (s. 118-110(2)).

  Note: For CGT events on or after 9 May 2017, the main residence exemption is not available for CGT event I1 that occurs when a taxpayer ceases to be an Australian resident (subject to a transitional provision). At the time of writing, the legislation to implement this measure has yet to be finalised. It is therefore outside the scope of this offering of the TAXAU module.
- The main residence exemption is not available for **adjacent land, which is disposed of separately** from the dwelling (s. 118-165). For example, it would not apply if a taxpayer subdivides their backyard and sells the subdivided portion.
- A full main residence exemption is not available in respect of a residence where a taxpayer and their **spouse nominate different residences** as their main residence (s. 118-170).
- A partial CGT liability arises where a transferred dwelling (eligible for a Subdivision 126-A marriage or relationship breakdown rollover relief) did not qualify as the main residence of both the transferee and transferor spouse (s. 118-178).
- A partial exemption is available where the dwelling was the main residence for a **part of the ownership period** (s. 118-185). This situation could arise where, for example:
  - The dwelling was not occupied as a main residence from the time it was first practicable to do so after acquisition (s. 118-135).
  - The six-year absence period is exceeded (s. 118-145).
  - The four-year period for building a dwelling on vacant land is exceeded (s. 118-150).

  Note: For CGT events on or after 9 May 2017, this partial main residence exemption does not apply if the taxpayer is an excluded foreign resident or a foreign resident who does not satisfy the life events test (subject to a transitional provision). At the time of writing, the legislation to implement this measure has yet to be finalised. It is therefore outside the scope of this offering of the TAXAU module.

Example – Main residence for part of ownership: Main residence exemption

Bill Brown, an Australian resident, purchased a dwelling on 1 July 2016 using borrowed funds and immediately rented it out on an arm's-length basis for two years. Bill continued to live at home with his parents, and claimed 'negative gearing' deductions on the property. On 1 July 2018, Bill terminated the tenancy arrangement and occupied the dwelling as his main residence. On 1 July 2019, Bill sold the property and made a $100,000 capital gain. Bill was an Australian resident at the time the dwelling was sold.

Bill's taxable capital gain (before discounting) is calculated using the formula in s. 118-185(2):

Gain/loss on the transaction	×	$\frac{\text{Non-main residence days}}{\text{Days in ownership period}}$	=	Taxable capital gain
$100,000	=	730 ÷ 1,095	=	$66,667

Note: In the above example the date the contract of sale was entered into (i.e. the time of CGT event A1) and the date of settlement under that contract (i.e. when legal ownership ends) are taken to both occur on 1 July 2019. However, in practice settlement would occur at a later point in time, say on 1 October 2019. In that situation, under s. 118-130(3) the total days in the ownership period would continue until legal ownership ends (i.e. 1,095 + 92 = 1,187).

- Only a partial exemption is available where the dwelling is **used fully for income-producing purposes** during the ownership period and the period of such use exceeds the six-year absence concession in s. 118-145 (s. 118-190).

- A partial exemption may only be available where a dwelling is **partly used for income-producing purposes at the same time as being the taxpayer's main residence** (s. 118-190). ATO guidance can be found in IT 2673 and TD 1999/71.

Example – Partly income-producing purpose: Main residence partial exemption

Bill Brown, an Australian resident, takes out a mortgage to buy a two-bedroom unit to live in as his main residence. He rents out the second bedroom on an arm's-length basis for his entire ownership period. Bill claims a deduction for 40% of the interest repayments and other holding costs (council rates and body corporate fees), based on the floor space shared with the tenant. Bill later sells the unit and makes a $100,000 capital gain. Bill was an Australian resident at the time the dwelling was sold.

The partial exemption rule in s. 118-190 applies. The taxable gain is determined by reference to the deductible portion of interest that was, or could be, deducted from the money Bill borrowed to acquire the unit using a reasonable approach. For example:

$100,000 × 40% = $40,000 taxable capital gain (before the CGT general discount)

Example – Partly income-producing purpose: Main residence full exemption

Sue Smith, an Australian resident, takes out a mortgage to buy a two-bedroom unit to live in as her main residence. She uses the second bedroom as a study, where she does after-hours work for her employer and studies for her Chartered Accountants Program qualification.

Applying case law (e.g. *Handley v. FCT*) and TR 93/30, Sue claims a deduction only for non-ownership costs that have a direct connection to the home study (e.g. power, heating), on a floor-area basis. No deductions are claimed for occupancy or ownership expenses (e.g. interest, council rates and body corporate fees).

Sue later sells the unit and makes a $100,000 capital gain. Sue was an Australian resident at the time the dwelling was sold.

The partial exemption rule in s. 118-190 does not apply. Sue could not claim a deduction for the interest on the money she borrowed to acquire the dwelling.

The $100,000 capital gain is fully disregarded under the main residence exemption. Having a home office to do work in will not jeopardise the main residence exemption, unless it amounts to business premises.

Deemed cost base

Section 118-192 provides a deemed CGT cost base rule for working out a capital gain or loss on a dwelling that has been a main residence and also used for income-producing purposes. The rule applies if:

- Only a partial main residence exemption would be available because the dwelling was used to produce income during the ownership period.
- The income-producing use started after 20 August 1996.
- The taxpayer would have been entitled to a full main residence exemption if they had entered into a contract to dispose of the dwelling just before the first time it was used for the income-producing purpose.

If these three conditions are satisfied, the taxpayer is taken to have acquired the dwelling at its market value at the time they first started using it for income-producing purposes (s. 118-192(2)).

The effect of this provision is that the first element of the dwelling's cost base and reduced cost base is the market value of the dwelling on the day it was first used for income-producing purposes (and the expenditure incurred by the taxpayer prior to that day is ignored). In a rising property market, s. 118-192 provides a useful cost base 'step up' opportunity. However, a valuation of the property at that time must be obtained.

Example – Main residence subsequently used for income-producing purposes: Main residence exemption

Bill Brown, an Australian resident, purchased on 1 July 2008 for $200,000, a dwelling in which he lived until he moved interstate on 1 July 2010. On 1 July 2010 his dwelling had a market value of $300,000. Bill rented out his dwelling for the whole time he was absent and did not acquire another dwelling interstate. On 30 June 2019, Bill sold the dwelling for $1,000,000. Bill was an Australian resident at the time the dwelling was sold. Assume Bill had no other amounts related to the calculation of his capital gain.

Under s. 118-192, Bill is deemed to have acquired the dwelling on 1 July 2010 (i.e. the day it was first used for income-producing purposes) for its market value of $300,000. Therefore, Bill made a capital gain of $1,000,000 – $300,000 = $700,000.

Under s. 118-145, Bill continues to treat the dwelling as his main residence from 1 July 2010 to 30 June 2016 (i.e. for a period of up to six years). Therefore, his non-main residence days are 1,095 (i.e. from 1 July 2016 to 30 June 2019) and his days in ownership period are 3,285 (i.e. from 1 July 2010 to 30 June 2019).

Bill's taxable capital gain (before discounting) for the income year ended 30 June 2019 calculated using the formula in s. 118-185(2) is:

Gain/loss on the transaction	×	Non-main residence days / Days in ownership period	=	Taxable capital gain
$700,000	=	1,095/3,285	=	$233,333

Note: In the above example the date the contract of sale was entered into (i.e. the time of CGT event A1) and the date of settlement under that contract (i.e. when legal ownership ends) are taken to both occur on 30 June 2019. However, in practice settlement would occur at a later point in time, say on 30 September 2019. In that situation, under s. 118-130(3) the total days in the ownership period would continue until legal ownership ends (i.e. 3,285 + 92 = 3,377).

Dwellings acquired from a deceased estate

Sections 118-195 to 118-210 provide either a full or partial exemption on the disposal of a dwelling by a beneficiary or trustee who acquired it from a deceased estate. These rules are discussed later in this unit in the section on CGT special rules.

Note: For CGT events happening after 9 May 2017, the deceased may need to be an Australian resident just before their death (see above for further explanation of the proposed limitation to the main residence exemption in respect of non-residents).

Required reading

Sections 118-110, 118-115, 118-120, 118-185, 118-140, 118-145 and 118-190 ITAA 1997.

Worked example 4.5: CGT main residence exemption

[Available online in myLearning]

Other exemptions

Life insurance

CGT events in relation to life insurance policies or annuity instruments that give rise to a capital gain or loss are generally disregarded for CGT purposes (s. 118-300). Specifically, such gains and losses are disregarded where they are made by:

- The original beneficial owner of a policy or instrument. In TD 94/31, the Australian Taxation Office (ATO) accepts that:
  - Where two or more persons (e.g. a husband and wife) jointly effect a life assurance policy, each person may be an original beneficial owner.
  - The person holding the rights under a life assurance policy may be an individual, a company or a trustee of a trust estate, provided the holder possesses 'all the normal incidents of beneficial ownership'. The fact that a trustee, which is not legally a beneficial owner, is included in this list by the ATO shows that the ATO takes an expansive and purposive interpretation of the law.
- An entity that acquired the interest in a policy for no consideration (e.g. a person nominated by the policy owner to receive the insurance payout in the event of the policy owner's death).
- The trustee of a complying superannuation fund, approved deposit fund (ADF) or pooled superannuation trust (PST).

The ATO adopts a pragmatic approach to the meaning of a life insurance policy (TD 2007/4). The life insurance exemption will apply to:

- A payment under a trauma policy if it is paid in respect of the death (rather than illness) of the insured.
- Terminal illness benefits (i.e. a pre-payment of a death benefit based on medical opinion that the insured's death is imminent). Under Australian insurance standards, a terminal illness benefit is one which is payable within 12 months of death.

Example – Trauma and life insurance policy: CGT exemptions

Bill Brown is the beneficial owner of a trauma and life insurance policy. Under the policy, Bill is to be paid a sum in the event that his wife, Noelene, suffers one of a number of traumas or dies. The CGT exemption applicable to each scenario is as follows:

Scenario 1: Noelene suffers a heart attack and dies

On receipt of the payment under the policy, CGT event C2 in s. 104-25 happens because Bill's rights under the policy end. Any capital gain or loss that Bill makes is disregarded under s. 118-300(1) item 3, because the payment under the policy was made as a result of Noelene's death.

Scenario 2: Noelene suffers a heart attack (a trauma event) and survives

The payment under the policy is not exempt under s. 118-300(1) item 3 because it was paid in respect of Noelene suffering a heart attack and not because of her death. However, the payment will be exempt under s. 118-37(1)(b), which exempts compensation received for an illness suffered by a relative.

General insurance

Payments under a general insurance policy are also CGT-exempt under s. 118-300 in cases where, should a CGT event happen in relation to the property that is the subject of the policy, any gain or loss would be disregarded.

Example – General insurance policy: CGT exemption

Bill Brown (the insured) receives an insurance payment for the destruction of his pre-CGT investment property. While the destruction of the property triggers CGT event C1, the insurance payout gives rise to CGT event C2. However, the insurance payout has no CGT consequences because the underlying asset is a pre-CGT asset (s. 118-300(1) item 2; TD 94/31).

CGT rollover that retains pre-CGT status may be available if the investment property is rebuilt (s. 124-85).

Pooled superannuation trusts

A pooled superannuation trust (PST) is a resident unit trust regulated by the Australian Prudential Regulation Authority (APRA). Assets of superannuation funds, AFDs, other PSTs and certain other specified entities are invested in PSTs.

Capital gains and losses are disregarded where they are made in relation to units in a PST and the entity is (s. 118-350):

- The trustee of a complying superannuation fund, ADF or PST.
- A life insurance entity with additional restrictions.

Look-through earnout rights

Look-through earnout rights under s. 118-565 are broadly indeterminate rights to future payments (i.e. financial benefits) that are:

- linked to the performance of a business or active asset after sale,
- not reasonably ascertainable at the time the right is created, and
- not required to be provided more than five years after the end of income year in which the underlying CGT event occurs.

The capital gain or loss arising on a look-through earnout right acquired on or after 24 April 2015 is disregarded (s. 118-575). The financial benefits paid/received are included in the cost base or capital proceeds of the underlying asset.

CGT rollovers

Overview

In certain circumstances, taxpayers can disregard a capital gain on a CGT event until another CGT event happens. This is called a 'rollover'. The main types of CGT rollovers available are:

- A **replacement asset** rollover, where one CGT asset is replaced with another (e.g. the replacement of a shearing shed destroyed in a bushfire).
- A **same asset** rollover, where the same CGT asset is transferred (e.g. an individual transfers assets to a wholly owned company).

With these types of rollover, the relief that is available allows a capital gain or loss arising from a CGT event to be deferred (i.e. rolled over into the new asset), thereby delaying the incidence of taxation.

In most situations, rollovers occur as the result of the taxpayer choosing to utilise the rollover. Care should be taken before choosing rollover relief. Always consider the taxpayer's current tax profile (e.g. if the taxpayer has a carry forward capital loss) and the ramifications of the rollover in the future. For example, where shares are rolled into a tax consolidated group and the Step 1 amount of the allocable cost amount (ACA) formula is calculated based on the historical rolled-over cost base of the shares rather than on their market value, this could result in a reduction in the tax cost of assets or a CGT event L3 capital gain depending on the asset mix (e.g. a large cash balance may cause a CGT event L3 capital gain) (see Unit 12).

Inherited tax characteristics

When a rollover occurs, the asset that is held afterwards (either the same or a replacement) generally carries the same tax characteristics as the asset that was held before the rollover.

Accordingly:

- If the original asset was acquired **before** 20 September 1985, the rolled-over asset will retain its pre-CGT status (however, scrip-for-scrip rollover is not available for pre-CGT assets).
- If the original asset was acquired **after** 19 September 1985, the cost base or reduced cost base of the rolled-over asset will be the same as the original asset.

Compulsory rollovers

Some rollovers are compulsory. The main rollovers in this category are summarised below.

Compulsory rollovers		
Rollover	**Example**	**Section reference**
Statutory licence	A taxpayer's Queensland commercial fishing licence is cancelled because of a Government decision to expand marine national parks. The taxpayer receives a new licence to conduct business in new fisheries	124-140
Crown leases	Big Agricultural Co. is permitted to have grazing cattle on Crown land in the Northern Territory under a pastoral lease. The territory's government renews the lease	124-575
Prospecting or mining rights	Junior Ore Explorer Limited conducts successful test drilling on its exploration tenement in Western Australia. It is then granted a mining permit over the same land by the state government	124-705

Compulsory rollovers		
Rollover	**Example**	**Section reference**
Marriage or relationship breakdown – spouses	As a result of a marriage breakdown, Sue Smith transfers an asset to her former spouse under a court order (which could also be done under a binding legal agreement) **Note:** 'Spouse' includes a de facto spouse and a partner of the same sex	126-5
Marriage or relationship breakdown – entities	As a result of Sue Smith's marriage breakdown, Smith Pty Ltd (or the trustee of the Smith Family Trust) transfers an asset to her former spouse under a court order. (This could also be done under a binding legal agreement) **Note:** This may give rise to a dividend under ordinary concepts or a deemed dividend under Division 7A (refer TR 2014/5); therefore, caution is required	126-15
Changes to trust deeds – complying superannuation funds or ADFs	The trust deed of a complying ADF or complying superannuation fund is amended or replaced for the purpose of: • complying with the *Superannuation Industry (Supervision) Act 1993*, or • enabling a complying ADF to become a complying superannuation fund The assets and members of the fund must not change as a consequence of the amendment or replacement	126-130
Securities lending arrangements	Financial Institution A agrees to 'lend' (dispose of) securities to Financial Institution B on condition that Financial Institution B returns the same or identical securities to Financial Institution A within 12 months	26BC(6) ITAA 1936

Specific types of rollovers

Three types of rollovers – disposal of assets to a wholly owned company, replacement asset rollover and same asset rollover – are detailed in the table below.

Types of rollovers		
Rollover	**ITAA 1997 Division**	**Description**
Disposal of assets to a wholly owned company	122	The disposal of an asset to a company in which the transferor(s) owns all the shares
Replacement asset	124	The taxpayer's ownership of one asset ends and another (replacement) asset is acquired
Same asset	126	The same asset is transferred from one taxpayer to another. The asset has the same CGT characteristics when held by the transferee as it did when it was held by the transferor

There are many rollovers that fall within these three categories. This unit will consider the replacement asset rollovers category, including involuntary disposals and scrip-for-scrip rollovers. Unit 9 will consider the disposal of assets to a wholly owned company category, in particular the disposal or creation of assets by partners to a company.

Involuntary disposals

As analysed earlier in this unit, under s. 104-10 CGT event A1 happens when an asset is disposed of and under s. 104-20 CGT event C1 happens when an asset is lost or destroyed. However, Subdivision 124-B allows the taxpayer to choose rollover relief for assets that have been compulsorily acquired, or lost or destroyed in circumstances where compensation is received.

The rollover is only available if the CGT event (i.e. CGT event A1 or CGT event C1) gives rise to a capital gain.

The consequences of a Subdivision 124-B rollover depend on the nature of the proceeds (i.e. money or an asset, or both) received in compensation for the lost or destroyed asset by the owner of the asset, and when the original asset was acquired.

Eligibility conditions

For a taxpayer to be able choose rollover relief:

- A CGT asset must have been:
  - compulsorily acquired by an Australian government agency, or an entity acting under a power of compulsory acquisition conferred on it by Australian or foreign law, or
  - lost or destroyed (in part or whole) (s. 124-70(1)).

Example – Subdivision 124-B rollover: whether an asset (or part thereof) is lost or destroyed, or merely damaged

The corrugated iron roof of a factory is completely torn off and destroyed as a result of a severe hailstorm. A Subdivision 124-B rollover is available for the destruction of the factory roof because part of the factory has been destroyed. However, if the roof was simply dented during the hailstorm, a rollover is not available because neither the factory nor the roof has been lost or destroyed.

Adapted from: TD 2000/38.

- An amount of money or another CGT asset (or both) must have been received as compensation (e.g. under an insurance policy) (s. 124-70(2)).
- For foreign residents, both the original and replacement assets must be taxable Australian property (s. 124-70(3) and (4)).

Where money is received, s. 124-75 requires that the taxpayer must incur capital expenditure in **acquiring another CGT asset** or in **repairing or restoring the original asset**, no earlier than one year before the event happens and no later than **one year** after the income year in which the event happens. The replacement asset cannot be trading stock or a depreciable asset.

Consequences of receiving money

Consequences of receiving money where the original asset is pre-CGT	
Consequence	**Section reference**
Any **replacement asset** will be pre-CGT if: • The disposal was due to a natural disaster, and the replacement asset is substantially the same as the original asset (having regard to the 'nature of the replacement asset, the use to which it is put, its cost, location, size, value, quality and composition, compared with those attributes of the original asset' (TD 2000/45)) • In all other cases, the consideration for the replacement asset does not exceed 120% of the market value of the original asset (breaching the 120% threshold rule means that the replacement asset will be post-CGT, and the cost base will be determined under the general cost base rules of s. 110-25)	124-85(3)
If a pre-CGT asset is **repaired or restored**, it is taken to be a pre-CGT asset as repaired or restored	124-85(4)

Consequences of receiving money where the original asset is post-CGT			
Condition	**Is there excess compensation?**	**Consequence**	**Section reference**
The compensation is **more than** the cost of the replacement asset or cost to repair or restore the asset	Yes. The notional gain is greater than the difference between the compensation and the cost of the replacement asset, or repair or restoration of the original asset	• A capital gain equal to the difference is included in assessable income • The cost base of the replacement asset (or the repair or restoration of the original asset) is reduced by the balance of the notional gain that is not treated as an actual gain	124-85(2) item 1
	No. The notional gain is equal to, or less than, the difference between the compensation and the cost of the replacement asset, or the repair or restoration of the original asset	The amount of the notional gain is included in assessable income	124-85(2) item 2
The compensation is **equal to, or less than,** the cost of the replacement asset or cost to repair or restore the asset	N/A	The gain is disregarded and the cost reduced by the notional capital gain	124-85(2) item 3

Example – Involuntary disposal rollover: Asset lost or destroyed

The extent to which a gain is deferred under a Subdivision 124-B rollover depends on the difference between the amount of compensation received and the cost of the replacement (or repaired or restored) asset.

Part A

In 2013, Simon bought a small factory for $75,000. In 2018, a fire destroyed **part** of the factory and he received $100,000 in compensation under an insurance policy.

The capital gain is worked out by using the apportionment rules for cost base under s. 112-30:

$$\text{Cost base of the asset} \times \frac{\text{Capital proceeds for the CGT event happening to the part}}{\text{Those capital proceeds plus the market value of the remainder of the asset}} = \text{Apportioned cost base}$$

Therefore, assuming that the factory's cost base at the time of the fire was $75,000 and the market value of the part that **was not** destroyed is $150,000, the apportioned cost base of the part that was destroyed is:

$$\$75{,}000 \times \frac{\$100{,}000}{\$100{,}000 + \$150{,}000} = \$30{,}000$$

In the absence of the Subdivision 124-B rollover relief, Simon's assessable capital gain would be $70,000 (i.e. Compensation received $100,000 – Apportioned cost base $30,000). This is referred to as the **notional gain**.

Part B

However, if Simon replaces the part of the factory that was destroyed, he can choose to defer his capital gain by applying the rollover provisions in Subdivision 124-B. The consequences for Simon of applying the rollover will depend on the amount he spends to repair the factory. The three different scenarios that may arise are:

1. The compensation is **more than** the cost of the replacement or repaired/restored asset, and the excess compensation is **equal to, or less than** the amount of the notional gain.
2. The compensation is **more than** the cost of the replacement or repaired/restored asset, and the excess compensation **exceeds** the notional gain.
3. The compensation is **equal to, or less than** the cost of the replacement or repaired/restored asset.

The following table summarises the consequences for Simon in the above three scenarios.

Consequences of a Subdivision 124-B rollover of money received in compensation

Description		Scenario 1	Scenario 2	Scenario 3
(a)	Cost base of part of factory destroyed by fire	$30,000	$30,000	$30,000
(b)	Compensation received under insurance policy	$100,000	$100,000	$100,000
(c)	Cost to replace/repair part of factory destroyed	$80,000	$15,000	$120,000
(d)	Notional gain [= (b) – (a)]	$70,000	$70,000[2]	$70,000
(e)	Excess compensation [= (b) – (c)]	$20,000	$85,000	0
(f)	Is notional gain > excess compensation [(d) > (e)]?	Yes	No	Yes
(g)	Revised gain [= (e)]	$20,000[1]	N/A[2]	0[3]
(h)	Revised cost base of replaced or repaired/restored asset [= (c) – ((d) – (e))]	$30,000[1]	$15,000[2]	$50,000[3]

Notes

1. Simon has spent less on repairing the factory than the compensation he received. As the excess compensation of $20,000 does not exceed the notional gain, it is treated as Simon's assessable capital gain.

   The portion of the notional gain that is not treated as assessable reduces the cost base of the replaced/repaired factory (i.e. amount spent $80,000 – $50,000 = $30,000).

   The total cost base of the fully restored factory is $75,000 (i.e. original cost base of the part of the factory that was not destroyed $45,000 plus adjusted cost base of restored part $30,000).
2. Simon has spent less on repairing the factory than the compensation he received. As the excess compensation exceeds the notional gain, the notional gain of $70,000 is treated as the assessable capital gain (i.e. there is no deferral of the gain).

   As no portion of the notional gain was treated as not assessable, the cost base of the replaced/repaired factory is not adjusted.

   The total cost base of the fully restored factory is $60,000 (i.e. original cost base of part of the factory that was not destroyed $45,000 plus cost base of the restored part $15,000).
3. Simon has spent more on repairing the factory than the compensation he received. As there is no excess compensation the assessable capital gain is reduced to $0.

   The notional gain that is not treated as assessable reduces the cost base of the replaced/repaired factory (i.e. amount spent $120,000 – $70,000 = $50,000).

   The total cost base of the fully restored factory is $95,000 (i.e. original cost base of the part of the factory that was not destroyed $45,000 plus adjusted cost base of restored part $50,000).

Adapted from: Section 124-85(2), using explanatory material in TD 93/178.

Consequences of receiving an asset

A Subdivision 124-B rollover also applies where a CGT asset, not money, is received as compensation for a lost or destroyed asset (s. 124-90). The consequences of such a rollover are tabled below:

Consequences of a Subdivision 124-B rollover when receiving an asset	
Original asset	**Replacement asset**
Pre-CGT	Deemed to be acquired before 20 September 1985 (s. 124-90(4))
Post-CGT	The first element of the cost base of the replacement asset is the cost base of the original asset (s. 124-90(3))
Whether the asset is pre-CGT or post-CGT	The capital gain on the original asset is disregarded (s. 124-90(2))

Consequences of receiving both money and an asset

Section 124-95 outlines the consequences of receiving both money and a CGT asset as compensation for a lost or destroyed asset.

The consequences are different for each element of the compensation that is attributable to the original asset. That is, each part of the compensation is treated separately, in accordance with the rules discussed above (i.e. the monetary compensation element is determined in accordance with the rules dealing with receiving money as compensation, and the asset compensation element is determined in accordance with the rules dealing with receiving an asset as compensation).

Scrip-for-scrip rollover

To prevent tax considerations acting as a deterrent to merger and takeover activities, Subdivision 124-M provides for scrip-for-scrip rollover to shareholders who are required to sell their shares in a company (i.e. the target company) in exchange for shares in another company (i.e. the acquirer or takeover company).

The consequences of a scrip-for-scrip rollover depend on whether the taxpayer receives shares, or shares and something else.

Eligibility conditions

A scrip-for-scrip rollover only applies where the shares in a company that is the target of a takeover or merger would, apart from the rollover, trigger a capital gain. The rollover does not apply where a capital loss would arise.

The rollover also does not allow pre-CGT shareholders in the target company to obtain pre-CGT shares in the acquiring entity or in the merged entity (i.e. there is no rollover for pre-CGT shares). The pre-CGT original shareholders will be deemed to have a market value cost base for the post-CGT shares they acquire in the scrip-for-scrip transaction (s. 124-800(1)).

The scrip-for-scrip rollover is not available if any capital gain the shareholder might make from their replacement shares in the acquirer company is to be disregarded. Examples include where the replacement shares are held as:

- trading stock, or
- non-taxable Australian property by a non-resident.

The other general requirements (outlined in s. 124-780) that need to be satisfied for scrip-for-scrip rollover relief to be available include the following:

- A post-CGT interest in one entity must be exchanged for a similar interest in another entity (i.e. a 'like for like' requirement). For example, a share in the target company must be exchanged for a share in the acquirer company (or an option, right or similar interest exchanged for a similar interest). The rollover is not available if shares are exchanged for options (s. 124-780(1)(a)).
- The exchange is the consequence of a single arrangement resulting in the acquirer company owning 80% or more of the voting shares or units in the target company (s. 124-780(1)(b) and s. 124-780(2)(a)).
- Holders of voting interests in the target company must be able to participate in the merger or takeover on 'substantially the same terms', or the takeover bid or scheme of arrangement complies with relevant provisions in the *Corporations Act 2001* (Corporations Act) (ss 124-780(2)(b) and (c), and (2A)).

Subdivision 124-M is a 'provision of last resort': see s. 124-795(3). Where a company reorganisation can fall under Subdivision 122-A (e.g. interposition of a holding company between an individual and a trading company) or Division 615 (e.g. interposition of a holding company between a shareholder group and a trading company), Subdivision 124-M does not apply.

Integrity rule

Scrip-for-scrip rollover integrity measures apply where:

- the shareholders of the target company and of the acquirer company do not deal with each other at arm's length (refer *Granby v. FCT*, which requires each party to be acting in their own best interests) and neither entity had at least 300 members just before the arrangement started, or
- the transaction involves members of the same linked group.

In such cases, the market value of the capital proceeds from the scrip-for-scrip transaction must be 'substantially the same' as the market value of the shares in the target company and the replacement shares must carry the 'same kind of rights and obligations' (ss 124-780(4) and (5)).

There are also integrity provisions that address situations in which shareholders can exert influence over both the target company and, after the takeover or merger is completed, the acquirer/merged company:

- Section 124-782 deals with the calculation of the acquiring company's (i.e. the takeover company's) cost base, where the target company vendors are significant stakeholders (30%) in both the target company and the acquiring company. It also deals with situations where shareholders in the target company and the acquiring company have an 80% common stake in both companies regarding voting rights, dividends and distributions of capital.
- If an arrangement that qualifies for a scrip-for-scrip rollover is taken to be a 'restructure', the cost base for the shares that the acquiring company acquires in the original entity will reflect the cost bases of the underlying net assets of the original entity (rather than the market value of the original entity) (s. 124-784B). An arrangement will be taken to be a restructure if, broadly, at the completion time, the market value of the replacement shares issued by the replacement entity under the arrangement in exchange for shares in the original entity is more than 80% of the market value of all the shares (including options, rights and similar interests to acquire shares) issued by the replacement entity (s. 124-784A).

Consequences of receiving shares

If a target company shareholder chooses scrip-for-scrip rollover relief:

- The gain on the original shares is disregarded (s. 124-785(1)), thereby deferring CGT until a later CGT event happens to the shares that are acquired in the acquirer company.
- The cost base of the replacement shares will be a reasonable portion of the cost base of the original shares exchanged for those shares. However, the cost base of the target company shares is first reduced by that part of the cost base that is reasonably attributable to any cash consideration (see the discussion on partial rollover relief below).
- Subject to CGT integrity measures (see discussion above), the acquiring company will obtain a market value cost base for the shares it holds in the target company after the scrip-for-scrip rollover.

The outcome for the shareholders in the target company is best illustrated by the following example.

Example – Scrip-for-scrip rollover: where shares received

Sue Smith owns shares in Target Limited (Target). She accepts a takeover offer from Acquirer Limited (Acquirer) for which she receives two (2) ordinary shares in Acquirer in exchange for each of her Target shares.

The market value of the Acquirer ordinary shares immediately after Sue acquired them was $20 per share.

The cost base of each Target share just before Sue ceased to own them was $15.

The offer made by Acquirer satisfies all the requirements of a scrip-for-scrip rollover.

In the absence of a scrip-for-scrip rollover being available, Sue would have made a capital gain per share of $25, calculated as follows:

Capital gain	=	Capital proceeds (2 shares × $20)	–	Cost base
$25	=	$40	–	$15

Scrip-for-scrip rollover allows Sue to disregard the capital gain.

The cost base of the Acquirer shares is the cost base of the Target shares. As the exchange is one share in Target for two shares in Acquirer, the cost base of the Target shares must be apportioned.

Sue's cost base for each ordinary share in Acquirer is $7.50 [($20 ÷ $40) × $15].

Consequences of receiving shares and something else

An original shareholder will only be eligible for scrip-for-scrip partial rollover relief if their shares are exchanged for both shares in the takeover or merged entity **and** something else, usually cash.

The rollover will apply only to the replacement shares and the cost base of the original shares will be apportioned between the replacement shares and the cash (s. 124-790).

Example – Scrip-for-scrip partial rollover where shares and cash are received

Bill Brown owns 100 shares in Target Limited (Target), each with a cost base of $6 each. He accepts a takeover offer from Acquirer Limited (Acquirer) which states that, for each of Bill's Target shares, he will receive one Acquirer share plus $10 cash.

Bill receives 100 shares in Acquirer and $1,000 cash. At the time, Acquirer shares are worth $20 per share.

The Subdivision 124-M rollover will **not** apply to the $1,000 cash consideration received.

Section 124-790 requires a reasonable allocation of the cost base of the original shares, having regard to the proportion that the cash bears to the total proceeds (i.e. cash plus value of shares received).

For example:

$$\text{Proportion of cost base for which cash was received} = \frac{\text{Cash}}{\text{Total proceeds: cash and value of replacement shares received}} \times \text{Cost base of original shares (100 shares} \times \text{\$6)}$$

$$\$200 = \frac{\$1{,}000}{\$3{,}000} \times \$600$$

Bill's capital gain will be:

$$\text{Capital gain} = \text{Cash} - \text{Cost base}$$

$$\$800 = \$1{,}000 - \$200$$

Bill's cost base for each of his Acquirer shares will be:

$$\text{Cost base for Acquirer shares} = \frac{\text{Cost base of original shares} - \text{Cost base of cash received}}{\text{Number of shares}}$$

$$\$4 = \frac{\$600 - \$200}{100}$$

Activity 4.5: Scrip-for-scrip rollover

[Available online in myLearning]

CGT special rules

Death

General rule

The CGT policy designers were keen to ensure that no tax liability arose when an individual died. From a political perspective, the introduction of CGT in 1985 would have proved very unpopular had it operated as a form of inheritance tax. Accordingly, s. 128-10 **disregards a capital gain or loss** on assets owned just before the date of an individual's (a deceased's) death.

The relevant cost base and acquisition rules relevant to this exception are summarised in the table below.

Determining cost base and asset acquisition time for asset passing from a deceased to a legal personal representative or beneficiary

Deceased's asset	CGT cost base	Time of acquisition[1]
Pre-CGT asset	Market value at date of death (s. 128-15(4) item 4)	When the deceased died (s. 115-30(1) items 5 and 6)
Post-CGT asset	The deceased's cost base, or reduced cost base (s. 128-15(4) item 1) Special rules apply to the deceased's trading stock and main residence, foreign residents and trusts established for the future care of a family member with a severe disability (s. 128-15(4) items 2–3B). For example: • Where a non-resident leaves non-taxable Australian property to a resident, the cost base is the market value at the date of death (item 3A) • Where a resident leaves a dwelling that was the deceased's main residence and not then (i.e. at the time of death) being used for the purpose of producing assessable income, the cost base is the market value at the date of death (item 3)	When the deceased acquired the asset (s. 115-30(1) items 3 and 4)

Note

1. Acquisition time is relevant when calculating the 12-month eligibility requirement for the CGT discount.

Exception – CGT event K3

The general rule above would result in a loss to Government revenue where, for example, the deceased's CGT asset passed to a beneficiary who fell outside the tax net (e.g. a tax-exempt charity or a non-resident). CGT event K3 (s. 104-215) therefore triggers a capital gain or loss just before the deceased's date of death where the asset passes to a tax-advantaged entity, being:

- an exempt entity
- the trustee of a complying superannuation fund, or
- a foreign resident, where:
  - the deceased was an Australian resident, and
  - the asset 'in the hands of the beneficiary' was not taxable Australian property (TAP).

The capital gain or loss under CGT event K3 is ascertained by comparing the market value of the asset at the date of death with the deceased's cost base or reduced cost base.

CGT event K3 can cause complications if a will is contested. For example, if an asset passes to a non-resident pursuant to a will, CGT event K3 applies just before death. If a court order is subsequently obtained under which the asset passes to a resident instead, the CGT event K3 needs to be reversed subject to the amendment period rules in s. 170 ITAA 1936.

CGT event K3 highlights the important role that both tax and legal practitioners play in helping clients devise tax effective wills, as illustrated by the example below. Practitioners also advise on the establishment of entities that help achieve their clients' estate planning objectives, such as testamentary trusts and self-managed superannuation funds.

Example – CGT and tax-effective wills

Bill Brown, an Australian resident, decides it is time he prepared a will. He goes to a newsagent and buys a 'do-it-yourself' will kit for $10.

Bill has only two assets:

- $100,000 in the bank.
- Shares in Big Australian Bank Limited, a company listed on the Australian Securities Exchange. These shares are currently worth $100,000. Bill acquired the shares in 1998 at a cost of only $10,000.

Bill bequeaths the cash to his niece, who is an Australian resident, and the shares to his brother, who is a New Zealand resident.

When Bill dies, the bequest to his brother will attract CGT event K3 and his executor will need to fund the CGT liability.

If Bill had instead bequeathed the shares to his niece and the cash to his brother, no CGT would arise as a result of Bill's death (subject to Part IVA ITAA 1936). This is because:

- The shares will pass to an Australian resident taxpayer (the niece) who also inherits Bill's $10,000 cost base under s. 128-15(4) and who will only pay CGT (with discount) when she sells the shares. In essence, the immediate CGT event K3 capital gain is swapped for a future capital gain.
- No CGT applies to the bequest of Australian currency because it is not a CGT asset (TD 2002/25 para. 2) and, in any event, there would be no capital gain in relation to the cash.

Sale of inherited dwelling

When the legal personal representative or beneficiary disposes of a dwelling received from a deceased person the following rules apply:

Rules for the sale of a dwelling inherited from a deceased estate	
CGT status and use of asset prior to death	**Tax treatment**
Pre-CGT asset (regardless of whether or not the dwelling was used as a main residence by the deceased)	Capital gain or loss is disregarded **if** (s. 118-195(1)): • the dwelling is sold within two years of death (or within a longer period allowed by the Commissioner – under PCG 2019/5 the Commissioner will allow capital gains on dwellings sold between two and three-and-a-half years of death to be disregarded without the need to apply for a private ruling), **or** • from the date of the deceased's death until it is sold by the beneficiary, the dwelling was used as the main residence by one of the following: – the deceased's spouse – a person who had the right to occupy the dwelling under the deceased's will, or – the beneficiary themselves If none of the above applies, the normal CGT rules on the sale of assets inherited from a deceased will apply in determining the capital gain or loss that arises, using a market value cost base at the date of death

Rules for the sale of a dwelling inherited from a deceased estate	
CGT status and use of asset prior to death	**Tax treatment**
Post-CGT asset and the dwelling was the deceased's main residence just before death **and** not used at that time for the purpose of producing assessable income	Same as above, except the cost base is the deceased's cost base **if** the capital gain/loss is not disregarded
Post-CGT asset and the dwelling does not satisfy any of the above requirements	The normal CGT rules on the sale of assets inherited from a deceased person will apply in determining the capital gain or loss that arises, using the deceased's cost base

The above is a summary of the rules in s. 118-195(1), which the legislation presents in a (different) table format.

A key point to note when interpreting the table in s. 118-195(1) is s. 118-195(1)(b), which states that 'at least one of the items in column 2 and at least one of the items in column 3 of the table are satisfied'. This means not simply reading the table across for each line item. The exemption is available, for example, where you satisfy column 2 of item 2 (a pre-CGT asset) **and** column 3 of Item 1 (sold within two years of death).

Note: For CGT events on or after 9 May 2017, the capital gain or loss on disposal of an inherited dwelling is not disregarded if the deceased was an excluded foreign resident just before death. However, under the transitional provision this amendment does not apply where the CGT event happens on or before 30 June 2020 and the deceased had an ownership interest in the dwelling on 9 May 2017. At the time of writing, the legislation to implement this measure has yet to be finalised. It is therefore outside the scope of this offering of the TAXAU module.

Example – Using an inherited dwelling for income-producing purposes

Bob Smith purchased his home in July 1995. Bob died in January 2019. Just before his death Bob was an Australian resident and the house was:

- Bob's main residence, and
- not used by Bob to produce assessable income.

Bob left the house to his 40-year-old son, Sean, who is an Australian resident. Sean already owned his own main residence, so he rented out Bob's house and then disposed of it 18 months after his father died.

Sean is entitled to a full CGT exemption, as he disposed of it within two years of his father's death.

Required reading

Sections 118-195 and 128-10 ITAA 1997.

Company liquidations

The taxation of companies is covered in Unit 8. However, in this section, the CGT issues arising for a company under liquidation are considered. These issues include:

- Where a liquidator declares the shares of a company under liquidation to be worthless.
- Where the liquidator's distributions result from the winding up of a company.
- The CGT ramifications of the cancellation of shares in a liquidated company.
- Where the liquidated company is a member of a tax consolidated group.

Liquidator declares shares to be worthless – CGT event G3

Shareholders may choose to trigger a capital loss on their post-CGT investments under CGT event G3 (s. 104-145) if a liquidator or an administrator of a company declares, in writing, that they have reasonable grounds to believe:

- there is no likelihood that shareholders will receive any further distributions from their shares, or
- financial instruments issued by the company have no value or only negligible value.

Example – Liquidator declares shares to be worthless: CGT event G3

Since 1999, Bob Brown has been a shareholder in Big Insurance Limited (Big Insurance), which is now a failed company in the hands of a liquidator. The company has many rights and obligations under its insurance and reinsurance contracts and it is envisaged that the liquidation process will take several years.

However, the liquidator has undertaken sufficient work to clearly establish that shareholders will receive no further distributions, given the substantial claims against Big Insurance by lenders and other secured creditors.

On 1 June 2019, the liquidator writes to shareholders to inform them of the situation, declaring there is little likelihood of further distributions.

Bob Brown therefore decides to invoke CGT event G3 to trigger a CGT loss on his shares in Big Insurance at the date the liquidator's declaration was made (1 June 2019). This enables Bob to apply the CGT event G3 loss against capital gains made during the income year ended 30 June 2019 and future years.

Note: The cost base and reduced cost base of the shares is deemed to be $nil for the purposes of any subsequent CGT event.

Liquidator's distributions – s. 47 ITAA 1936

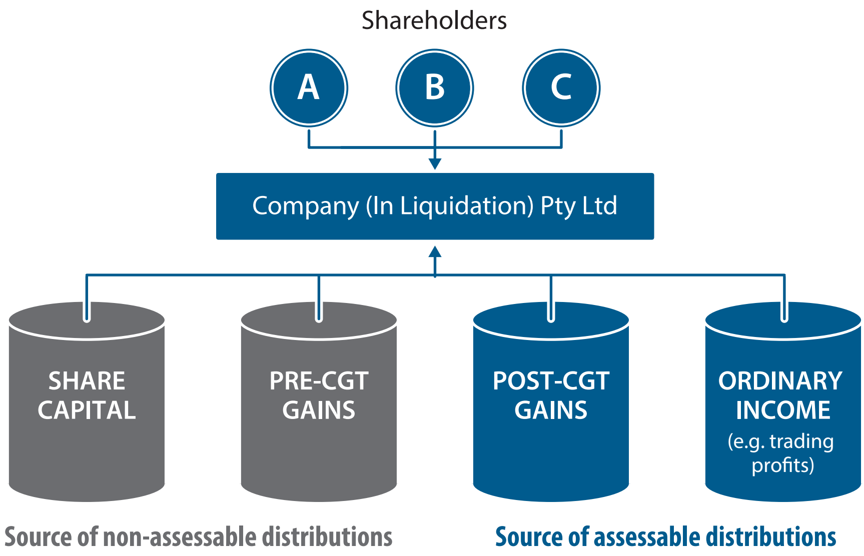
The liquidation or winding up of a company eventually results in the dissolution of the company and the cancellation of shareholders' shares. The company ceases to exist and the liquidator's distribution of the company's surplus funds (if any) is considered to represent a capital distribution at common law.

For income tax purposes, s. 47(1) and (1A) ITAA 1936 **deem certain liquidator's distributions to be dividends**, which are frankable. This will be the case where a liquidator is distributing amounts to shareholders that represent ordinary income or assessable income that was derived by the company. This would include any assessable capital gain (ignoring indexation).

On the other hand, a tax-free profit on the sale of a pre-CGT asset by the company, or a capital gain made by the company that is sheltered from CGT by a market value uplift under Division 149 (where pre-CGT assets are deemed to be post-CGT assets due to a change in majority underlying interests), will not give rise to a deemed dividend. This is because these profits and gains are not income or assessable income of the company.

It is very important, therefore, that tax practitioners understand the source of a liquidator's distributions so that the deemed dividend under s. 47 ITAA 1936 is calculated correctly. The starting point for identifying the source of the distributions is how they are accounted for by the liquidator: see *Archer Bros Pty Ltd (in vol. liq.) v. FCT*; TD 95/10 and TD 2000/5.

The following diagram illustrates how a liquidator accounts for distributions.



Cancellation of shares – CGT event C2 and G1

Having calculated the deemed dividend under s. 47 ITAA 1936, the next step is to consider the CGT implications associated with the cancellation of shares in a liquidated company.

Assuming that shareholders acquired the shares after 19 September 1985, a range of interrelated tax provisions come into play.

Two CGT events are relevant:

- CGT event C2 is the specific CGT event applicable to the ending of an asset (i.e. the cancellation of shares) (s. 104-25).
- CGT event G1 could also apply, where the liquidator's distributions have a non-assessable component (e.g. a return of share capital or is sourced from pre-CGT gains – see diagram above) (s. 104-135).

Where there is a deemed dividend under s. 47 ITAA 1936 and a capital gain arises regarding the shares, the capital gain will be **reduced under s. 118-20** (the anti-overlap provision) by the amount of the dividend.

Within 18-month time frame

CGT event C2 happens when ownership of an intangible asset ends. TD 2001/27 confirms that CGT event C2 applies to the cancellation of shares under the Corporations Act. The event happens when a company is deregistered (TD 2000/7).

Where a company is dissolved within 18 months of the liquidator's distribution, only CGT event C2 is applicable (s. 104-135(6)). The capital proceeds (i.e. the interim and final distributions from the liquidator) are compared to the taxpayer's cost base or reduced cost base and the gain or loss is calculated accordingly (s. 104-25(3)). The anti-overlap provision in s. 118-20 is then applied to prevent double taxation.

Compliance with the 18-month time frame allows interim distributions to be made without attracting the operation of CGT event G1. This means that:

- The CGT cost base of the shares in the company will not be eroded by any non-assessable distribution from the liquidator.

- No gain under CGT event G1 can arise.
- Where available, the CGT discount and small business CGT relief can be utilised when CGT event C2 occurs (as distinct from CGT event G1, which erodes cost base).

Outside 18-month time frame

Where a company cannot be dissolved within the 18-month time frame, the non-assessable component of the liquidator's distributions will trigger CGT event G1, thereby:

- Eroding the CGT cost base of the shares in the company by the amount of the non-assessable distribution from the liquidator (s. 104-135(4)).
- Triggering a gain by the amount of any further non-assessable distribution once the cost base has been eroded to nil (s. 104-135(3)).

Member of tax consolidated group

Although the tax consolidation regime is considered in Unit 12, it is important at this stage to note that the liquidation of a subsidiary within a tax consolidated group does not attract the consequences discussed above.

Under the single entity rule (s. 701-1), the existence of the subsidiary and the membership interest in that subsidiary is generally ignored when considering the application of the income tax law to the consolidated group. In short, the shares in the subsidiary do not exist for income tax purposes under the single entity rule.

Required reading

Section 47 ITAA 1936.

Sections 104-25, 104-135 and 104-145 ITAA 1997.

Worked example 4.6: Liquidator's distribution

[Available online in myLearning]

Pre-CGT asset integrity provisions

The introduction of CGT in 1985 included integrity measures that were designed to ensure that pre-CGT status could not be claimed indefinitely by:

- Entities with pre-CGT assets with post-CGT improvements over a specified value.
- Individuals who owned pre-CGT interests in entities that owned predominantly post-CGT assets.
- Entities with pre-CGT assets whose ultimate owners had acquired their interests after CGT was introduced.

Separate assets for CGT purposes

At common law, land and any fixtures are considered to be one asset, but this is overridden by the CGT rules. For example, where a plot of pre-CGT land has a post-CGT asset built on it, the assets are **deemed to be separate assets**, so that the post-CGT asset does not escape CGT.

In addition, a post-CGT capital improvement to a pre-CGT asset may be a separate asset where the cost base of the improvement at the time of a later CGT event is more than the set 'improvement threshold' and exceeds 5% of the capital proceeds.

The improvement threshold for the 2018–2019 income year is $150,386 under TD 2018/8.

If the improvement is treated as a separate CGT asset, the capital proceeds from the CGT event must be apportioned between the original asset and the improvement (s. 116-40). The effect is that only the improvement is subject to CGT.

Subdivision 108-D sets out circumstances where separate assets are deemed to exist for CGT purposes.

Note: A building erected on post-CGT land is treated as a single asset with the land.

> **Required reading**
> Subdivision 108-D ITAA 1997.

Sale of interests in a company or trust – CGT event K6

Application

CGT event K6 (s. 104-230) addresses the situation in which a taxpayer disposes of pre-CGT:

- shares in a private company, or
- an interest in a non-discretionary trust (e.g. a unit trust – see Unit 10),

where at least **75% of the market value** of the company or trust is comprised of **post-CGT** assets (s. 104-230(2)).

CGT event K6 is designed to prevent shareholders in private companies (or beneficiaries in non-discretionary trusts) obtaining CGT-free gains where the entity's assets are predominantly comprised of post-CGT assets which carry unrealised gains.

Where it applies, CGT event K6 treats part of the capital proceeds from the sale of pre-CGT shares (or an interest in a trust) as a capital gain that is subject to CGT (s. 104-230(6)).

Note that CGT event K6 can never result in a capital loss (s. 104-230(6)).

Calculation method

The income tax legislation does not provide a specific method that must be followed to determine the part of the capital proceeds that is treated as a capital gain.

However, the ATO applies the following process for calculating the capital gain (adapted from TR 2004/18):

- **Step 1 –** Determine how much of the capital proceeds actually relates to the post-CGT property using a proportional market value basis:

$$\text{Capital proceeds} \times \frac{\text{Market value of entity's post-CGT property}}{\text{Market value of all the entity's property}}$$

- **Step 2 –** Determine how much of the Step 1 amount relates to the amount by which the market value of the entity's post-CGT property exceeds the costs bases of that property:

$$\text{Step 1 amount} \times \frac{\text{Market value excess}}{\text{Market value of entity's post-CGT property}}$$

  Where Market value excess = Market value of post-CGT property – Cost base of post-CGT property.

  The capital gain is equal to the **lesser of**:

  - Market value excess
  - Step 2 amount.

Example – Sale of pre-CGT shares: CGT event K6

Bob Brown owns 100% of the shares in Brown Pty Ltd, a private company. Bob acquired his shares in 1982 (i.e. pre-CGT) and has held them continuously. On 31 March 2019, Bob disposes of his shares for $2.5 million. At the time of Bob's disposal, Brown Pty Ltd held the following two assets:

- Post-CGT property that has a cost base of $1 million and a market value of $2 million.
- Pre-CGT property that has a cost base of $100,000 and a market value of $500,000.

CGT event A1 happens on 31 March 2019 when Bob disposes of his shares in Brown Pty Ltd. As the shares are pre-CGT, the CGT event A1 capital gain is disregarded (s. 104-10(5)). However, Bob also needs to consider the application of CGT event K6 (s. 104-230).

Brown Pty Ltd's percentage of post-CGT property is:

Market value of post-CGT property $2 million ÷ Market value of all property $2.5 million = 80%

As this percentage is at least 75%, CGT event K6 applies. Bob must determine the amount of the capital proceeds that are reasonably attributable to the amount by which the market value of the post-CGT property exceeds the cost base of that property.

Bob follows the ATO's approach to determine his capital gain:

- **Step 1** – the amount of capital proceeds that relate to post-CGT assets is:
  Capital proceeds $2.5 million × 80%
  =$2 million.
- **Step 2** – the reasonably attributable amount is:
  Step 1 amount $2 million × (Market value post-CGT property $2 million – Cost base of post-CGT property $1 million) ÷ Market value of post-CGT property $2 million
  = $1 million

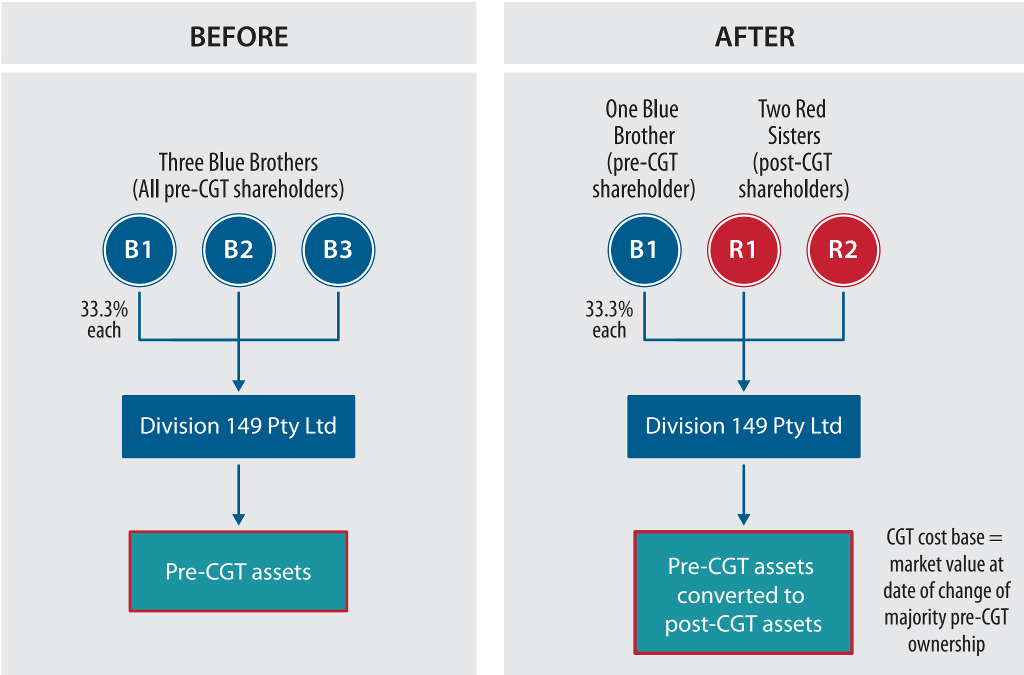
  Thus, Bob's capital gain = $1 million.

Majority post-CGT ownership of an asset

Application

Division 149 deems a pre-CGT asset held by an entity to cease being a pre-CGT asset when majority underlying interests in the asset are no longer held by ultimate owners who had majority underlying interests (more than 50%) in the asset immediately before 20 September 1985 (s. 149-30(1)).

Division 149 is designed to prevent an entity selling its assets CGT-free where the majority of the entity's ultimate owners acquired their interests after CGT was introduced. The following diagram illustrates how the pre-CGT assets of a company become post-CGT assets because of a change in majority underlying interests.



Consequences

At the earliest time that the majority underlying interests are not held by the same ultimate shareholders or beneficiaries that held the interests before CGT was introduced, the asset is deemed to be acquired by the entity (s. 149-30) (applicable to non-public entities).

The asset is also deemed to be acquired at its market value (s. 149-35).

There are further issues to consider when dealing with a public entity. The rules are modified in the case of public entities; however, a detailed knowledge of these rules is not required.

Note that Division 149 does not produce a capital gain per se. It simply **deems pre-CGT assets to have been acquired post-CGT at their prevailing market values**, so that future CGT events may give rise to capital gains or capital losses.

Exceptions

Division 149 is not triggered where ownership changes are caused by:

- the rollover of assets because of the breakdown of a marriage or relationship, or
- a person's death.

In such cases, s. 149-30(3) and (4) treats the 'new owner' in these circumstances as one that 'stands in the shoes' of the former owner.

CGT administration

Record-keeping requirements

Taxpayers must keep records of every act, transaction, event or circumstance that may be relevant to working out whether they have made a capital gain or loss from a CGT event (s. 121-20).

Note that the record-keeping period for CGT records is five years **starting after the relevant CGT event occurs** (s. 121-25(2)). This means that CGT records for long-held assets will need to be kept for many years. The special nature of the CGT record-keeping requirement is often not fully understood by taxpayers and some destroy their records after they have kept them for five years in accordance with the general income tax record-keeping provision in s. 262A(4) ITAA 1936. Where the necessary CGT records are unavailable, practitioners are often required to reconstruct the data necessary to perform CGT calculations.

Activity 4.6: Net capital gain – various CGT assets
[Available online in myLearning]

Other key resources

Quick reference guides
4.1: CGT general rules – overview
4.2: CGT general rules – change in residency
4.3: CGT general rules – taxable Australian property under s. 855-15
4.4: CGT general rules – CPI rates for indexed cost base
4.5: CGT main residence exemption – overview
4.6: CGT rollovers – overview
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

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Unit 5: Capital expenditure

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Explain, calculate and recommend the most appropriate decline in value for depreciating assets.
2. Explain and calculate balancing adjustments.
3. Explain the taxation consequences of a change in ownership or interest in a depreciating asset.
4. Explain the interactions between the CGT provisions, the trading stock provisions and the capital allowance provisions.
5. Explain and calculate the deduction available for capital works.
6. Explain and apply the provisions in relation to the interaction between the capital works allowance and the CGT regimes.
7. Explain and calculate deductible capital expenditure.

Introduction

As explained in Unit 1, a general deduction is **not** allowed under s. 8-1(2)(a) for 'a loss or outgoing of capital, or of a capital nature'. However, a more specific provision may apply to the capital expenditure.

Where capital expenditure relates to a CGT asset and is not otherwise deductible, the cost base of that CGT asset includes the capital expenditure (see Unit 4).

Where capital expenditure generates assessable income or relates to an asset that is used in carrying on a business, the tax legislation may provide a mechanism to allow a deduction, subject to specific requirements and limitations. This unit considers the following categories of deductions for capital expenditure:

- Decline in value deduction (i.e. tax depreciation) and balancing adjustments (i.e. gain or loss on disposal) for depreciating assets (e.g. plant and equipment) under the capital allowance rules (Division 40).
- Deduction for buildings and structural improvements under the capital works rules (Division 43).
- Deduction for certain business-related capital expenditure under the 'blackhole' rules (s. 40-880).
- Deduction for lease termination expenditure (s. 25-110).
- Immediate deduction for certain types of capital expenditure (various provisions).

This unit will also discuss the interaction of the capital allowance and capital works provisions with the CGT provisions (see Unit 4) and the trading stock provisions (see Unit 1).

The concessional decline in value deductions that small business entities (SBEs) are able to elect is discussed in Unit 6.

Note:

- The income tax year end covered in this offering of the TAXAU module is 30 June 2019. Therefore, the amendments applicable from 1 July 2019 are outside the scope of the module. The details provided in this unit are for reference purposes only.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Depreciating assets (capital allowances)

Overview

The process of obtaining a tax deduction for a decline in value – commonly referred to as tax depreciation – is established in Division 40 'Capital allowances'.

The section that allows the decline in value deduction is s. 40-25. For this deduction to be available to a taxpayer there must be a **depreciating asset**, and the taxpayer must be the **holder** of the depreciating asset during the income year.

Where these requirements are satisfied and the asset is not immediately deductible nor allocated to a pool, the steps to calculate the taxpayer's deduction for the **decline in value** of that asset for an income year are:

- Determine the **cost** of the depreciating asset.
- Determine the **effective life** of the depreciating asset.
- Determine the **start time**.
- Calculate the **decline in value** and **adjustable value**.
- Reduce the decline in value deduction for any **non-taxable use** and for **second-hand assets** in certain residential rental properties.

Where the asset is **immediately deductible**, the taxpayer's decline in value deduction for an income year is the asset's cost reduced by any non-taxable use.

In addition to a deduction for a decline in value, the taxpayer may have an assessable or deductible **balancing adjustment** where an asset, that is not allocated to a pool, is no longer held or used (e.g. disposed of, lost or destroyed).

Where an asset is allocated to a **pool**, the taxpayer's decline in value deduction for an income year is calculated on a whole of pool basis (i.e. individual assets are not tracked) and disposal proceeds reduce the pool's balance.

Application

Depreciating asset

A deduction for decline in value is only available where there is a 'depreciating asset'. A 'depreciating asset' as defined under s. 40-30, as:

- an asset that has a **limited effective life,** and
- can reasonably be **expected to decline in value** over the time it is used (e.g. a machine, a car, a computer, etc.). Some items are not inherently likely to decline in value (e.g. some precious metals like gold, other items like jewellery, crystals etc.).

There is no requirement that the asset be income-producing. The definition therefore covers private and non-income-producing assets.

Exclusions

The definition of a depreciating asset under s. 40-30 specifically excludes **land**, **trading stock** (as defined in Unit 1), and **intangible assets** unless specifically included (see below).

Under s. 40-45, the following assets are also specifically excluded from the application of the capital allowance provisions in Division 40:

- An asset provided to an employee as a fringe benefit that is an eligible work-related item under s. 58X FBTAA 1986 (see Unit 3).
- Buildings and structural improvements to which a Division 43 capital works deduction applies (see later in this unit).

Inclusions

The following **intangible assets** are specifically included in the definition of a depreciating asset under s. 40-30, provided they are not trading stock:

- Mining, quarrying and prospecting rights.
- Intellectual property that is a patent, registered design or copyright (i.e. not all items of intellectual property are depreciating assets, e.g. a trademark is excluded).
- In-house software (i.e. software that is purchased or developed to help run the taxpayer's business).
- Spectrum and datacasting transmitter licences.

An animal can be a depreciating asset (e.g. guard dogs used by a security business, or see TR 2008/2 in relation to racehorses).

A depreciating asset can also include an improvement to land or a fixture on land, whether the improvement or fixture is removable or not – as if it was an asset that is separate from the land.

A composite item can be a single depreciating asset or more than one depreciating asset depending on the relative functions of the entire item, as against its components, and the circumstances in which it is used (see TR 2017/D1).

Holder

A deduction for decline in value is available to the entity that is the 'holder' of a depreciating asset under s. 40-40. The holder is usually the legal owner (item 10) but can sometimes be the economic user (economic owner) of the asset (e.g. item 6).

Example – Holder of a depreciating asset

Harvey Enterprises Pty Ltd (Harvey) is the legal owner of a mobile packaging machine, which it leased out to Bibs 'n Bobs on 1 July 2018 for 12 months. Under the lease agreement, Bibs 'n Bobs may, at any time, exercise its rights under the option agreement and take immediate possession of the machine for a nominal value of $1. Bibs 'n Bobs would also then become the legal owner of the equipment if it exercised this option. The machine is in high demand and its market value at the end of the lease is estimated to be $20,000.

Bibs 'n Bobs is the economic owner of the machine under s. 40-40 Item 6, because:

- It 'possesses the asset, or has a right as against the former holder [Harvey] to possess the asset immediately'.
- It 'has a right as against the former holder [Harvey] the exercise of which would make the economic owner [Bibs 'n Bobs] the holder'.
- 'It is reasonable to expect that the economic owner [Bibs 'n Bobs] will become its holder by exercising the right, or that the asset will be disposed of at the direction and for the benefit of the economic owner [Bibs 'n Bobs].'

Therefore, Bibs 'n Bobs is the holder of the depreciating asset and, subject to satisfying the other Division 40 requirements, can claim a decline in value deduction.

Required reading

Sections 40-30 and 40-40 ITAA 1997.

Cost

Once the holder of a depreciating asset has been identified, the cost of the depreciating asset needs to be determined in order to calculate its decline in value to the holder. Generally, the cost of a depreciating asset consists of amounts that a taxpayer has paid, or is taken to have paid, in relation to the asset.

General rules (first and second elements)

The cost of a depreciating asset is the sum of the costs that the holder of that asset has incurred, either to hold the asset or to bring it to its present condition and location. Therefore, the cost of a depreciating asset may consist of **two elements** (s. 40-175):

- **First element costs** (s. 40-180 and s. 40-185) – unless a special rule applies, these are the costs that are incurred **when** the taxpayer starts to hold the asset. Typically, the 'first element of cost' is the amount a taxpayer has **paid to hold** a depreciating asset (s. 40-185(1) item 1). However, it also includes any amount of liability assumed (s. 40-185(1) item 2) provided that the liability is not deductible to the purchaser (s. 40-215).
- **Second element costs** (s. 40-190) – these are the costs that are incurred **after** the taxpayer starts to hold the asset, including:
  - Amounts which have contributed to bringing the asset to its present condition and location (e.g. where a canopy is added to a 'ute' and relocation costs). This would include material and labour costs.
  - Any expenditure incurred that is reasonably attributable to a balancing adjustment happening to the asset (e.g. costs incurred in demolishing an old asset would form part of the second element costs of the **old** asset, but not the new replacement asset).

Inclusions

The following types of expenditure are likely to be **included** as second element costs:

- Freight and delivery costs.
- Customs duties and other import levies.
- The cost of modifications, alterations or improvements to a depreciating asset.
- The cost of minor rearrangements and removal of other plant and equipment at the relevant premises to enable the new plant to be installed.
- Initial repairs (see repairs covered in Unit 1).

Both first and second element costs **can include** non-cash benefits that a taxpayer has provided. Non-cash benefits are covered in Unit 1.

Exclusions

Second element costs **do not include** the following:

- Costs incurred in making structural alterations to a building in which plant and equipment is to be housed. Such costs may qualify for deduction as capital works under Division 43 (see later in this unit).
- Post-installation costs (e.g. the cost to train staff to operate a machine).
- Goods and services tax (GST) input tax credits and decreasing adjustments (Subdivision 27-B), if the taxpayer is entitled to claim them.
- Amounts that are otherwise deductible outside Division 40 (s. 40-215) (e.g. repairs to an asset that are deductible under s. 25-10 and borrowing costs deductible under s. 25-25 – see Unit 1).
- Expenses that are not of a capital nature (s. 40-220) (e.g. interest incurred in borrowing money to acquire the depreciating asset, which is deductible under s. 8-1).

Special rules

There are special rules for establishing cost in certain circumstances:

- Depreciating assets brought into a **partnership** are deemed to have a cost equal to their market value (s. 40-180(2) item 5).
- Where the depreciating asset is acquired for **more than an arm's-length value** from a related party, its market value is substituted for the first element of cost (i.e. the cost is reduced). In contrast to CGT rules (see Unit 4), no substitution is required where the depreciating asset is acquired for less than market value (s. 40-180(2) Item 8) – that is, there is no cost uplift for depreciating assets.
- When the depreciating asset is **acquired with other assets** without a separately allocated cost for its acquisition (refer ATO ID 2002/818), or a depreciating asset is **split into separate assets**, the cost of the depreciating asset is the part of the acquisition or split that can be reasonably attributed to the depreciating asset (ss 40-195, 40-115 and 40-205) (see 'Splitting and merging assets' later in the unit).
- When the depreciating asset is a **car**:
  - Where the car is **acquired at a discount** because another depreciating asset is disposed of for less than its market value, the first element of cost is increased by that discount (s. 40-225).
  - Where the car's **cost (exclusive of GST claimable as an input tax credit) exceeds the 'car cost limit'**, the first element of cost is reduced to the amount of the car cost limit for the income year in which the car is acquired (s. 40-230). For the income year ended 30 June 2019 the car cost limit is $57,581 under TD 2018/6 (unchanged for the 2019–2020 income year – annual determinations by the ATO are no longer published). However, this limitation does not apply to the modifications made to a car for the use of disabled individuals.

  Under s. 995-1, a **car** means a motor vehicle (except a motor cycle or similar vehicle) designed to carry a load of less than one tonne **and** fewer than nine passengers. A motor vehicle means any motor-powered road vehicle (including a four-wheel drive vehicle). Therefore, a car generally includes:

  - Motor cars, station wagons, panel vans and utilities (excluding panel vans and utilities designed to carry a load of one tonne or more).
  - All other goods-carrying vehicles designed to carry less than one tonne.
  - All other passenger-carrying vehicles designed to carry fewer than nine occupants.

Example – Cost of a car

- Where a car is acquired for $66,000 inclusive of GST, the cost after the reduction for the input tax credit that can be claimed is $60,765 (i.e. $66,000 – $5,235; the GST input tax credit is $5,235 as it is limited to $^1/_{11}$ of the car depreciation cost limit (see Unit 2)). As $60,765 is more than the car cost limit, the cost of the car for depreciation purposes is reduced to $57,581.
- Where a car is acquired for $60,000 inclusive of GST, the cost after the reduction for the input tax credit that can be claimed is $54,765 (i.e. $60,000 – $5,235). As $54,765 is less than the car cost limit, it is the cost of the car for depreciation purposes (i.e. there is no further reduction).
- Where a car is acquired for $55,000 inclusive of GST, the cost after reduction for the input tax credit that can be claimed is $50,000 (i.e. $55,000 – $5,000; the GST input tax credit is equal to the actual GST component as it is less than $^1/_{11}$ of the car depreciation cost limit). As $50,000 is less than the car cost limit, it is the cost of the car for depreciation purposes (i.e. there is no further reduction).

Required reading

Sections 40-175, 40-180, 40-185, 40-190, 40-225 and 40-230 ITAA 1997.

Effective life

The effective life of a depreciating asset is generally used to determine the rate at which the asset will decline in value during an income year. It is not applicable where the taxpayer is an SBE that has chosen to apply the SBE capital allowance rules (see Unit 6) or where the taxpayer has elected to pool eligible assets (see later in this unit).

Broadly, the effective life of a depreciating asset is the period of time that it can be expected to be used by **any entity** (not just the current owner of the asset) for income-producing purposes, if it is kept in good order and condition. Second-hand condition can be taken into account. For example, if a lessor uses an asset for five years and then sells the asset, the effective life is five years **plus** the period that the purchaser will use the asset for. This is a common error in practice.

Measurement methods

Taxpayers generally have a choice, under s. 40-95, of two methods for working out the effective life of a depreciating asset:

- The taxpayer can **self-assess** the asset's effective life based on how long it could be used if it was kept in reasonably good working condition (s. 40-105).
- The taxpayer can rely on the **Commissioner's determination** (s. 40-100). For the 2018–2019 income year see TR 2018/4 (for the 2019–2020 income year see TR 2019/5). Unless there are large, expensive, tailor-made items of plant (e.g. power stations etc.), most businesses use the Commissioner's determination in order to avoid disputes with the ATO and the compliance costs of proving an alternative effective life.

A choice of effective life is **not available** when an asset is acquired from an associate (s. 40-95(4)) or has a statutorily prescribed effective life (see below).

Statutorily prescribed life

The effective life of a depreciating asset is **statutorily prescribed** for the following:

- **Intangible assets** under s. 40-95(7). For example:
  - Standard patent – 20 years.
  - Copyright (except film) and related licences – lesser of 25 years and the period until it ends.
  - Registered designs – 15 years.
  - In-house software and related licences – 5 years.

    This includes software that is acquired (i.e. off the shelf) or developed, and is used by the taxpayer in performing the functions for which it was developed (s. 995-1). It does not include any amounts that are deductible outside Division 40 (e.g. costs to maintain a website, off-the-shelf software that is licensed periodically, etc. – see TR 2016/3).
  - Other licences (including a spectrum licence) – term of the licence.
- **Certain other assets** under s. 40-102. For example:
  - Bus with a gross vehicle mass of more than 3.5 tonnes – 7.5 years.
  - Light commercial vehicle (e.g. delivery van) – 7.5 years.

Note: The Government had introduced draft legislation to provide taxpayers with an option to self-assess the effective life of certain intangible assets acquired on or after 1 July 2016 (i.e. intangible assets as per the table in s. 40-95(7)). However, the Government subsequently removed this proposal from the draft legislation before it was finalised. As legislation to implement this measure had yet to be re-introduced and finalised at the time of writing, it is outside the scope of the TAXAU module. In practice you may need to consider its implications.

Re-estimation requirements

The legislation allows for the **re-estimate** of a depreciating asset's effective life (s. 40-110). The rules, broadly, are as follows:

- A taxpayer may choose to recalculate the effective life of a depreciating asset where the effective life that has been used is no longer accurate due to changed circumstances relating to the asset's use.
- A taxpayer must recalculate the effective life of a depreciating asset where its cost increases by at least 10% (exclusive of GST) during an income year. This could arise, for example, because of substantial improvements to the asset.

> **Required reading**
>
> Sections 40-95, 40-100, 40-102, 40-105 and 40-110 ITAA 1997.

Start time

A depreciating asset starts to decline in value from its 'start time' – that is, when the asset is first used or installed ready for use for any purpose (not just a taxable purpose) (s. 40-60). This includes a private purpose.

For the purposes of working out the decline in value, the number of days held is calculated from (and including) the day the asset is installed and ready for use for any purpose, whether income producing or not.

For example, an asset acquired on 15 June will have 16 days of depreciation in the first income year. An asset acquired on 30 June will have one day of depreciation.

> **Required reading**
>
> Section 40-60 ITAA 1997.

Adjustable value

Adjustable value (i.e. written-down value) is the asset's cost less its decline in value since first used (or installed ready for use) for any purpose, whether business or private.

In other words, under s. 40-85, cost is reduced by the decline in value to date, regardless of whether the decline in value has been deducted (i.e. ignoring any adjustments for non-taxable use and for second-hand assets in certain residential rental properties).

> **Required reading**
>
> Section 40-85 ITAA 1997.

Decline in value (i.e. tax depreciation)

General rules

A taxpayer can generally **choose one** of two methods to calculate the decline in value for depreciating assets that are held during an income year (s. 40-65). These methods are the prime cost (PC) method and the diminishing value (DV) method.

Key points to note for the taxpayer's choice of method are as follows:

- The taxpayer must choose either one of these methods for the **first income year** in which they are allowed a decline in value deduction for the depreciating asset.
- The choice is exercised on an **item-by-item basis**.
- Once the taxpayer has chosen the method of calculation for a particular depreciating asset, that choice **cannot be changed** (s. 40-130). However, assets that were depreciated using the DV method and which have become low-value assets can be subsequently allocated to a pool (see pooled assets below).

However, the choice of method is **not** available for the following:

- **Intangible assets**, which must be depreciated using the PC method (s. 40-72(2)).

  Intangible assets also have a prescribed effective life under s. 40-95(7) where the taxpayer has not self-assessed the asset's effective life (see earlier in this unit). Therefore, for example, in-house software (i.e. software that is acquired or developed and used by the taxpayer in performing the functions for which it was developed) is depreciated at a rate of 100% ÷ 5 years effective life = 20% of its PC each year, subject to the number of days in each year.
- **Assets acquired from an associate**, which must be depreciated on the same basis as used by the associate (s. 40-65(2)) and with the same effective life (s. 40-95(4)). For example:
  - If the associate was using the DV method for the asset – the taxpayer must use the DV method and the same effective life that the associate was using.
  - If the associate was using the PC method for the asset – the taxpayer must use the PC method and an effective life equal to any period of the asset's effective life that is yet to elapse at the time the taxpayer started to hold it.

Unlike accounting depreciation, the PC and DV methods do not take into account any estimated residual value on disposal for the depreciating asset.

The PC and DV methods are **not applicable** where the taxpayer is an SBE that has chosen to apply the SBE capital allowance rules (see Unit 6), has elected to pool eligible assets, or is entitled to an immediate deduction (see below).

Prime cost method

Where the PC method is chosen or must be applied, it provides for fixed decline in value deductions on an annual basis (s. 40-75). The formula used in the PC method is:

$$\text{Cost} \times \frac{\text{Days held during income year}}{365} \times \frac{100\%}{\text{Asset's effective life}} = \text{Decline in value}$$

Key points to note for the PC method are as follows:

- The formula must be adjusted in later income years if the effective life is recalculated or there are second element costs.
- Days held during income year includes both the date of acquisition and disposal.
- The calculated decline in value is **reduced by any non-taxable use** (s. 40-25) and for **second-hand assets** in certain residential rental properties (s. 40-27) to arrive at the deduction. However, a reduction to the decline in value deduction is not reflected in the calculation of adjustable value for the depreciating asset.

Diminishing value method

Where the DV method is chosen, the decline in value is based on a percentage of the asset's adjustable value (i.e. its closing written-down value) of the prior year (s. 40-70).

Where the asset was acquired on or after 10 May 2006, the formula used to calculate the decline in value for a particular income year is (s. 40-72):

$$\text{Base value} \times \frac{\text{Days held during income year}}{365} \times \frac{200\%}{\text{Asset's effective life}} = \text{Decline in value}$$

Where **base value** of a depreciating asset:

- In the first income year is its cost.
- In a subsequent income year is calculated as follows:

$$\text{Cost} - \text{Decline in value to date} = \text{Opening adjustable value (s. 40-85)}$$

$$\text{Opening adjustable value} + \text{Second element costs in later income year} = \text{Base value}$$

Key points to note for the DV method are as follows:

- The decline in value of an asset for an income year can never exceed its base value.
- Days held during income year includes both the date of acquisition and disposal.
- There is no requirement for capital allowances to be apportioned when a second element of cost is incurred during an income year. For example, if an improvement is made to an asset on the last day of the year, depreciation is available for the full opening adjustable value plus the second element cost (ss 40-70 and 40-72).
- As stated under the PC method above, the calculated decline in value is **reduced by any non-taxable use** (s. 40-25) and for **second-hand assets** in certain residential rental properties (s. 40-27) to arrive at the deduction. However, a reduction in the decline in value deduction is not reflected in the calculation of adjustable value for the depreciating asset – that is, the base value is reduced by the total decline in value for the particular income year irrespective of whether a decline in value deduction was claimed.
- The DV method gives greater tax deductions in earlier years and smaller tax deductions in later years.

Note: The above formula for the PC method and DV method use 365 days, rather than referring to the number of days in the income year, as this is what is specifically included in the income tax legislation. Due to this drafting anomaly, leap years are technically not taken into account in the denominator. For the purposes of calculations in the TAXAU module, the impact of leap years is fully ignored (i.e. it is assumed that February always has 28 days). In practice, the impact of leap years may be taken into account in both the numerator and the denominator.

Required reading

Sections 40-65, 40-70, 40-72, 40-75, 40-85 and 40-130 ITAA 1997.

Worked example 5.1: Depreciating assets – decline in value

[Available online in myLearning]

Immediate deduction

An immediate deduction (i.e. decline in value deduction for the total cost) is available for certain depreciating assets that are used in deriving assessable income.

Assets used in producing non-business income

Under s. 40-80(2), the **decline in value** of a depreciating asset is the asset's **cost** if:

- the cost does not exceed $300 (GST-inclusive) (e.g. a briefcase for work)
- the asset is used predominantly for the purpose of producing assessable income that is not income from carrying on a business (e.g. salary income, rental property income)
- the asset is not part of a set of assets acquired in an income year where the total cost of the set of assets exceeds $300
- the total cost of the asset and any other identical, or substantially identical, assets acquired in the income year does not exceed $300.

Example – Assets acquired in a set

Sacha owns a fully furnished rental property. During the income year, Sacha purchased four new kitchen stools at a total cost of $1,000.

Sacha may be entitled to an immediate deduction under s. 40-80 as she is deriving non-business income and each stool costs $250. However, as the stools belong to a set, an immediate deduction is not allowed as the total cost of the set of assets exceeds $300.

Assets used in producing business income

Under s. 40-82, the **decline in value** of a depreciating asset in the income year that it is first used, or installed for use, for a taxable purpose, is the asset's **cost** (or opening adjustable value plus current year second element costs if the asset's start time occurred in an earlier income year) if:

- the cost is less than $30,000
- the asset is acquired in the period from 7.30pm on 2 April 2019 to 30 June 2020
- the current year ends in the period from 2 April 2019 to 30 June 2020
- the taxpayer is a 'medium sized business' for the current income year and for the income year in which it started to hold the asset.

A taxpayer is a medium sized business if it is not a small business entity (SBE), but would be a SBE if each reference to $10 million aggregated turnover in the SBE eligibility conditions (under Subdivision 328-C) were instead a reference to $50 million aggregated turnover (see Unit 6).

As for the PC method and the DV method, the decline in value amount determined above is **reduced by any non-taxable use** to arrive at the deduction for the current income year (s. 40-25).

Where s. 40-82 applies, the depreciating asset's **adjustable value is reduced to $Nil**. If the asset is subsequently disposed of, there will be a balancing adjustment event and the asset's terminating value (i.e. proceeds of sale) will give rise to an assessable balancing adjustment for the taxpayer (see later in this unit under 'Balancing adjustments').

Where s. 40-82 does not apply to a taxpayer carrying on a business that is not an SBE, the ATO will allow items, that have a **GST-inclusive cost of $100** and that are **expensed for accounting purposes**, to be claimed as an **outright tax deduction** (PS LA 2003/8). For example, if a company acquires a calculator for $80, it can be assumed, for tax purposes, to be revenue in nature and deducted immediately under s. 8-1.

Required reading

Sections 40-80(2) and 40-82 ITAA 1997.

Decline in value reductions

As noted earlier, the section that allows a deduction for the decline in value of a depreciating asset is s. 40-25. However, a limitation may be placed on the amount that can be claimed under this section. These limitations (or reductions) do not change the decline in value of a depreciating asset for the income year nor its adjustable value.

Non-taxable use

A tax deduction for the decline in value is only available when the depreciating asset is used for a taxable purpose. Therefore, the amount of the decline in value calculated must be reduced to reflect its use for any purpose other than a taxable purpose from the start time (s. 40-25(2)).

For example, assume Ben is a non-business taxpayer who holds a depreciating asset that he uses for private purposes for 30% of his total use in the income year. If the asset declines in value by $1,000 in the current income year, Ben would have to reduce the decline in value by $300 (i.e. 30% of $1,000), and therefore would only be entitled to an income tax deduction of $700.

Note: A balancing adjustment must also be reduced for non-taxable use (see below under 'Balancing adjustments').

Second-hand assets in residential rental properties

From 1 July 2017, a tax deduction for the decline in value is not available under s. 40-27 for depreciating assets related to the use of residential premises to provide residential accommodation (i.e. depreciating assets in a residential rental property) where either of the follow apply:

- The taxpayer was not the holder of the asset when it was first used or installed ready for use (other than as trading stock) by any entity (e.g. it is a second-hand asset).
- The asset was used or installed ready for use at any time either in the taxpayer's residence or for a non-taxable purpose, and in a way that was not occasional.

However, this deduction reduction provision does not apply where:

- The taxpayer is carrying on a business.
- The taxpayer is a company, superannuation fund (excluding a self-managed fund), managed investment trust or public trading trust.
- The asset is supplied to the taxpayer as part of new residential premises (or within six months of the supply of new residential premises).

For example:

- Where an individual taxpayer acquires an existing rental property that has a dishwasher installed at the time of acquisition (i.e. it is a second-hand dishwasher), the decline in value deduction on the dishwasher is reduced to $0 under s. 40-27 (i.e. the individual is not entitled to claim a deduction).
- Where an individual taxpayer acquires an existing rental property and after the acquisition installs a new dishwasher in the property, there is no reduction in the decline in value deduction (i.e. the individual is entitled to claim the decline in value as a deduction).
- Where an individual taxpayer acquires a new rental property (i.e. off the plan from a developer) that has a dishwasher installed at the time of acquisition (i.e. it is a new dishwasher supplied as part of a new residential premises acquisition), there is no reduction in the decline in value deduction (i.e. the individual is entitled to claim the decline in value as a deduction).

Required reading

Sections 40-25 and 40-27 ITAA 1997.

Balancing adjustment

Application

A balancing adjustment is similar to an accounting profit or loss on the sale of a depreciating asset. A balancing adjustment is included in a taxpayer's taxable income in the income year of the balancing adjustment event.

A balancing adjustment event (s. 40-295) occurs when a taxpayer either:

- stops **holding** a depreciating asset, or
- permanently stops **using** a depreciating asset for any purpose (whether or not it has ever actually been used).

'**Hold**' has the meaning given by s. 40-40. Therefore, a taxpayer will usually stop holding a depreciating asset when they are no longer its legal owner.

For example, where a taxpayer sells a rental property, they will stop holding the fixtures and fittings (i.e. depreciating assets) in the rental property as at the time the contract of sale settles. However, note that for CGT purposes, the taxpayer is taken to have disposed of the land and buildings (under CGT event A1) as at the time the contract of sale was entered into (see Unit 4). The taxpayer therefore needs to take these different timings into account when apportioning the proceeds of disposal under a contract of sale between the depreciating assets and the assets subject to CGT.

Calculation method

The balancing adjustment calculation compares the **termination value** and the **adjustable value** (i.e. written-down value) of the depreciating asset at the time of the balancing adjustment event to determine whether the asset has been over-depreciated or under-depreciated for tax purposes. This is because the aim of the capital allowances system is to provide deductions that are equivalent to the overall cost to a taxpayer of having held an asset.

Assessable balancing adjustment

Under s. 40-285(1), an assessable balancing adjustment is calculated as follows:

Termination value	–	Adjustable value	=	Assessable balancing adjustment amount

Deductible balancing adjustment

Under s. 40-285(2), a deductible balancing adjustment is calculated as follows:

Adjustable value	–	Termination value	=	Deductible balancing adjustment amount

A deductible balancing adjustment is available under s. 40-285(2) if an asset is sold for a loss, including (but not limited to) situations where the asset has not ever actually been used (refer ATO ID 2003/185 and item 2 of s. 40-300(2)).

Termination value

Termination value is what is received, or taken to be received, for the asset when a balancing adjustment event occurs – typically, the proceeds of selling an asset.

Under s. 40-300, termination value is calculated as the amount received on disposal of the depreciating asset less any disposal costs. However, where an asset is disposed of at less than its market value (but not over its market value), market value is substituted under s. 40-300 item 6.

There are also special rules for determining the termination value of a car (see below).

Special rule for cars

The decline in value deduction for a car is restricted to the car cost limit, which is $57,581 for the income year ended 30 June 2019. As the decline in value deduction is based on this capped amount, when a car is disposed of, the termination value of the car is adjusted downwards.

The termination value is adjusted under s. 40-325 as follows:

$$\text{Termination value} \times \frac{\text{Car limit in year car was first held + second elements of the car's cost}}{\text{Total cost of the car (ignoring the car limit) after applying Subdivision 27-B (i.e. excluding GST)}}$$

Refer to ss 27-95(1) and (2) in relation to applying Subdivision 27-B:

(1) The termination value of a depreciating asset is reduced if the relevant balancing adjustment event is a taxable supply. The reduction is an amount equal to the GST payable on the supply.

(2) However, subsection (1) does not apply if the termination value of the depreciating asset is modified under Division 40 to be its market value.

The termination value adjustment needs to take into account the GST credit on the acquisition. Under s. 69-10 GST Act, the GST credit is limited to $^1/_{11}$ of the car cost limit.

Example – Disposal of a car exceeding the cost limit

Bestofluck Pty Ltd (Bestofluck) acquired an Audi car for $88,000 (inclusive of GST) and sold it approximately two years later when it had an adjustable value of $29,000. The car limit for the year in which the car was first held was $57,581 (i.e. for the income year ended 30 June 2017). There are no second elements of cost. The car was sold for $66,000 (inclusive of GST).

To calculate whether there is an assessable or deductible balancing adjustment amount on the disposal of the car to be included in Bestofluck's taxable income, the adjusted termination value needs to be calculated.

Step 1 – exclude the GST component from the termination value

$66,000 – [$66,000 × (1/11)] = $60,000

Step 2 – adjust the termination value downwards to reflect the $57,581 car limit

$60,000 × $57,581 ÷ [$88,000 – ($57,581 × 1/11)]

= $60,000 × $57,581 ÷ $82,765

= $41,743

Step 3: the balancing adjustment is an assessable balancing adjustment:

$41,743 termination value – $29,000 adjustable value = $12,743

Note:

- The total cost of the car (excluding GST) in the denominator is $82,765, which is calculated by subtracting the GST input tax credit of $5,236 (i.e. $^1/_{11}$ of $57,581) from the $88,000 cost.
- If the car in this example was acquired in the income year where the car cost limit is not $57,581, then the car cost limit applied above would be that other limit rather than $57,581.

Required reading

Sections 40-285, 40-300, 40-305 and 40-325 ITAA 1997.

Balancing adjustment reductions

Non-taxable use

Where an asset has been used for a non-taxable purpose, the balancing adjustment amount is reduced, in proportion to the extent of use of the depreciating asset for non-taxable purposes.

The reduction under s. 40-290 is the amount of the balancing adjustment multiplied by the sum of the reductions in the decline in values to date divided by the total decline in value.

To the extent the balancing adjustment is reduced, CGT event K7 will apply (see Unit 4 and later in this unit under 'Interaction with CGT').

Second-hand assets in residential rental properties

The decline in value deduction for second-hand assets in certain residential rental properties is restricted. Where the deduction has been reduced and the asset is subsequently disposed of, the balancing adjustment is also reduced. The reduction under s. 40-291 is the amount of the balancing adjustment multiplied by the sum of the reductions in the decline in value to date divided by the total decline in value.

For example, where no decline in value deduction was available, the balancing adjustment amount will be reduced by 100%, that is to $0. However, CGT event K7 will allow a capital gain or capital loss on the disposal (see Unit 4 and later in this unit under 'Interaction with CGT').

Worked example 5.2: Depreciating assets – balancing adjustments

[Available online in myLearning]

Activity 5.1: Depreciating assets – decline in value and balancing adjustments

[Available online in myLearning]

Involuntary disposals

A taxpayer may choose to exclude some or all of a balancing adjustment amount resulting from an involuntary disposal of a depreciating asset. Under s. 40-365, where a taxpayer ceases to hold a depreciating asset because it is:

- lost or destroyed
- compulsorily acquired by an Australian Government agency, or
- disposed of to an Australian Government agency after compulsory negotiations,

the taxpayer can choose whether or not to include a balancing adjustment in assessable income. The taxpayer may choose instead to include some or all of the amount that would otherwise be a balancing adjustment as a **reduction in the cost**, or in the base value, of one or more **replacement assets**.

Any replacement asset must be:

- acquired no earlier than one year before the involuntary disposal occurred or no later than one year after the end of the income year in which the involuntary disposal occurred, and
- used by the taxpayer, or be installed and ready for use, for a wholly taxable purpose by the end of the income year in which the taxpayer started to hold it.

Required reading

Section 40-365 ITAA 1997.

Pooled assets

To simplify the calculation of a decline in value and balancing adjustments, a taxpayer can elect to use 'depreciation pools'. Low-value pools can also accelerate deductions in certain situations.

The following pooling rules are separate to the pooling rules that are applicable where the taxpayer is an SBE that has chosen to apply the SBE capital allowance rules (see Unit 6).

Low-value pools

Under s. 40-425, taxpayers can choose to establish low-value pools for eligible assets. The rates that apply to calculating the decline in value deduction for assets in a low-value pool are outlined below.

Calculating the decline in value deduction for assets in a low-value pool

Type of asset	Eligible assets[1]	Other issues	Rate of decline in value (s. 40-440)
Low-cost assets	Assets that cost less than $1,000[2]	All low-cost assets of that or any later year must be pooled once a pooling choice is made (i.e. an 'all in' principle applies) (s. 40-430)	Current year additions = 18.75% of the taxable purpose proportion Subsequent years (i.e. closing pool balance from previous year) = 37.5%
Low-value assets	Assets with an opening adjustable value for the current year of less than $1,000 that have declined in value under the DV method Note: Assets which are depreciated on a PC basis are **not** low-value assets	Not compulsory to allocate all low-value assets to the low-value pool (i.e. the 'all in' principle does **not** apply)	Current year additions for balances re-allocated from DV method calculations in previous year = 37.5% of taxable purpose proportion Current year additions for second element costs of pooled assets (i.e. costs incurred in the current year) = 18.75% of taxable purpose proportion Subsequent years (i.e. closing pool balance from previous year) = 37.5%

Notes

1. Horticultural plants and grapevines cannot be pooled as low-value assets.
2. Software that is acquired for less than $1,000 can be allocated to a low-value pool. However, software that is acquired for more than $1,000 cannot be allocated to a low-value pool once its adjustable value is less than $1,000. Since it is required to be depreciated using the PC method, it would not be a 'low-value asset' (s. 40-70(2)).
3. Under s. 40-425 (7A), a taxpayer cannot allocate a depreciating asset to a low-value pool if the decline in value for the asset for the income year is determined under s. 40-82 (about assets costing less than $30,000 of a medium sized business).

For example, assume a taxpayer has a low value pool with an opening balance (i.e. closing balance at the end of prior year) of $2,250. During the current year the taxpayer transfers an asset with an adjustable value (i.e. written down value using the DV method) of $950 into the pool and incurs $200 on enhancing a pooled asset (i.e. a second element cost). The taxpayer's decline in value in the low value pool for the year is: ($2,250 × 37.5%) + ($950 × 37.5%) + ($200 × 18.75%) = $1,238.

Taxable purpose portion

Taxpayers who allocate a depreciating asset to a low-value pool are required under s. 40-435 to make a reasonable estimate of the percentage of the asset's use that will be for a taxable purpose (i.e. an income-producing purpose). The taxable purpose proportion is added to the low-value pool. If this percentage changes later, no adjustment can be made.

Balancing adjustment events

Under s. 40-445, when a balancing adjustment event occurs for a depreciating asset that has been, or will be, allocated to a low-value pool, the depreciating asset's **termination value is subtracted from the pool balance**.

If the asset has not been used exclusively for a taxable purpose, the asset's termination value is **reduced by the non-taxable purpose proportion**. This is because only the taxable purpose portion was allocated to the pool (see above). To the extent that the amount allocated to the pool is reduced for non-taxable use, CGT event K7 will apply (see Unit 4 and later in this unit under 'Interactions with CGT').

Where the termination value exceeds the closing balance of the pool, the **excess is included in assessable income** (s. 40-445).

Required reading

Sections 40-425, 40-430, 40-435 and 40-440 ITAA 1997.

Worked example 5.3: Depreciating assets – low value pool

[Available online in myLearning]

Software development pools

Taxpayers have the option of deducting expenditure that is incurred in developing in-house software (i.e. software used by the taxpayer in performing the functions for which it was developed) on a pooled basis. However, this option does not apply for in-house software that is acquired (e.g. off-the-shelf software packages).

The expenditure for the year that is allocated to a software development pool is deductible at the following rates (s. 40-455).

Deductions for software development pools (s. 40-455)	
Income year deduction	**Rate of deduction %**
Year 1	Nil
Year 2	30
Year 3	30
Year 4	30
Year 5	10

The following key points apply to in-house software development pools:

- Once a choice to create an in-house software development pool is made for an income year, any development expenditure incurred after that time (whether in that income year or a later one) must be allocated to the pool (s. 40-450).
- Development expenditure can only be pooled if the taxpayer intends to use the software solely for a taxable purpose (s. 40-450).
- A separate in-house software development pool must be created for each income year (s. 40-450).
- Any amount derived as consideration in respect of development expenditure that has been pooled is included in the taxpayer's assessable income (s. 40-460). It **does not** reduce the pool balance.

Note: If in-house software developed by a taxpayer is not allocated to a software development pool, it is depreciated on a PC basis, unless its cost is less than $1,000, in which case it can be allocated to a low-value pool.

Change in ownership or interests

Partnership or interests of partners

The definition of 'balancing adjustment event' in s. 40-295 includes situations in which there is a change in the interests of persons who own a depreciating asset. This could occur because of either:

- the formation or dissolution of a partnership, or
- a variation in the constitution of a partnership, or in the interests of the partners.

Where such a change occurs, s. 40-300 treats the taxpayer as having disposed of their interest at market value (s. 40-300(2) item 5), unless a joint election is made under s. 40-340(3). If such an election is made, s. 40-340 provides relief from any balancing adjustment.

Splitting and merging assets

There are special rules that apply when a depreciating asset is split into more than one asset (s. 40-115), or more than one asset is merged into a single asset (s. 40-125).

In the case of a **split**, the taxpayer is treated as if they had stopped holding the first asset (i.e. the original asset) at the time of the split and started holding new assets (i.e. the assets resulting from splitting the first asset) at the same time.

A similar treatment is applied in the case of a new asset being created from the **merging** of other assets. That is, the taxpayer is treated as if they had stopped holding the separate assets (i.e. the original assets) and started holding the new asset (i.e. the asset resulting from merging the separate assets).

Split assets should be allocated a reasonable proportion of the adjustable value of the original asset just before the split, as well as any costs involved in the split (s. 40-205).

A merged asset is taken to cost an amount that is calculated by adding together the adjustable values of the separate assets immediately before the merger and any costs involved in the merger.

The taxpayer is treated as if they had started holding the new assets at the time the split or merger occurred. Therefore, the effective life of the new assets needs to be reassessed to calculate the decline in value. There is no balancing adjustment brought about by a split or merger (s. 40-295(3)).

Required reading

Sections 40-115, 40-125, 40-205, 40-295, 40-300 and 40-340 ITAA 1997.

Interaction with CGT and trading stock

Depreciating assets where decline in value is fully deductible

The CGT regime encompasses all 'CGT assets'. This, by definition, includes types of depreciating assets.

However, to prevent the occurrence of double taxation or double deductions, capital gains or losses are disregarded where there is a balancing adjustment event in respect of depreciating assets where the decline in value of the asset is fully deductible (s. 118-24). For example, where the asset is used solely for taxable purposes.

This effectively excludes most depreciating assets from the CGT regime and allows them to be dealt with exclusively under Division 40.

Depreciating assets where decline in value is partly non-deductible – CGT event K7

CGT event K7 applies where any part of the balancing adjustment for the depreciating asset is reduced because a proportion of the deductions for decline in value was not allowable or where any part of the cost allocated to a pool is reduced.

CGT event K7 could occur where:

- The asset was wholly or partly used for private purposes or non-income-producing purposes.
- The asset is a second-hand asset used in certain residential rental properties.

CGT event K7 can result in either a capital gain or loss. However, due to the operation of s. 118-10(3), a capital gain or loss may be otherwise disregarded if it is a personal use asset like a boat used for private purposes and acquired for less than $10,000 (discussed in Unit 4).

If the use of a depreciable asset (that is not an asset to which s. 40-27 applies) is 100% taxable, CGT event K7 would not apply. If the use is 100% non-taxable, there will be a capital gain or loss under CGT event K7 based on the difference between the assets terminating value and its cost (s. 104-240 and s. 104-245).

An example applying CGT event K7 to a non-pooled asset is included in Unit 4.

Required reading

Sections 104-240 and 104-245 ITAA 1997.

Depreciating assets becoming or ceasing to be trading stock

It is possible for a depreciable asset to change its tax character – that is, it can change from a depreciable asset (e.g. a company car for the managing director of a car retailer) to trading stock (e.g. a car to be sold to the public by the car retailer), or vice versa.

The provisions applicable to trading stock are set out in Division 70. The definition of trading stock in s. 70-10 caters for changes in an asset's use by looking at the asset's **current** use, rather than the original purpose of its acquisition.

As discussed in Unit 1:

- Under s. 70-30, where a taxpayer starts holding as trading stock an item that it already owns, but does not hold as trading stock (i.e. held as a depreciable asset), there is a deemed disposal and reacquisition of the item by the taxpayer at either its cost or market value.
- However, under s. 70-110, where an item stops being trading stock of a taxpayer, but continues to be held by the taxpayer (i.e. held as a depreciable asset), there is a deemed disposal and reacquisition of the item at cost.

The income tax treatment of depreciable assets becoming/ceasing to be trading stock is illustrated in the following examples.

Example – Asset changing its tax character from trading stock to depreciating asset		
	Before	**After**
Asset	Selling and hiring business withdraws bulldozer X from sale Assume bulldozer X's acquisition cost is $100,000 and the remaining effective life is 10 years	Bulldozer X hired out to a client
Tax character	Trading stock	Depreciable asset
Income tax treatment	**Division 70 treatment** Section 70-110 treats the taxpayer as having both sold the asset at arm's length for its cost and reacquired it for the same amount	**Division 40 treatment** The cost of the depreciable asset will be the cost of the asset used in the s. 70-110 calculation
Tax consequences	Assessable income under s. 70-110 = $100,000 Assuming asset was purchased in an earlier income year and trading stock is valued at cost = allowable deduction under s. 70-35 for the excess of opening stock over closing stock = $100,000 – $0 = $100,000 However, if the asset was instead purchased in the current income year = allowable deduction under s. 8-1 for purchase = $100,000	Assessable income under s. 6-5 for hiring fee income Assuming the PC method used = decline in value deduction available under s. 40-25 = $100,000 ÷ 10 = $10,000

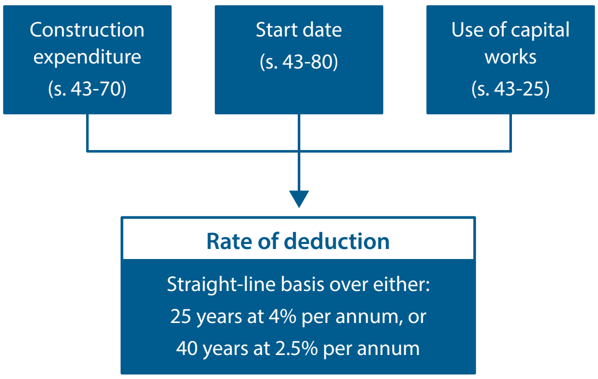
Example – Asset changing its tax character from depreciating asset to trading stock		
	Before	**After**
Asset	Selling and hiring business takes bulldozer X from the hiring pool Assume bulldozer X's acquisition cost $20,000, current adjustable value is $12,000 and current market value is $5,000	Bulldozer X held as an item of trading stock available for sale
Tax character	Depreciable asset	Trading stock
Income tax treatment	**Division 40 treatment** Taxpayer will have an assessable/deductible balancing adjustment under s. 40-285 The termination value under s. 40-305 is the value of the asset chosen under s. 70-30 The adjustable value under s. 40-85 is the asset's written-down value at the time of the change	**Division 70 treatment** Section 70-30 deems the taxpayer to have sold and reacquired the asset at one of the following values (chosen by the taxpayer): • Cost • Market value
Tax consequences	If the taxpayer's s. 70-30 choice is to use: • Cost: Assessable balancing adjustment = termination value – adjustable value = $20,000 – $12,000 = $8,000 • Market value: Deductible balancing adjustment = adjustable value – termination value = $12,000 – $5,000 = $7,000 Therefore, the taxpayer should elect to use market value to minimise taxable income	Taxpayer decline in value deduction is available under s. 40-25 up to the time of the change Assuming the asset is still on hand at year end, the taxpayer will have: • Assessable income under s. 70-35 for the excess of closing stock over opening stock = $5,000 – 0 = $5,000 • Allowable deduction under s. 8-1 for the deemed purchase of trading stock on hand at the chosen market value = $5,000

Buildings and structural improvements (capital works)

Overview

As an incentive to stimulate the construction industry, certain capital works expenditure is deductible under Division 43 'Deductions for capital works'.

Taxpayers seeking to claim a deduction for capital works under ss 43-10 and 43-15 need to consider a number of issues. The following diagram illustrates the relevant issues.



Application

While the term 'capital works' is not defined, under s. 43-20 the Division applies to:

- Buildings.
- Structural improvements.
- Environmental protection earthworks.
- An extension, alteration or improvement to any of these items.

The deduction under Division 43 is available where:

- The taxpayer owns, leases or otherwise holds the whole or some part of the capital works (ss 43-115 and 43-120).
- An unamortised balance of the original capital expenditure incurred in constructing the capital works (i.e. the construction expenditure) exists (s. 43-70).
- The taxpayer uses its portion of the capital works for income-producing purposes (s. 43-140). Where construction of the capital works began before 1 July 1997, there must also have been an intention to use the capital works at the time the expenditure was incurred (s. 43-90).

Construction expenditure

Construction expenditure is broadly defined as capital expenditure that is incurred in respect of the construction of capital works (s. 43-70). It includes preliminary expenses such as architects' fees, engineering fees and costs associated with obtaining approval for the building, as well as the cost of foundation excavations (TR 97/25).

The following costs **do not qualify** as construction expenditure (s. 43-70(2)):

- Depreciable plant and equipment.
- Expenditure for which specific tax concessions are available.
- The acquisition cost of the land, together with on-site preparation costs, such as clearing and demolishing buildings (see IT 2254).
- Landscaping costs.

Note: Until 1 July 2001, the definition of 'plant' was the subject of many court cases, since it was only plant on which capital allowances were available. As Division 40 was expanded to include depreciating assets, these cases remain relevant only in determining whether items are excluded from capital works (which would then qualify them for the more favourable capital allowances regime).

Deduction rate

The deduction rate is dependent on the date construction began (i.e. the start date) and the use to which the works are put. Under s. 43-25, the use is determined:

- For capital works that began **before 27 February 1992 –** at the date of construction.
- For capital works that began **after 26 February 1992 –** in the current year.

Accordingly, for capital works that began before 27 February 1992, the period of the capital works deduction is 25 years if the rate of deduction is 4%, or 40 years if the rate is 2.5%. For other capital works, the period is 25 years, 40 years, or some period between 25 and 40 years depending on their use.

Under s. 43-80, the **start date** of the construction of capital works is generally taken to be the date on which the excavation of foundations or other comparable activity occurred (TR 97/25).

The deduction rates are summarised in the following table. The rules for determining a capital works deduction have changed many times. Thus, the rates in the following table are a combination of the existing law and former laws as applicable to older buildings and structural improvements.

Applicable rate of deduction for construction expenditure (ss 43-25, 43-140 and 43-145)

Type of construction	Start of construction	Notes	Deduction rate %
Industrial buildings	After 26 Feb 1992	1	4.0
Other non-residential buildings	20 Jul 1982–21 Aug 1984 22 Aug 1984–15 Sept 1987 After 15 Sept 1987	2, 3	2.5 4.0 2.5
Short-term traveller accommodation	22 Aug 1979–21 Aug 1984 22 Aug 1984–15 Sept 1987 16 Sept 1987–26 Feb 1992 After 26 Feb 1992	2	2.5 4.0 2.5 4.0

Applicable rate of deduction for construction expenditure (ss 43-25, 43-140 and 43-145)			
Type of construction	**Start of construction**	**Notes**	**Deduction rate %**
Other residential accommodation	18 Jul 1985–15 Sept 1987 After 15 Sept 1987	2	4.0 2.5
Structural improvements	After 26 Feb 1992		2.5
Environment protection earthworks	After 18 Aug 1992		2.5

Notes

1. Construction on an industrial building that began before 27 February 1992 qualifies for deduction at the rates shown for 'other non-residential buildings'. Industrial activities are defined in s. 43-150.
2. The rate is 4% for certain pre-16 September 1987 contracts.
3. This includes expenditure on buildings used for research and development where construction began after 20 November 1987.

Example – Capital works deduction rate

An industrial building, which was constructed after 26 February 1992, changes its use to 'other residential accommodation' in the year ended 30 June 2019. The rate of capital works deduction changes from 4% to 2.5% in the 2019 income year (the period is apportioned if the change in use happens part way through the income year).

An industrial building, which was constructed in 1985, changes its use to 'other residential accommodation' in the year ended 30 June 2019. The rate of capital works deduction in respect of the original construction expenditure remains 4%. (Note: There would be no entitlement to a capital works deduction in the current year for the original construction expenditure as its cost has been completely amortised as it is over 25 years old). However, for any capital works in respect of the building after 26 February 1992 (e.g. an extension to the building), the rate of capital works deduction changes from 4% to 2.5% in the 2019 income year.

Calculation method

A taxpayer is entitled to a deduction for capital works under ss 43-10 and 43-15. The capital works deduction amount is calculated under ss 43-210 and 43-215 as follows:

Construction expenditure	×	Rate of deduction	×	Days used in that manner ÷ 365	=	Capital works deduction

Key points to note for a capital works deduction are as follows:

- The amount of the deduction cannot exceed the undeducted construction expenditure (i.e. the balance of construction expenditure that has not previously been claimable as a tax deduction) (s. 43-15).
- The write-off period for which the deduction is available does not begin until the construction, improvement or extension is **complete and used**, or maintained ready for use, for income-producing or research and development purposes (s. 43-30).

Example – Capital works deduction amount

Redco acquired a warehouse from Greenco for $800,000 on 1 July 2018 under an arm's-length transaction. Redco uses this building as a warehouse in which to store its trading stock.
The warehouse was constructed by Greenco at a cost of $500,000. Greenco started to use the building on 1 July 2016.

The building represents capital works constructed after 1992. The construction expenditure that Greenco incurred qualifies for a capital works deduction of 2.5% per annum (for 'other non-residential buildings'). Industrial activities are defined in s. 43-150 but the definition does not extend to a building that is used for warehouse storage. The construction expenditure is based on the cost of construction that was incurred by Greenco and not on the warehouse's acquisition cost to Redco.

The capital works deduction to Redco for the year ending 30 June 2019 is:

2.5%	×	$500,000	=	$12,500

The deduction for capital works that is available to Redco is limited to the $475,000 undeducted amount (i.e. $500,000 – $25,000 for two years' capital works deductions claimed by Greenco). The period over which the deduction can be claimed must not exceed 40 years commencing 1 July 2016, which was when Greenco first used the warehouse.

Required reading

Sections 43-10, 43-15, 43-20, 43-25, 43-70, 43-80, 43-140, 43-145 and 43-150 ITAA 1997.

Asset disposal or destruction

Disposal

When an asset that includes capital works expenditure is disposed of, Division 43 **does not** trigger a balancing adjustment event. The entitlement to any future capital works deductions simply passes to the acquirer.

For example, if a building that has $1 million in construction costs is sold for $2 million, the purchaser bases its future capital works deduction claims on the $1 million construction costs, not the $2 million paid (i.e. the cost base of the building for CGT purposes). Alternatively, if the building is sold for $500,000, the purchaser also bases its future capital works deduction claims on $1 million construction expenditure, not the $500,000 paid (i.e. the cost base of the building for CGT purposes).

Destruction

If an asset that includes capital works expenditure is destroyed, a balancing adjustment deduction arises for the amount of any undeducted capital works expenditure in excess of any recovery that relates to the destruction of the capital works, such as an insurance payout (s. 43-250).

However, the balancing adjustment deduction is only available where the taxpayer uses the asset that includes capital works expenditure for income-producing purposes (or it was last used by the taxpayer in that way) (s. 43-40).

For example, if a building that was previously used by the taxpayer for income producing purposes has undeducted construction expenditure of $1 million and it is demolished, the taxpayer is entitled to a $1 million balancing adjustment deduction. However, if that same building had never been used by the taxpayer for an income-producing purpose, then no balancing adjustment deduction is available. This might arise where land with an existing building is acquired with the intention of demolishing the existing building and constructing a new building.

Required reading

Sections 43-40 and 43-250 ITAA 1997.

Activity 5.2: Capital works deduction

[Available online in myLearning]

Interaction with CGT

When a CGT event occurs in relation to an asset, a capital gain or loss is calculated by applying the CGT rules that are applicable to that CGT event.

The Division 43 tax deduction for capital works has an impact on the calculation of the cost base of the CGT asset (as covered in Unit 4). Where the CGT asset was acquired after 13 May 1997, any expenditure that would otherwise be included in the cost base/reduced cost base is excluded to the extent that it is deductible.

Deductions arising under Division 43 will be excluded from the CGT cost base/reduced cost base. These exclusions are:

- The capital works deductions the taxpayer has claimed or can claim.
- Any balancing deduction arising on the destruction of the capital works.

For example, if the cost base of a building is $1 million and Division 43 deductions of $50,000 are claimed, the cost base of the building would be reduced to $950,000 (see Unit 4).

'Blackhole' expenditure

Overview

Certain business capital expenditures are not deductible, nor included in the cost base of any CGT asset, nor included in the cost of any depreciating assets. If this situation applies, the taxpayer should consider s. 40-880. Section 40-880 is referred to as the 'blackhole' provision because, without it, the expenditure would fall through a metaphorical black hole and receive no recognition under the tax legislation.

Section 40-880 allows taxpayers to deduct current, past and proposed business-related capital expenditure. That is, rather than being prescriptive about the types of expenditure that qualify for deduction, the section is drafted broadly based on principles so that it covers a wider range of business capital expenditure.

Eligibility for the deduction is established at the time the business capital expenditure is incurred. It is not relevant if the business later ceases being carried on, or the proposed business does not commence.

For s. 40-880 to apply, capital expenditure generally must be business-related. Therefore, expenditure related to a passive (non-business) activity would not normally attract s. 40-880. For example, if a company is set up to be a passive investment company, the costs of forming the company will not qualify for deductions under s. 40-880. Similarly, if an individual spends money on an aborted takeover of a company, their costs will not qualify for deduction under s. 40-880.

However, where a shareholder or member incurs capital expenditure in winding up an entity (i.e. a company, partnership, or trust) that carried on a business, that person does not need to be carrying on a business, they can be a passive investor (refer s. 40-880(2)(d)).

The expenditure must be business-related. If a company incurs costs to allow its shareholders to sell their shares in the company, this would not generally be a business-related cost – it would be a shareholder cost. Section 109C ITAA 1936 may also deem these to be a dividend.

Application and calculation method

An overview of the types of business-related capital expenditure that taxpayers are allowed to deduct and the calculation of the deduction is outlined in the following table. A summary of s. 40-880 can also be found in TR 2011/6.

Overview of business-related capital expenditure deductions allowed under s. 40-880	
Types of expenditure	Expenditure to: • Establish a business structure • Convert a business structure to a different structure • Raise equity for a business • Defend a business against a takeover Costs: • To a business of unsuccessfully attempting a takeover • To stop carrying on a business • Of liquidation and deregistration incurred by shareholders, beneficiaries and partners where the company, trust or partnership carried on a business • Of feasibility studies or market research

Overview of business-related capital expenditure deductions allowed under s. 40-880	
Restrictions on deductibility	The deduction is only available for business capital expenditure to the extent that the business is, was, or is proposed to be carried on for a taxable purpose (s. 40-880(3)) Taxable purpose is defined by s. 40-25(7) and broadly means the purpose of producing assessable income A deduction is not available where it is specifically denied by another provision of the ITAA 1997 or ITAA 1936
Calculation of deduction	For **non-SBE** taxpayers and **expenditure that is not eligible** for the small business start-up concession: • Eligible business capital expenditure is deductible over a five-year period on a straight-line basis (s. 40-880(2)) • 20% of the expenditure is deductible in the first year regardless of when incurred during the income year **Note:** Expenditure that is eligible for the small business start-up concession is deductible immediately (s. 40-880(2A)) (see Unit 6)
Related tax issues	Individual taxpayers need to consider the non-commercial loss provisions in Division 35 (covered in Unit 7). This may impact on the timing of the deduction available under s. 40-880 Share capital raising costs that are used to fund the acquisition of a controlled foreign company (see Unit 14) would not be deductible under s. 40-880 because there would be a disqualifying nexus with non-assessable non-exempt (NANE) s. 768-5 dividends

Example – 'Blackhole' expenditure

Target Ltd (Target) is the subject of an 'unfriendly' takeover attempt by Acquirer Ltd (Acquirer). Target's directors engage in a takeover defence strategy, which includes incurring expenditure on legal and accounting advice, valuations, public relations and the services of strategists from a merchant bank. Much of this expenditure is incurred in complying with the *Corporations Act 2001* (Cth) obligations.

The defence strategy is successful. In considering the takeover defence costs, the company's group tax manager concludes that, although it is business-related expenditure (refer ATO ID 2007/110), it is of a capital nature because it involves the entity's structure. In applying the s. 40-880 'last resort' approach:

- No deductions are available under s. 8-1 (because the expenditure is capital) or a specific deduction provision.
- The expenditure does not form part of the cost of a depreciating asset (Division 40) or relate to capital works (Division 43) held by Target.
- No CGT asset was acquired in the takeover defence, nor does the expenditure add to the cost base of an existing asset held by Target.
- No other provision specifically denies a deduction.

Section 40-880 will allow the expenditure to be claimed in equal portions over a five-year period on a straight-line basis, starting in the year it was incurred (i.e. there is no daily apportionment).

Assuming blackhole expenditure of $5,000 has been included in Target's accounting profit in the current income year, an adjustment adding back the $5,000 and subtracting $1,000 (i.e. 20% of the expenditure) will be required when it prepares its reconciliation of accounting profit to taxable income. In the subsequent four years, an adjustment subtracting $1,000 will be required.

Required reading

Section 40-880 ITAA 1997.

Activity 5.3: Blackhole expenditure

[Available online in myLearning]

Other capital expenditure

Capital expenditure to terminate a lease

Lease termination payments are generally capital in nature because they affect the structure of the business. Accordingly, they are generally not deductible under s. 8-1 (refer TR 2005/6). However, s. 25-110 allows taxpayers to deduct capital expenditure to terminate a lease or licence (including authority, permit or quota) over five years if the expenditure is incurred in the course of carrying on a business (or ceasing to carry on a business).

The amount the taxpayer can deduct is 20% of the expenditure:

- for the income year in which the lease or licence is terminated, and
- for each of the next four income years.

For example, where $10,000 is paid for the termination of a lease on 15 December 2018, the deduction in the income year ended 30 June 2019 is $2,000 (i.e. no apportionment is required) and $2,000 can also be claimed in each of the next four years.

For further guidance on the taxation of leases see Unit 13.

Required reading

Section 25-110 ITAA 1997.

Capital expenditure related to primary production

For taxpayers that carry on a primary production business (see definition in s. 995-1), there are a number of special rules applicable to the calculation of assessable income (i.e. see Division 385) and allowable deductions (i.e. see Subdivisions 40-F, 40-G, 40-J and 40-K).

For example, s. 40-548 allows an immediate deduction for primary producers who incur capital expenditure in respect of fodder storage assets from 19 August 2018.

The special rules applicable to primary production are outside the scope of the TAXAU module.

Immediately deductible capital expenditure

Immediate deductions are available under Subdivision 40-H for expenditure on:

- Exploration or prospecting.
- Rehabilitation of mining or quarrying sites.
- Petroleum resource rent tax.
- Environmental protection.

These specialist areas of the law are outside the scope of the TAXAU module.

Other key resources

Quick reference guides
5.1: Decline in value – general taxpayers
5.2: Blackhole expenditure under s. 40-880
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 6: Small business entities (SBEs)

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Explain and apply the definition of an SBE taxpayer.
2. Explain and apply the SBE concessions in calculating an SBE's taxable income.
3. Analyse and apply the small business CGT relief provisions.

Introduction

This unit examines a range of tax concessions applicable to eligible a small business entities (SBEs).

The small business tax concessions reflect a variety of policy objectives:

- To provide small business owners with access to funds for retirement or business expansion.
- To encourage entrepreneurial risk-taking behaviour (investment).
- To recognise the important role of small business in the Australian economy (e.g. small business employs the majority of Australian workers).

The result is a range of concessions that provide greater flexibility for small business taxpayers in managing their affairs.

Note:

- The income tax year end covered in this offering of the TAXAU module is 30 June 2019. Therefore, the amendments applicable from 1 July 2019 are outside the scope of the module.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

SBE general concessions

Overview

The general tax concessions available to SBEs are primarily contained in Division 328. Only eligible SBEs are able to elect to access the concessions. The general tax concessions that are available to SBEs include:

- Tax rate and offset (subject to satisfying separate requirements).
- Trading stock.
- Prepayments.
- Capital allowances – decline in value.
- Blackhole expenditure – start-up expenses.
- Other SBE concessions:
  - Fringe benefit tax (FBT) car parking exemption.
  - Certain GST concessions.
  - Pay-as-you-go (PAYG) instalments based on GDP-adjusted notional tax.
  - A reduced time frame, compared with other business taxpayers, within which the Commissioner may amend an income tax return assessment.

In addition to the above general tax concessions, an SBE taxpayer may be eligible to access various CGT concessions and a restructure rollover concession (see later in this unit).

Eligibility conditions

Unless stated otherwise, to be eligible for the general SBE concessions, the taxpayer must satisfy the definition of a 'small business entity', as defined in Subdivision 328-C.

SBE definition

Under s. 328-110, for a taxpayer to be an SBE:

- It must carry on, or be in the process of winding up, a **business**.
- It must satisfy the less than **$10 million** aggregated turnover test.

Note: The aggregated turnover threshold for the 2015–2016 and earlier income years was $2 million.

Aggregated turnover test

The aggregated turnover is a 'blackline test'. If the turnover exceeds this amount by $1, the entity will not be an SBE. The aggregated turnover test will be satisfied if any one of the following three tests is met.

Test 1 – Prior year test

The aggregated turnover for the previous year was less than the threshold. The calculation for this test is applied as at the first day of the income year. If a small business satisfies this test, then it does not need to consider either the second or the third test.

Test 2 – Current year test

This test has two requirements:

(a) The aggregated turnover for the current year is 'likely' to be less than the threshold, calculated as at the first day of the income year (or as at the day the taxpayer starts to carry on the business).

(b) The aggregated turnover for at least one of the two previous income years was less than the threshold.

Note: Section 328-110(3)(b) excludes a taxpayer from being an SBE taxpayer where their aggregated turnover for each of the two previous income years was equal to or greater than the threshold.

Given that this test is applied as at the first day of the income year (generally, this would be 1 July), the current year test requires an estimate of the current year turnover based on objective factors, including:

- Aggregated turnover in previous income years.
- Sales and specific contracts not expected to recur in the current year.
- Definitive plans that may involve winding down the business.
- Other factors outside the taxpayer's control (e.g. drought or natural disasters).
- Market variables such as declining industry prices or increased competition.

Test 3 – Additional test

The actual aggregated turnover, calculated at the end of the current income year (generally this is 30 June), is less than the threshold.

For all three tests, the aggregated turnover for a business carried on for part of the income year (e.g. a business commencing or being wound-up during the year) must be calculated on a reasonable basis for the whole income year (s. 328-120(5)).

Required reading

Section 328-110 ITAA 1997.

Aggregated turnover calculation

Critical to determining whether an entity is an SBE taxpayer is the concept of aggregated turnover. Aggregated turnover (defined in s. 328-115) can be calculated in three steps.

Step 1 – Calculate the entity's annual turnover

Annual turnover for an income year is the total ordinary income that the entity derives in the income year in the ordinary course of carrying on a business (s. 328-120(1)). Annual turnover is GST-exclusive (s. 328-120(2)). The concepts of 'ordinary income' and 'ordinary course of business' are explained in Unit 1. Examples of ordinary income derived in the ordinary course of carrying on a business would:

- Include sales from trading stock or fees for professional services provided.
- Generally exclude investment income or sales of capital assets (e.g. rent, interest, dividends and capital gains). However, where interest or rent is earned in the ordinary course of business (e.g. a boarding house business), it would be included.

Where an entity has carried on a business for part of the income year, the entity is required to calculate a reasonable annualised estimate of its annual turnover (s. 328-120(5)).

Step 2 – Apply the aggregation rules

Aggregated turnover includes the annual turnover of all relevant entities (see s. 328-115). Relevant entities include any entities that are:

- connected with you, or
- affiliated with you, at any time during the income year.

'You' in this instance refers to the taxpayer wanting to be identified as an SBE taxpayer (see to s. 328-115(2)).

The concepts of 'connected with' and an 'affiliate of' an entity are explained later in this unit under Condition 3 of the SBE CGT concessions.

Step 2 requires the identification of all entities connected or affiliated with a taxpayer wanting to be classified as an SBE taxpayer. The annual turnover for each of these relevant businesses is included in this step.

Step 3 – Calculate the aggregated turnover

The relevant annual turnover for an entity (s. 328-115(2)) for the income year is the sum of:

- The entity's annual turnover (see Step 1).
- The annual turnover of any entity that is 'connected with' the entity at any time during the income year (see Step 2(a)).
- The annual turnover of any entity that is an 'affiliate of' the entity at any time during the income year (see Step 2(b)).

An entity's aggregated turnover for an income year excludes, broadly, amounts derived from dealings between relevant connected entities or affiliated entities (refer to s. 328-115(3)) so as to prevent double counting. If there are no entities connected or affiliated with the entity wanting to be classified as an SBE, then that entity's aggregated turnover is the same as its annual turnover (i.e. the Step 2 amount is $nil).

Required reading
Sections 328-115 and 328-120 ITAA 1997.

Worked example 6.1: SBE eligibility
[Available online in myLearning]

Tax rate and offset

Company tax rate

The rate of income tax for a company that is a **'base rate entity'** is as follows:

Corporate tax rate for base rate entity	
Income year ended	**Rate**
30 June 2018 to 30 June 2020	27.5%
30 June 2021	26%
30 June 2022 and later income years	25%

The rate of income tax for a company that is **not a 'base rate entity'**, is **30%**.

Note:

- An **SBE** will only be a 'base rate entity' where it satisfies the additional requirements as contained in the definition of that type of entity. A '**base rate entity**' (s. 23AA ITRA 1986) is an entity where **both** of the following requirements are satisfied:
  - No more than 80% of its assessable income for the income year is 'base rate entity passive income' (BREPI).
  - Its aggregated turnover, worked out as at the end of the income year, is less than the relevant threshold amount. The threshold amount is **$50 million** for the income year ended 30 June 2019 and later income years (for 30 June 2018 it was $25 million).

  It should be noted that, under the definition of a base rate entity, aggregated turnover is only tested at the end of the income year (i.e. despite aggregated turnover being defined under the SBE rules, the three aggregated turnover tests under the SBE rules are not applicable for a base rate entity). It should also be noted that, unlike under the SBE rules, there is no requirement for a base rate entity to be carrying on a business.

  For further analysis of 'base rate entity' and 'base rate entity passive income' see Unit 8.
- For the income years ended 30 June 2016 and 30 June 2017, a lower tax rate of 28.5% and 27.5% respectively, applied to a company that satisfied the definition of an SBE (i.e. it was not linked to the definition of a 'base rate entity'). For the income year ended 30 June 2015 and earlier income years, all companies applied the same tax rate of 30%.
- A passive investment company:
  - **May** qualify for the above lower corporate tax rates for the income years ended 30 June 2016 and 30 June 2017 as, in accordance with TR 2019/1, the company may carry on a business in a general sense and therefore satisfy the definition of an SBE.
  - **May** qualify for the above lower corporate tax rate for the income years ended 30 June 2018 and later, provided it satisfies the definition of a 'base rate entity'.
- A company that is an SBE maintains a franking account and may pay franked dividends to its shareholders. The maximum franking credit that can be attached to a dividend is determined based on the SBE's 'corporate tax rate for imputation purposes'. This rate is:
  - The company's corporate tax rate for the income year, worked out on the assumption that its aggregated turnover, assessable income, and base rate entity passive income are the same as the prior income year, and applying the corporate tax rates of the current income year.
  - If the company did not exist in the prior income year, it is the lower corporate tax rate of 27.5% for the income year ended 30 June 2019.

  For further franking account analysis see Unit 8.

Small business tax offset

An individual taxpayer pays tax on their taxable income at marginal tax rates, irrespective of the type of income derived (see Unit 7). However, an individual is entitled to a small business income tax offset when calculating their net tax payable where:

- the individual runs an SBE (i.e. as a sole trader), or
- the individual's assessable income includes a share of the net income of an SBE (e.g. a partner distribution from a partnership that is an SBE or a trust distribution from a trust that is an SBE).

This offset corresponds to the reduced tax rate available for SBEs that are incorporated. For the purposes of this offset, the **SBE aggregated turnover threshold is $5 million** (i.e. in the aggregated turnover provisions replace all references to $10 million with $5 million).

The amount of the tax offset is 8% of the income tax payable on the portion of the individual's income that is small business income, capped at $1,000. For example, an individual taxpayer with $10,000 of tax payable on SBE income is entitled to a tax offset of $10,000 × 8% = $800. An individual taxpayer with $50,000 of tax payable on SBE income is entitled to a tax offset of $1,000 (i.e. the maximum amount, as $50,000 × 8% exceeds $1,000).

Note: The rate will increase to 13% in the 2020–2021 income year and to 16% in the 2021–2022 income year. However, the maximum value of the offset will remain at $1,000, thereby limiting the real benefit of the increased rate.

Trading stock

In Unit 1, it was explained that s. 70-35 requires a taxpayer to compare its opening stock value with its closing stock value and make the appropriate adjustment to the entity's taxable income.

An SBE can elect not to account for this adjustment for an income year if a reasonable estimate of the closing stock shows an increase or decrease of no more than $5,000 from the opening stock figure (s. 328-285).

The effect of s. 328-285 is that the value of closing stock will be the same as the opening stock.

A reasonable estimate requires attention to both the quantity and value of stock on hand.

In the ATO's view (see PS LA 2008/4), an estimate will be reasonable where it:

- takes into account all relevant factors and considerations likely to affect the number and value of the particular entity's items of trading stock on hand
- has been undertaken in good faith
- results from a rational and reasoned process of estimation, and
- is capable of explanation to, and verification by, a third party.

Given the small margin (i.e. $5,000), this concession is not used often in practice. It would also not be used in practice where the opening stock value exceeds the closing stock value, as under s. 70-35 the taxpayer is entitled to an allowable deduction which would minimise taxable income.

Required reading

Section 328-285 ITAA 1997.

Activity 6.1: Trading stock – SBE

[Available online in myLearning]

Prepayments

As explained in Unit 1, the following prepayments are excluded from the prepayment rules regardless of the type of taxpayer:

- Prepayments which are 'excluded expenditure' (refer s. 82KZL ITAA 1936). Excluded expenditure is deductible in full under s. 8-1.
- Prepayments which are deductible under specific provisions outside of s. 8-1 (e.g. tax related expenses, repairs, superannuation contributions, etc.). The timing of the deduction is determined under the specific provision.

For all other prepayments, an SBE taxpayer needs to consider the prepayment rules contained in s. 82KZM ITAA 1936. The application of the prepayment rules for an SBE taxpayer is as follows:

- If the prepayment relates to a period of **no longer than 12 months**, ending in the next income year, the SBE taxpayer can claim a deduction for the full amount when incurred under s. 8-1.
- Otherwise, the expenditure must be apportioned over the period to which the expenditure relates, to a maximum of 10 years (the eligible service period – see Unit 1 for further details).

Required reading

Section 82KZM ITAA 1936.

Activity 6.2: Prepayments – SBE

[Available online in myLearning]

Depreciating assets (capital allowances)

Broadly, the SBE capital allowance rules allow an SBE taxpayer to choose to allocate depreciating assets to a general small business pool. This avoids the need to calculate decline in value on a daily basis for individual depreciating assets and brings forward the timing of the deductions.

Application

SBE taxpayers can choose to apply the SBE capital allowance rules for **an income year**, instead of applying the relatively more complex rules in Division 40, to **all** of the depreciating assets it holds and uses (or has installed ready for use), for a **taxable purpose** (s. 328-175).

Division 40 was considered in detail in Unit 5. Except as otherwise detailed in this unit, the terminology explained in Unit 5 is also applicable for the SBE capital allowance rules. So, for example:

- The taxable purpose is still the percentage of use for the production of assessable income.
- The cost of the depreciating asset is net of any GST input tax credit that an entity is entitled to claim (s. 27-100).

Exclusions

The following assets (among others) are **not eligible** for pooling under the SBE capital allowances rules (s. 328-175):

- Buildings and structural improvements (as they qualify for deductions under Division 43).
- Assets under certain leases (e.g. a leasing company or a passive investment company that holds depreciating assets in a residential rental property cannot take advantage of the SBE capital allowance rules).

- Assets allocated to a low-value pool under Division 40 (as distinct from a 'small business pool' mentioned below) before the taxpayer chose to use the SBE capital allowance rules (see Unit 5).
- In-house software where expenditure on the asset is allocated to a software development pool under Division 40 (see Unit 5). Therefore, this expenditure does not qualify for immediate deduction under s. 328-180 (see below).

Opening pool balance – existing assets

When a taxpayer first applies the SBE capital allowance rules, any eligible depreciating assets that the taxpayer holds at the start of that income year, must be allocated to the small business pool (s. 328-185(3)).

For the first year a taxpayer chooses to apply the SBE capital allowance rules, the opening pool balance is the sum of the **taxable purpose portions** of the **adjustable values** (i.e. the closing written down value as determined under Division 40) of eligible depreciating assets (s. 328-195). Unlike Division 40 where the entire cost is used to calculate the decline in value of an asset and the deduction it then reduced by the portion related to non-taxable use, in a small business pool only the taxable purpose portion of the cost of an asset is allocated to the pool.

For later income years (i.e. income years after the taxpayer's first year applying the SBE capital allowance rules), the opening pool balance is equal to the closing pool balance from the prior income year, adjusted for changes in taxable purpose if required under s. 328-225.

Asset additions – immediate deduction

Under s. 328-180 ITAA 1997 and IT(TP)A 1997, SBE taxpayers that have chosen to apply the SBE capital allowance rules for an income year are entitled to claim an immediate deduction for the taxable purpose portion of depreciating assets (new and second-hand) that **cost less than the applicable immediate deduction threshold**. The threshold amount is:

- \$20,000 from 7.30pm on 12 May 2015 to 28 January 2019
- \$25,000 from 29 January 2019 to 7.30pm on 2 April 2019
- \$30,000 from 7.30pm on 2 April 2019 to 30 June 2020
- \$1,000 from 1 July 2020 onwards.

Therefore, for the income year ended 30 June 2019 there are three different thresholds that apply to an SBE. However, the low-value pool balance threshold as at 30 June 2019 is \$30,000.

The immediate deduction concession applies on an asset by asset basis. The ATO has provided draft guidance in TR 2017/D1 on whether composite assets are a single asset or multiple assets, for example, whether a cement mixer is a separate asset from the transit vehicle.

Eligibility for the immediate deduction concession is based on the total cost of the asset. In addition, where the total cost is less than the applicable threshold and the depreciating asset is used partly for private purposes, the immediate deduction is limited to the taxable purpose portion (i.e. the portion of the asset's cost that is used for producing assessable income).

For example, if a machine costing \$900 is acquired in the income year ended 30 June 2019 and is used 70% for business, only \$630 will be allowed as an immediate deduction and the balance is not deductible. However, if a machine costing \$32,000 is acquired in the income year ended 30 June 2019 and is used 60% for business, there is no immediate deduction as the total cost exceeds the applicable threshold. The taxable purpose portion of the asset (i.e. 60% × \$32,000 = \$19,200) must be allocated to the small business pool (see below).

Where an immediate deduction is claimed, no amount is allocated to the small business pool.

Note: The Government has also introduced an immediate asset write-off of \$30,000 for medium sized business from 7.30pm on 2 April 2019 to 30 June 2020. Broadly, this concession applies to businesses that are not an SBE but would be an SBE if all references to \$10 million aggregated turnover in the SBE eligibility conditions were instead references to \$50 million aggregated turnover (see above under 'Eligibility conditions' and Unit 5).

Asset additions – allocated to pool

Depreciating assets with a **total cost equal to or exceeding** the applicable immediate deduction threshold (see above) are allocated to the small business pool at the **end** of that income year (even if the taxpayer no longer holds the asset) (s. 328-185(4)). However, unlike the Division 40 rules (for diminishing value and prime cost calculations):

- Only the taxable purpose portion of the depreciating asset is allocated to the pool. Thus, an SBE taxpayer must make a reasonable estimate of taxable use (s. 328-205).
- There is no apportionment on a days basis. Instead the depreciating asset is allocated on the last day of the income year.

Note: An SBE taxpayer must make an adjustment to the amount allocated to the pool in a later income year where the reasonable estimate of taxable use for that later income year is more than 10% different to the original estimate (s. 328-225).

Decline in value

General rule

There are three components to the calculation of the annual decline in value deduction available to an SBE that has chosen to apply the SBE capital allowance rules (s. 328-190):

- Opening pool balance – apply a rate of 30%.
- Asset additions (i.e. acquired) – apply an equivalent half-year rate of 15%.
- Asset enhancements (i.e. cost addition amounts to existing pooled assets) – apply an equivalent half-year rate of 15%.

Low pool balance rule

A taxpayer calculates the annual decline in value deduction using the above general rule until the notional closing pool balance is less than the immediate deduction threshold (i.e. the closing balance **before** calculating the current year decline in value deduction, **but after** adding in additions and reducing for disposals during the income year). In the year that the balance falls below the immediate deduction threshold, it can be written off as a low pool value (s. 328-210).

For example, assume the opening pool balance on 1 July 2018 is $38,500. During the year, a new asset costing $32,600 was acquired and pool assets were sold for $51,600. Under s. 328-210, the notional closing pool balance is $38,500 + $32,600 – $51,600 = $19,500. Because this amount is less than the immediate deduction threshold as at 30 June 2019, the taxpayer's pool decline in value deduction for the income year ended 30 June 2019 is taken to be the notional closing pool balance of $19,500 and the pool's closing balance as at 30 June 2019 is $nil.

Asset disposals

The treatment of the disposal of a depreciating asset under the SBE capital allowance rules depends on whether the cost of the asset was immediately deducted or was allocated to the small business pool:

- For disposal of an asset **not allocated** to the small business pool (i.e. costing less than the applicable immediate deduction threshold)
  - the taxable purpose portion of the asset's termination value is included in assessable income (s. 328-215(4)).
- For disposal of an asset **allocated** to the small business pool (i.e. costing equal to or more than the applicable immediate deduction threshold)
  - the taxable purpose proportion of the asset's termination value is subtracted from the pool balance (s. 328-200). However, if as a result the closing pool balance is less than zero (or the amount calculated under s. 328-210 is less than zero), then the amount by which it is less than zero is included in the taxpayer's assessable income (s. 328-215(2)).

Closing pool balance

The closing pool balance is calculated under s. 328-200. Broadly, it is equal to the following:

Add: Opening pool balance

Add: Taxable purpose portion of the cost of depreciating assets allocated to the pool (i.e. cost of additions and enhancements that are not immediately deductible)

Less: Decline in value or low pool value write-off for the income year

Less: Taxable purpose portion of termination value of depreciating assets allocate to the pool (i.e. sale proceeds on disposals that are not included in assessable income)

Change in taxpayer choice or status

If a taxpayer chooses to apply the SBE capital allowance rules for an income year and **opts out** of the rules for a later income year (where that choice is available), the taxpayer generally cannot opt back into the SBE capital allowance rules for at least five years. However, this five-year restriction has been removed until 30 June 2019.

Once a depreciating asset is allocated to a small business pool, it must remain in that pool until it is fully deducted, **even where the taxpayer is not an SBE** in a later income year or the taxpayer chooses not to use the SBE capital allowance rules for assets acquired in a later income year (s. 328-220). The taxpayer will continue to calculate the annual decline in value deduction at a rate of 30% of the opening pool balance, until the closing pool balance (before calculating the current year decline in value deduction) is less than the immediate deduction threshold. In the income year the balance is below the immediate deduction threshold, it can be fully written-off as a low pool value (s. 328-210).

Taxpayers who stop using the SBE capital allowance rules must deal with subsequently acquired depreciating assets under Division 40 (i.e. the general capital allowance rules), which are covered in Unit 5.

Primary producers

Primary producers (broadly, tax entities carrying on a primary production business, as defined in s. 995-1(1)) that are SBEs can choose whether to claim deductions under the primary production provisions in s. 40-F or s. 40-G, or use the SBE provisions under s. 328-D.

Note: The primary production provisions are outside the scope of the TAXAU module.

Required reading

Sections 328-185, 328-190, 328-195, 328-200, 328-210 and 328-215 ITAA 1997.

Sections 328-180(6) and 328-200 IT(TP)A 1997.

Activity 6.3: Decline in value – SBE taxpayer

[Available online in myLearning]

Blackhole expenditure – start-up expenses

SBE taxpayers (including individuals not in business) are entitled to an immediate deduction under s. 40-880(2A) for costs incurred in relation to a business that is proposed to be carried on (i.e. start-up expenses), including:

- Expenditure in obtaining advice or services related to the proposed structure, or proposed operation of the business (e.g. professional, accounting or legal advice).
- Government fees, taxes or charges relating to establishing the business or its operating structure (e.g. costs associated with raising capital).

For other types of taxpayers and for non-qualifying expenses of an SBE, blackhole expenses are deductible over five years under s. 40-880(2) (see Unit 5).

Other concessions

Other concessions available to SBE taxpayers are briefly summarised in the table below. While these concessions do not impact on the taxable income calculation, it is important to be aware of them. Further details can be found on the ATO website (www.ato.gov.au → Business → Small business entity concessions).

Other SBE concessions	
Concession	**Description**
Annual apportionment of GST input tax credits	An SBE can choose to apportion GST input tax credits (e.g. partly private acquisitions) on an annual basis, rather than at the time each input tax credit is claimed
Accounting for GST on a cash basis[1]	GST is accounted for in the tax period in which consideration is received and input tax credits are claimed in the tax period in which consideration is expended
Paying GST by quarterly instalments[1]	Estimated GST is paid by quarterly instalments with an annual reconciliation once the annual GST return is lodged. Instalments are generally based on the previous year's GST
FBT car parking	Provides an exemption from FBT for car parking benefits where the other requirements of s. 58GA FBTAA 1986 are met
FBT portable electronic devices	There is an extension of the work-related items exemption in s. 58X FBTAA 1986 to cover more than one electronic device even where the devices have substantially identical functions (e.g. laptops, tablets, calculators, GPS navigation receivers, mobile phones, etc.)
PAYG instalments based on GDP-adjusted notional tax	The taxpayer pays quarterly PAYG instalments based on either an amount notified by the Commissioner or calculated by the taxpayer
Two-year time frame within which the Commissioner may amend an income tax return assessment	Limits the usual four-year period of review for a business taxpayer to two years

Note

1. Does not apply to SBEs that qualify under the additional rule (actual aggregated turnover) test.

SBE CGT concessions

Overview

The CGT concessions for SBEs are contained in Division 152. For the concessions to apply to a taxpayer on the disposal of business assets, the taxpayer must first satisfy the basic eligibility conditions in s. 152-10. Broadly, these basic conditions require that the following:

- Condition 1 – A CGT event happens in relation to a CGT asset.
- Condition 2 – Apart from Division 152, the CGT event would have resulted in a capital gain.
- Condition 3 – The taxpayer is either:
  - a CGT SBE for the income year, or
  - satisfies the maximum net asset value test, or
  - is a partner in a partnership that is a CGT SBE for the income year and the CGT asset is an interest in an asset of the partnership.

  Alternatively, the asset is a qualifying passive asset.
- Condition 4 – The CGT asset satisfies the active asset test.
- Condition 5 – Additional basic conditions must be satisfied if:
  - the CGT asset is a share in a company or an interest in a trust, or
  - the CGT event involves certain rights or interests in relation to the income or capital of a partnership.

A particular point to note, in respect of the above conditions, is that the aggregated turnover threshold of $10 million that applies for general CGT concession purposes is replaced with a CGT SBE aggregated turnover threshold of $2 million.

If the basic eligibility conditions are satisfied, the next step is to consider the four small business CGT concessions that are available, which are the:

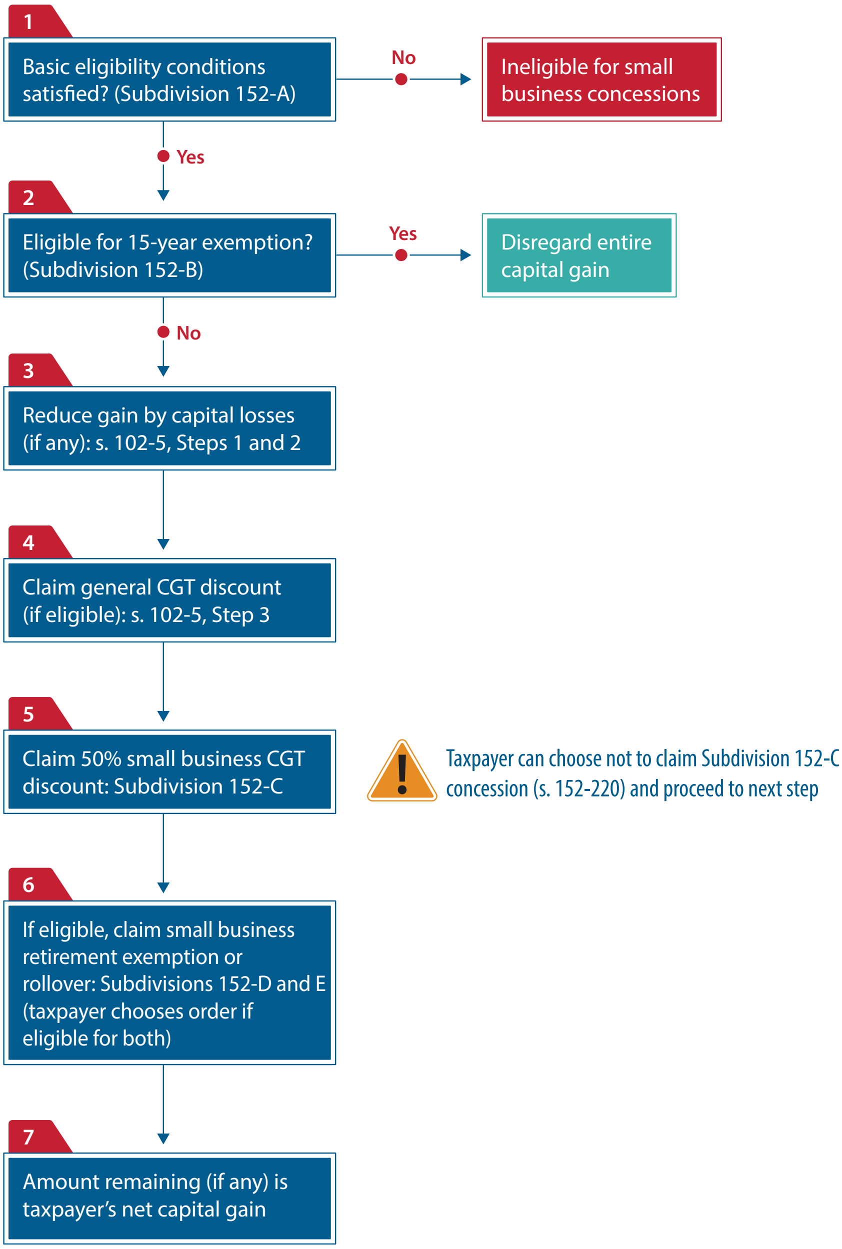
- 15-year CGT asset exemption (Subdivision 152-B).
- 50% reduction (Subdivision 152-C).
- Retirement exemption (Subdivision 152-D).
- Rollover relief (Subdivision 152-E).

The four CGT concessions are subject to further specific eligibility conditions. Where these are satisfied, the SBE taxpayer can apply the particular concession.

The CGT concessions are available in many situations. However, they are particularly useful when small business owners are winding down or exiting their small business. Where small business owners are looking to expand their business by using more complex business structures, the small business restructure rollover contained in Subdivision 328-G is also available (see later in this unit). It applies to all assets of the business (i.e. CGT assets, depreciating assets, trading stock and revenue assets) and may, depending on the circumstances, be a more generous concession for small businesses than those available under the general CGT rollover provisions (as discussed in Unit 4) or the small business CGT concessions.

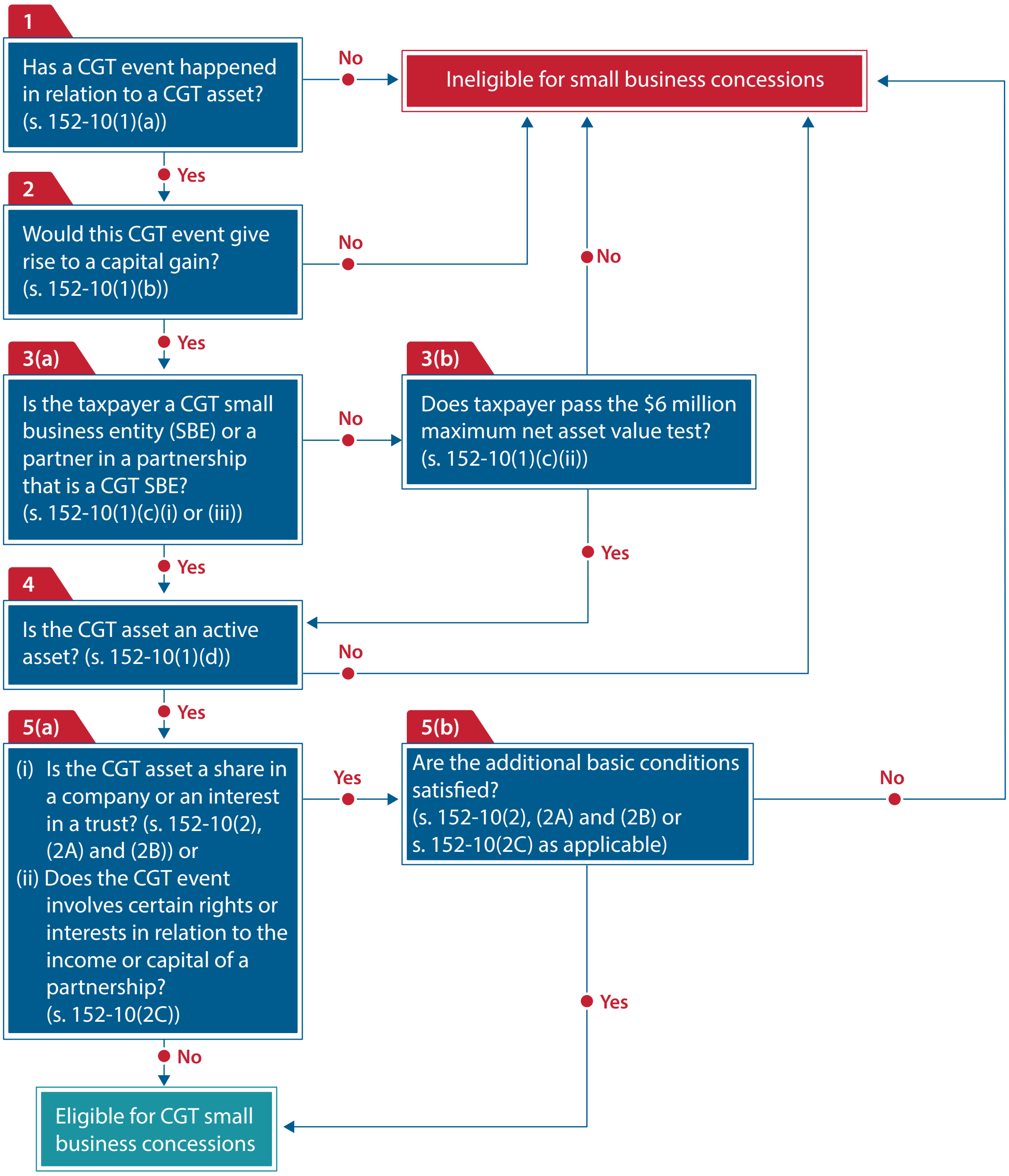
Net capital gain calculation method

Section 102-5 sets out the method that all taxpayers must follow when calculating a net capital gain. The flow chart below provides a step-by-step guide to calculating a net capital gain when the CGT small business concessions apply.



Basic eligibility conditions

A taxpayer must satisfy the basic eligibility conditions in s. 152-10 before considering which of the four small business CGT concessions apply. These conditions are summarised in the flow chart below and further explained in the accompanying notes.



Condition 1 – CGT event happens

A CGT event (other than CGT event K7) must happen in relation to a taxpayer's CGT asset (s. 152-10(1)(a)). For example, this would include a sale (CGT event A1), an individual or company ceasing to be an Australian resident (CGT event I1), and even a value-shifting gain (CGT event K8). (CGT events are discussed in Unit 4.)

Condition 2 – CGT capital gain arises

A **capital gain** must arise as a result of the CGT event (before the application of Division 152) (s. 152-10(1)(b)). It follows that transactions relating to **pre-CGT assets** and events that give rise to a **capital loss are not covered** by the CGT small business concessions. However, capital gains which would otherwise be offset by capital losses are within the scope of this condition.

Condition 3 – CGT SBE test or $6 million net asset test satisfied

CGT small business entity test

This test requires that the taxpayer is a CGT small business entity or a partner in a partnership that is a CGT small business entity (s. 152-10(1)(c)(i) or (iii)). However, note the following:

- A partner could alternatively pass the $6 million maximum net asset value test (see below).
- The small business CGT concessions are also available for **passively held assets** of a taxpayer where an 'affiliate' or 'connected entity' (see below) of the taxpayer is a CGT SBE and the CGT event happens in an income year in which the asset is being used in a business that is carried on by the affiliate or connected entity (s. 152-10(1A)).

A CGT small business entity is defined in s. 152-10(1AA) to be an SBE that would continue to be an SBE if each reference in s. 328-110 to $10 million were a reference to **$2 million** (see above under the general SBE concessions).

Broadly, the practical impacts of the test are as follows:

- **If the taxpayer is carrying on a business** and has an **aggregated turnover of less than $2 million**, it can access the small business CGT concessions **regardless of the value of the assets** owned by the taxpayer. For example, a business with a $1 million turnover which owns a $50 million active asset would qualify.
- **Passive investors may be CGT SBE taxpayers**. For example, a taxpayer holding several residential rental properties as a passive investor (TR2019/1). However, the assets held by the taxpayer would not generally qualify for the CGT SBE concessions as they would not be active assets (TD 2019/D4).

Note: The Government has proposed amendments to ensure that partners cannot access the concessions when they alienate future income. This measure is outside the scope of the module.

$6 million net asset value test

As an alternative, Condition 3 requires that the taxpayer (including a partner in a partnership) pass the $6 million maximum net asset value test (s. 152-10(1)(c)(ii)).

The $6 million ceiling is not indexed and is calculated under s. 152-15 by reference to the net value of CGT assets (determined just before the CGT event happens), which are held by:

- The taxpayer who owns the asset(s).
- Entities 'connected with' the taxpayer. An entity is connected with another entity if:
  - either one controls the other (see below), or
  - both are controlled by the same third entity (s. 328-125(1)).
- Affiliates and their connected entities. An 'affiliate' is described in s. 328-130(1) and (2) as an individual or company that acts (or could reasonably be expected to act) in accordance with the taxpayer's directions, or in concert with the taxpayer, in relation to the business of the individual or company. However, a business relationship between the taxpayer and the individual or company is not, of itself, sufficient to give rise to affiliate status. For example:
  - A spouse would only be an affiliate if they so act.
  - A partner in a partnership would not be an affiliate of another partner merely because they act in concert in connection with the affairs of the partnership.
  - A director of a company would not be an affiliate of another director merely because they act in concert in connection with the affairs of the company.
  - A trust or superannuation fund cannot be an affiliate of the taxpayer.

The inclusion of assets held by connected entities and affiliates in the calculation is a double-edged sword. On the one hand, their assets may cause the $6 million threshold to be exceeded. On the other hand, they enable a taxpayer who is not carrying on business with passive assets to access the concession when the asset is used in a business by an SBE that is a connected entity or affiliate (s. 152-10(1A)).

Control

The concept of 'control' in relation to entities who are 'connected with an entity' is defined in s. 328-125(2)–(8) and summarised in the following table.

Connected entities and the meaning of control[1]	
Type of entity	**Entity is 'connected with' taxpayer or taxpayer's affiliates if the taxpayer, its affiliates or both of them together …**
Company[1]	Own or have the right to acquire interests in the company that give it at least 40% voting power in the company[2]
Discretionary trust[1]	• Direct the trustee of the trust (or could reasonably expect the trustee) to act in accordance with their directions or wishes, or • Have received at least a distribution of capital or income from the trust in any of the previous four income years and that capital or income (as the case may be) constitutes at least 40% of the total capital or income (as the case may be) distributed in that relevant year[2] The trustee may nominate in writing no more than four beneficiaries as controllers of the trust for an income year in which the trustee did not make a distribution of income or capital because the trust had a tax loss, or no net income, for that year (s. 152-78(2))
Other entity type (e.g. partnership, fixed trust)	Own or have the right to acquire interests in the entity that gives it the right to receive at least 40% of any distribution of income or capital by the entity[2]

Notes

1. The rules shown here relate to direct control of a company or a discretionary trust. There are also indirect control rules (not covered in the TAXAU module).
2. If the control percentage is at least 40% but less than 50%, the Commissioner may determine that control does not exist if satisfied that another entity (not being the taxpayer or any of its affiliates) controls the entity.

Asset inclusions

In calculating the net value of the **taxpayer's CGT assets**, **all the CGT assets** owned by the taxpayer are taken into account, not just those used in the business. Taxpayers often assume that only business assets are counted – this is incorrect.

Asset exclusions

However, certain assets are specifically **excluded**. These are:

- Shares, units or other interests in another entity that is connected with the taxpayer or with an affiliate of the taxpayer (s. 152-20(2)(a)). This exclusion exists to avoid double-counting these assets because the underlying net assets of the entity would already be taken into account. However, liabilities related to any such shares, units or interests are taken into account.
- If the entity is an individual:
  - Assets used solely for the personal use and enjoyment of the entity or the entity's affiliate over the whole ownership period (refer ATO ID 2011/37) (e.g. cars, furniture, paintings, boats, holiday house, etc.).
  - The portion of the main residence of the individual that is not used to produce assessable income and for which they would not have been able to deduct any interest on their mortgage on the dwelling if they had incurred such interest (this would include any interest claimed during the six-year absence concession in s. 118-145).
  - A right to any amount payable from a superannuation fund or an asset of a superannuation fund.
  - An individual's life insurance policy (s. 152-20(2)(b)).

In calculating the net value of an **affiliate's CGT assets**, generally only assets that are **used to carry on a business** by the taxpayer, or the taxpayer's connected entities, are counted (ss 152-20(3) and (4)).

Note: Look-through earnout rights can impact the net value of assets. However, their impact is outside the scope of the TAXAU module.

Net value

The net value of the CGT assets is the amount 'whether positive, negative or nil' that is obtained by subtracting the following from the sum of the market values of the assets (s. 152-20(1)):

- the taxpayer's liabilities related to the assets, and
- provisions made by the entity for annual leave, long service leave, unearned income, and tax liabilities.

A taxpayer also must subtract negative net asset values from the value of other assets.

In *CoT v. Byrne Motels Qld Pty Ltd*, the court held that the agent's selling commissions and legal fees were liabilities in respect of the CGT assets just before the CGT event (even though they were only incurred upon the actual sale) and therefore should be taken into account when applying the maximum net value test.

The $6 million test is a 'black-line' test. If the net value exceeds $6 million by $1, the test is failed.

Taxpayers often restructure their asset mix in order to get under the $6 million threshold (e.g. sell shares and buy a bigger home or put money into superannuation, etc.). The general anti-avoidance provisions in Part IVA ITAA 1936, however, should be kept in mind.

Example – $6 million maximum net asset value test

A CGT event happens to Bob Brown's small business. The market value of Bob's CGT assets just before the CGT event is:

Asset	**Market value $**
Land used in business	1,500,000
Business goodwill	1,200,000
Trading stock	1,000,000
Depreciating assets	800,000
Storage shed (which derives rent) – Bob owes $2 million to Big Bank for a loan used to acquire this asset	2,500,000
Home – 50% use for income-producing purposes	1,600,000
Amount in Bob's self-managed superannuation fund	900,000
Total	9,500,000

Bob has no connected entities or affiliates.

Even though gains from depreciating assets give rise to an assessable balancing adjustment under Division 40 (rather than a CGT gain), depreciating assets are nonetheless CGT assets (as is trading stock) and must be included in the net asset value calculation.

Bob's $2,000,000 loan to buy the storage shed is a liability which must be taken into account in the net asset value calculation.

Bob must include 50% of the value of his home, representing the income-producing use percentage, and must not include the other 50% ($800,000) (s. 152-20(2)(b)(ii) and (2A)).

Bob's self-managed superannuation fund amount ($900,000) is disregarded (s. 152-20(2)(b)(iv)).

Therefore, the net value of Bob's CGT assets is:

$9,500,000 – $2,000,000 – $800,000 (i.e. 50% private portion of the home) – $900,000 = $5,800,000.

Bob 'passes' the $6 million maximum net asset value test in s. 152-15.

Worked example 6.2: Net value of assets – SBE

[Available online in myLearning]

Condition 4 – CGT asset satisfies the active asset test

Under s. 152-35(1), a CGT asset satisfies the active asset test where:

- the taxpayer has owned it for 15 years or less and the asset was an **active asset** for a total of at least **half** of the **test period**, or
- the taxpayer has owned it for more than 15 years and the asset was an **active asset** for a total of at least **seven and a half years** during the **test period**.

Test period

Under s. 152-35(2), the test period begins when the asset was acquired and ends at the earlier of the CGT event, or when the business ceased, if the business in question ceased to be carried on in the 12 months before the CGT event (or such longer time as the Commissioner allows).

The periods in which the asset is an active asset do not need to be continuous, but they must add up to the minimum periods specified above.

Active asset

A CGT asset is an active asset if it is owned by the taxpayer and is:

- used in a business carried on (whether alone or in partnership) by the taxpayer, an affiliate of the taxpayer, or an entity connected with the taxpayer (s. 152-40(1)(a))
- an intangible asset, such as goodwill or a restrictive covenant, which is inherently connected with a business carried on (whether alone or in partnership) by those mentioned above (s. 152-40(1)(b)), or
- a share in a resident company (or an interest in a resident trust), provided that the total of:
  - the market values of the company or trust's active assets
  - the market values of any of the company's or trust's financial instruments that are inherently connected with a business that the company or trust is carrying on, and
  - any of the company's or trust's cash that is inherently connected with the business (e.g. cash resulting from the collection of trade debts)

  is 80% or more of the market value of all of the assets of the company or trust (s. 152-40(3)).

Exclusions

Under s. 152-40(4), the following CGT assets **cannot be** 'active assets':

- Shares in a company or interests in a trust that is connected with the taxpayer, unless the market value of the active assets of the company or trust is 80% or more of the market value of all the company or trust's assets.
- Financial instruments (e.g. bank accounts, loans, debentures, bonds and futures).
- Assets whose main use is to derive interest, an annuity, rent, royalties or foreign exchange gains (unless the main use for deriving rent was only temporary, or the asset is an intangible asset that the taxpayer has substantially developed or improved so that its market value has been substantially enhanced). In determining the 'main use' of the asset, s. 152-40(4A)(a) and (b) not only disregard the taxpayer's personal use and enjoyment, but also require the taxpayer to treat any affiliate or connected entity's personal use as its own.
- Shares and trust interests in widely held entities (e.g. listed companies), unless held by a 'CGT concession stakeholder' (see below) in the widely held entity.

Example – Active and non-active assets

A company uses a house purely as an investment property and rents it out. The house is not an active asset because the company is not using the house in the course of carrying on a business. If, on the other hand, the company used the house as a guest house, the house would be an active asset because the company would be using it to carry on a business and not to derive rent.

Note: Under Condition 4, there is no requirement that the share or trust interest be related to a small business. However, the additional requirements under Condition 5 must also be satisfied.

Condition 5(i) – If the CGT asset is a share in a company or an interest in a trust, additional basic conditions are satisfied

If the CGT asset is a share or interest in a trust, the following conditions must be satisfied just before the CGT event:

- Modified active asset test (s. 152-10(2)(a))
- Taxpayer test (s. 152-10(2)(b))
- Object entity test (s. 152-10(2)(c))
- CGT concession stakeholder test:
  - Where an **individual** taxpayer owns the shares or trust interest in the object entity (i.e. the company or trust that is being sold), that individual is a 'CGT concession stakeholder' in the object entity (s. 152-10(2)(d)(i)).
  - Where a **company or trust** owns the shares or trust interest in the object entity (i.e. the company or trust that is being sold), 'CGT concession stakeholders' in the object entity have a 'small business participation percentage' (s. 152-65) of 90% or more in the vendor entity (s. 152-10(2)(d)(ii)).

The tests in s. 152-10(2)(a), (b) and (c) apply for CGT events on or after 8 February 2018. The purposes of these three tests is to ensure that the CGT concessions are only available for assets used in a small business or ownership interests in a small business (i.e. to prevent the concessions being inappropriately applied to interests in large businesses).

Modified active asset test

Under s. 152-10(2)(a), the share or interest must satisfy a **modified active asset test**. In effect, rather than treating shares or interests as active assets based on the activities of the underlying company, the modified test looks through such membership interests to include the proportionate amount of the value of the assets of other entities (referred to as later entities) to which the interests ultimately relate.

The basic requirements for determining if the share or interest in the object entity (i.e. the entity that is being sold) is an active asset under s. 152-40(3) (see above under Condition 4) are modified so that:

- Financial assets and cash connected with a business of the object entity (or a later entity) are excluded (from increasing active assets in the calculation) if the purpose of them was to help satisfy the active income test (s. 152-10(2A)(a)).
- Where the assets of the object entity include a share or trust interest in a later entity (i.e. there is a chain of entities), then the object entity's assets (for the purposes of the calculation):
  - **Exclude** the shares and trust interests in each later entity (s. 152-10(2A)(b).
  - **Include** a proportionate amount of the market value of each later entity's assets. The proportion is equal to the object entity's 'small business participation percentage' in the later entity (i.e. market value × small business participation percentage in the later entity) (s. 152-10(2A)(c), (d) and (e)).

A later entity's assets will only be **active assets** if the **later entity**:

- is either a CGT SBE, **or** satisfies the maximum net asset value test, based on modified assumptions about when entities are 'connected with' other entities (s. 152-10(2B)(a)) (see below), **and**
- is either an entity in which the taxpayer (i.e. the vendor entity) has a 'small business participation percentage' of at least 20%, **or** is a 'CGT concession stakeholder' (s. 152-10(2B)(b)).

Thus, a taxpayer will satisfy the modified active asset test, if for the lesser of seven and a half years or at least half the period a taxpayer has held the share or interest, at **least 80**% of the sum of:

- the total market value of the assets of the object entity (disregarding any shares in companies or interests in trusts), and
- the total market value of the assets of any entity (a later entity) in which the object entity had a small business participation percentage of greater than zero, multiplied by that percentage,

relates to assets that are active assets, or cash or financial instruments that are inherently connected with a business carried on by the object entity or a later entity.

Example – Modified active income test

Jesse, an Australian resident individual, owns 50% of the shares in A Co, an Australian resident company. A Co owns 10% of B Co, another Australian resident company. Jessie, A Co and B Co each carry on a business and are an SBE under the general rules. B Co is not an affiliate of A Co.

Jessie sells his shares in A Co. In working out if the shares satisfy the modified active asset test, when working out the total value of the assets of A Co, Jesse must disregard the value of the shares A Co holds in B Co and include 10% of the value of the assets of B Co.

Further, for this purpose none of the assets of B Co are active assets for A Co. Jesse's small business participation percentage in B Co is 5% (i.e. 50% × 10%).

Taxpayer test

Under s. 152-10(2)(b), the **taxpayer** must either:

- satisfy the **maximum net asset value test** (see above under Condition 3), **or**
- have **carried on a business** just before the CGT event.

This condition ensures that entities that do not satisfy the maximum net asset value test, do not benefit from the small business CGT concessions where the relevant business activities are too remote to justify the entity receiving a concession for business activities.

Object entity test

Under s. 152-10(2)(c), the **object entity** (i.e. the company or trust that is being sold) must either:

- be a **CGT SBE**, or
- satisfy the **maximum net asset value**,

based on **modified assumptions** about when entities are 'connected with' other entities.

The basic requirements of the SBE and maximum net asset tests (see above under Condition 3) are modified so that:

- They do not include the turnover or value of CGT assets of entities that can control the object entity (i.e. include only assets and turnover for the object entity, its affiliates and entities it controls). This ensures that the outcomes for taxpayers do not depend upon the income or assets of third parties over which the taxpayer has no control.
- An entity is treated as controlling another entity at a time if it has an interest of 20% or more in that other entity at that time, rather than 40% or more. This means that more entities are considered to be 'connected with' one another for the purpose of this test and need to count the assets or turnover of the other entity towards their aggregate turnover or total net CGT assets.
- In working out if one entity controls another for these purposes, any determinations by the Commissioner under s. 328-125(6) are disregarded.

This condition prevents the small business CGT concessions being available for interests in entities that are carrying on a business that is not a small business as it has both substantial aggregate turnover and net assets.

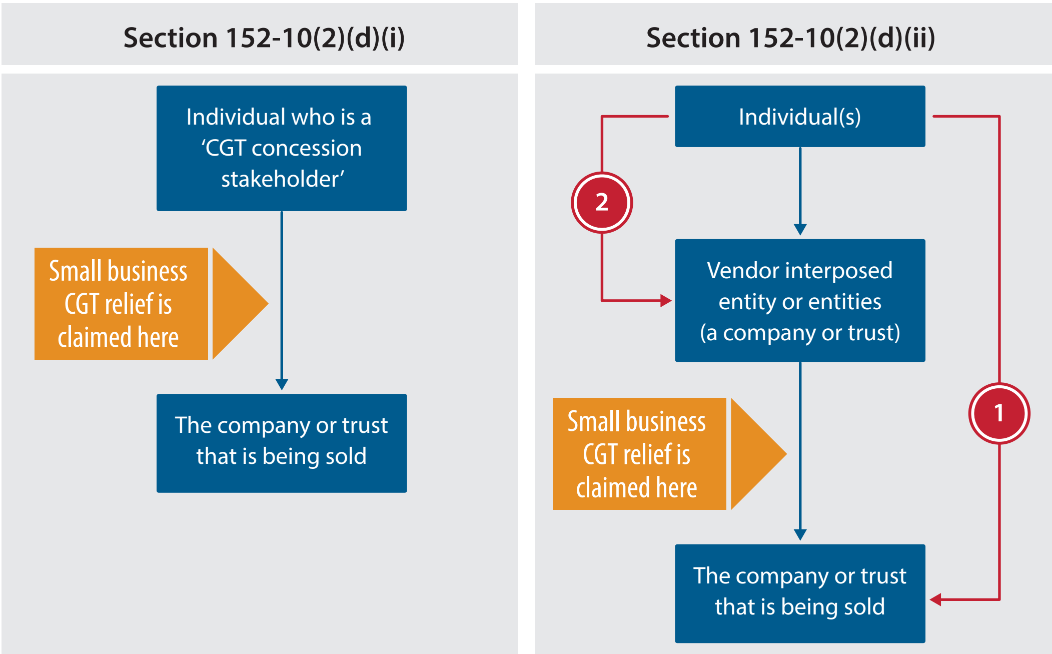
Example – Object entity test

Peter, an individual taxpayer, owns 100% of the shares in Co A, a company that is an SBE under the general rules. Co A owns a 20% interest in Co B, a company that is not an SBE and does not satisfy the net asset value test under the general rules. Peter sells his shares in A Co.

Peter is not eligible to apply the small business CGT concessions to the capital gain on sale of his shares in Co A. Under the modified conditions, Co A and Co B are connected with each other. Therefore, Co A (i.e. the object entity) would not satisfy the modified SBE or net asset value tests.

CGT concession stakeholder test

The two scenarios in s. 152-10(2)(d)(i) and (ii) are depicted in the following diagram.



1. There must be individual CGT concession stakeholders in this entity.
2. The CGT concession stakeholders in 1 must have a small business participation percentage of at least 90% in the vendor entity.

CGT concession stakeholder

Under ss 152-60(a) and (b), an individual is a CGT concession stakeholder of a company or trust being sold if the individual is:

- a 'significant individual' in the company or trust, or
- the spouse of a significant individual in the company or trust, if the spouse has a small business participation percentage in the company or trust at that time that is greater than zero.

Under s. 152-55, a significant individual is an individual who has a 'small business participation percentage' in the company or trust of at least 20%. However, under s. 152-50, the significant individual test is satisfied if the company or trust has a minimum of one significant individual just before the CGT event. In other words, a taxpayer who is not themselves a significant individual may be able to access the small business CGT concessions.

Small business participation percentage

The small business participation percentage is calculated by considering both the direct and indirect participation percentages (s. 152-65).

The method for calculating an entity's direct and indirect small business participation percentage in a company or trust is outlined in ss 152-70 and 152-75. For a company, the direct small business participation percentage is calculated as the entity's smallest holding percentage in:

- the voting power in the company (ignored if shares are jointly held – see s. 152-70(3))
- entitlement to any dividend that the company pays, or
- any entitlement to a distribution of capital that the company makes (s. 152-70(1) item 1).

For a trust, the entity's direct small business participation percentage is calculated based on the entity's smallest percentage entitlement to the income or capital of the trust (s. 152-70(1) items 2 and 3). If a discretionary trust did not have net income or had a tax loss for a particular year, the small business participation percentage can still be calculated even though the trustee makes no distributions of income or capital (s. 152-70(4) and (6)).

The indirect small business participation percentage in a company or trust is calculated by tracing the taxpayer's interests through interposed entities (s. 152-75).

90% small business participation percentage test

Because the significant individual test requires an individual stakeholder (i.e. a natural person), the alternative 90% small business participation percentage test is relevant where there is an interposed entity (such as a discretionary trust) between the CGT concession stakeholders and the company or trust in which the shares or interests are held.

The interposed entity passes this test if 90% of the participation percentages (see above) in that entity are held by CGT concession stakeholders of the company or trust in which the shares or interests are held.

As with the significant individual test, participation percentages can be held directly or indirectly through multiple interposed entities.

Example – The 90% small business participation percentage test

A discretionary trust sells shares in Small Pty Ltd (Small). Bob Brown receives 90% of the distributions from the trust, which has a 50% interest in Small.

The trust cannot be a CGT concession stakeholder in Small because it is not an individual and therefore cannot satisfy the CGT concession stakeholder test in s. 152-10(2)(a).

However, the trust can satisfy the 90% small business participation percentage test in s. 152-10(2)(b) because Bob is a CGT concession stakeholder in Small. His small business participation percentage in the company is 45% (which is greater than 20%) and his small business participation percentage in the trust is 90%.

On the other hand, if the trust held 20% of Small, Bob would **not** be a CGT concession stakeholder in Small because even though his small business participation percentage in the trust is 90%, his small business participation percentage in Small would only be 18% (90% × 20%), which is less than 20%.

Worked example 6.3: CGT concession stakeholders – SBE
[Available online in myLearning]

Condition 5(ii) – If the CGT event involves certain rights or interests in relation to the income or capital of a partnership, additional basic conditions are satisfied

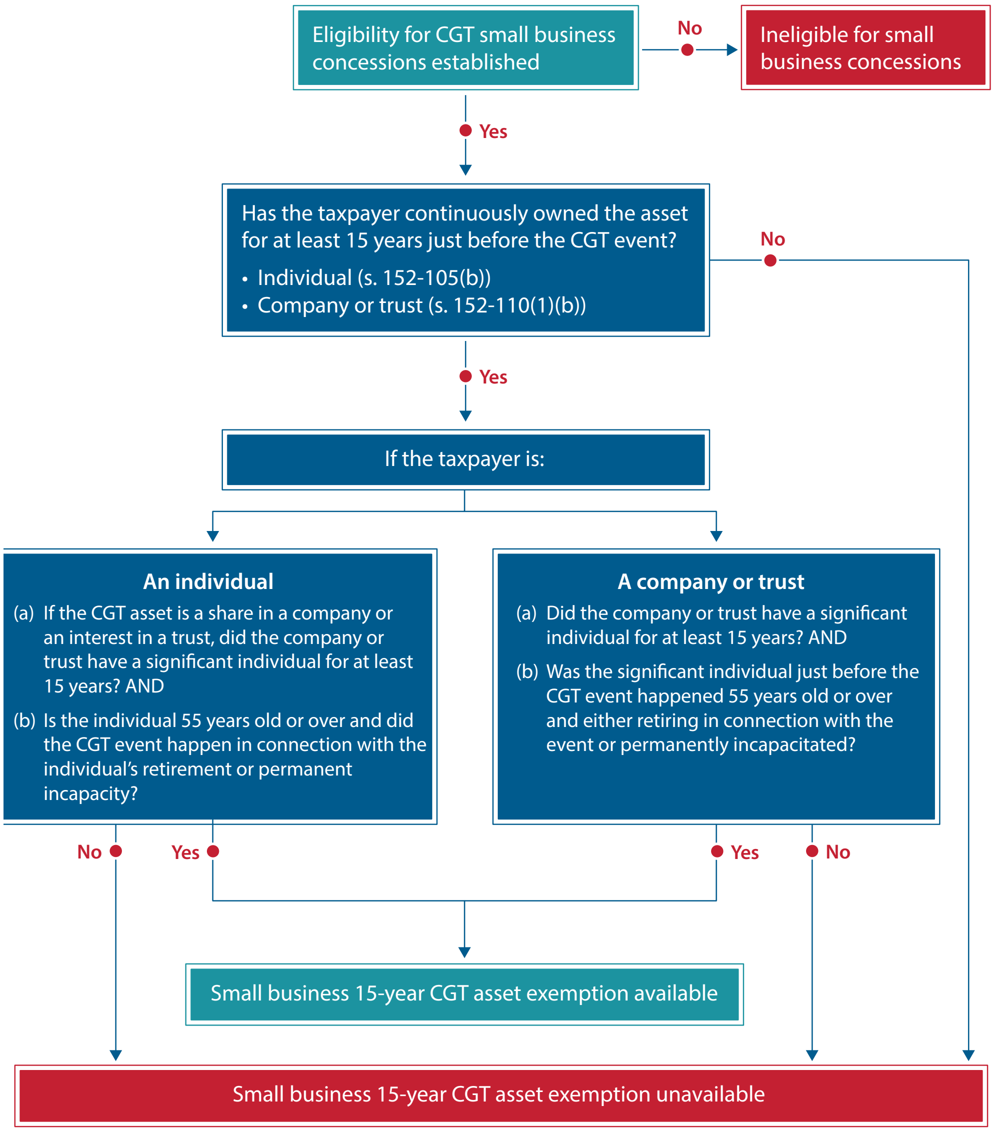
If the CGT event involves certain rights or interests in relation to the income or capital of a partnership, then that right or interest must be a membership interest of the entity in the partnership at the specified time (s. 152-10(2C)).

Small business 15-year CGT asset exemption

The small business 15-year CGT asset exemption takes priority over all other CGT small business concessions. If a taxpayer qualifies for the 15-year exemption, the entire gain is exempt. In addition, the taxpayer does not have to apply capital losses against the capital gain before applying the 15-year exemption.

Eligibility conditions

A flow chart illustrating eligibility for the small business 15-year exemption is set out below.



Individual taxpayers

If the taxpayer is an individual, under s. 152-105 the 15-year CGT asset exemption is available if the following conditions are satisfied:

- The basic conditions are satisfied.
- The individual continuously owned the CGT asset for the 15-year period ending just before the CGT event.
- If the CGT asset owned by the individual is an interest in a company or trust, the company or trust had a significant individual for a total of at least 15 years (even if the 15 years was not continuous and it was not always the same significant individual) during which the individual owned the CGT asset.

- At the time of the CGT event, the individual is:
  - 55 years of age or over and the event happened in connection with their retirement (i.e. they cannot continue working as they did before – see below), or
  - permanently incapacitated.

Where all of these conditions are satisfied, the individual can disregard any capital gain arising from the CGT event.

Company or trust taxpayers

If the taxpayer is a company or a trust (i.e. the CGT event happens to a taxpayer that is a company or a trust), under s. 152-110 the 15-year CGT asset exemption is available if the following conditions are satisfied:

- The basic conditions are satisfied.
- The entity continuously owned the CGT asset for 15 years (subject to s. 152-115) and that period ended just before the CGT event.
- The entity had a significant individual for a total of at least 15 years (even if the 15 years were not continuous and it was not always the same significant individual) during which the entity owned the CGT asset.
- Just before the CGT event, a significant individual of the company or trust is:
  - 55 years of age or over and the event happened in connection with their retirement, or
  - permanently incapacitated.

Retirement and permanently incapacitated

'Retirement' and 'permanently incapacitated' are not defined. A tax practitioner will need to look carefully at the particular circumstances of each case. The guidance on the meaning of these terms, tabled below, is adapted from the ATO's *Small business CGT concessions* online materials.

Defining 'retirement' and 'permanently incapacitated'		
	Retirement	**Permanently incapacitated**
ATO guidance	A significant reduction in the number of hours the individual works, or a significant change in the nature of their present activities must at least have occurred for their situation to be regarded as retirement. However, it is not necessary that there is a permanent and everlasting retirement from the workforce	Based on the meaning of the term 'permanent incapacity' in retirement and superannuation law, an indicative description (p. 39) is: Ill health (whether physical or mental), where it is reasonable to consider that the person is unlikely, because of ill health, to engage again in gainful employment for which the person is reasonably qualified by education, training or experience. The incapacity does not necessarily need to be permanent in the sense of everlasting
Example	A small business operator, who is over 55 years old, sells his business. Under the terms of the sale, he agrees to be employed by the new owner for a few hours each week for two years	Fred is a landscape gardener. He falls from a tree, breaking both arms and a leg. He is hospitalised for several weeks, then continues his recovery at home. Despite physiotherapy, it is nearly a year before he regains full use of his limbs and undertakes normal activities again During this time, as Fred could not operate the business effectively, he sold the business
Conclusion	The sale of the business would be in connection with the operator's retirement. He has permanently or indefinitely ceased being self-employed and commenced gainful employment on a much-reduced scale with another party, although still performing similar activities	Although Fred suffered a serious injury, he was always expected to regain his physical capabilities. It could not be said Fred was permanently incapacitated at the time he sold the business

Distribution to CGT concession shareholders

A capital gain made by a company or trust that qualifies for the 15-year CGT asset exemption may be distributed to a CGT concession stakeholder of the company or trust as a **non-assessable amount** if the following conditions are satisfied:

- The company or trust must make the payment within the later of **two years** of the CGT event and, if relevant, six months after the latest time a financial benefit (i.e. receipt of further capital proceeds) could become due under a look-through earnout right. (Note that, financial benefits under look-through earnout rights may be received for up to five years after the end of the income year in which the CGT event happens.) .
- The payment is made to a person who was a CGT concession stakeholder just before the event (s. 152-125(1)(b)).
- The payment must not exceed an amount that is determined by multiplying the CGT concession stakeholder's participation percentage by the exempt capital gain (s. 152-125(2)).

The distribution of this non-assessable amount by a company is **not a dividend** (s. 152-125(3)) but **does not erode the cost base of the shareholder's shares** in the company (i.e. CGT event G1 does not apply) (s. 104-135(1A)). A taxpayer's interest in a non-discretionary trust is also not eroded by the non-assessable distribution (i.e. CGT event E4 does not apply) (s. 104-70 read in conjunction with s. 104-71(1)(g)).

Curiously, provided that a shareholder is a CGT concession stakeholder in a company (e.g. an individual who has 20% of a company), they do **not** have to retire, or be over 55, or have owned their shares in the company for 15 years, as long as there is **another** CGT concession stakeholder who is over 55 and is retiring (or is otherwise incapacitated). For example, if a 25-year-old acquires shares in a company which satisfies s. 152-110, and then the company sells the business tax-free, the 25-year-old can get a tax-free dividend under s. 152-125, even though they are not retiring and may have only held their shares for a couple of years. Moreover, because there would be no cost base reduction under CGT event G1 in relation to the non-assessable, non-exempt dividend, the 25-year-old could also get a capital loss on the sale of their shares if they sold them ex-dividend.

Activity 6.4: 15-year asset exemption – SBE
[Available online in myLearning]

Small business CGT 50% reduction

Where the conditions for the 15-year CGT asset exemption are not satisfied (see s. 152-215), the small business 50% reduction in Subdivision 152-C allows an eligible taxpayer to reduce the capital gain arising from a business asset (an active asset) by 50% (s. 152-205).

If the capital gain has been:

- Reduced by the general CGT discount percentage, the small business 50% reduction applies to that reduced gain (s. 152-205) (see example below).
- Calculated using the indexation method, the small business 50% reduction will simply apply to further reduce the capital gain, after indexation has been taken into account.

Eligibility conditions

To access this concession, only the basic eligibility conditions in Subdivision 152-A (discussed above) need to be satisfied. That is, unlike the other small business concessions, the small business 50% reduction does not impose any additional requirements (s. 152-205).

Using the concession

The capital gain may be further reduced by either the small business retirement exemption or small business rollover relief, or both (s. 152-210(1)) (discussed below). The taxpayer can choose the order in which the concessions are to be applied (s. 152-210(2)).

A taxpayer may choose not to apply the small business 50% reduction concession (s. 152-220).

Individuals would typically take advantage of the extra 50% reduction to reduce a taxable capital gain by 75% (i.e. when applied in conjunction with the 50% general CGT discount).

Example – General CGT discount and 50% small business reduction

The combined effect of applying the general CGT discount and the 50% small business reduction for an individual taxpayer is as follows.

	$
Capital gain on active asset (basic eligibility conditions satisfied)	1,000
Less: General CGT discount	(500)
Capital gain	500
Less: 50% small business reduction	(250)
Taxable capital gain (75% reduction)	250

A company or non-discretionary trust might, depending on the circumstances, choose not to apply the 50% small business reduction where the shareholder or beneficiary/unit-holder is retiring or close to retirement age. The company or non-discretionary trust may be able to make a larger, tax-free payment under the small business retirement exemption (see below). The benefit of the 50% reduction is also clawed back because the tax saved at:

- the company level means that insufficient franking credits are available to fully frank the distribution of the concessionally taxed amount, and
- the non-discretionary trust level means that the distribution of the tax-deferred amount results in an erosion of the cost base of the beneficiary/unit holder under CGT event E4 (s. 104-70). There are no CGT consequences for the beneficiary of a discretionary trust because the ATO accepts that CGT event E4 does not apply to discretionary trusts (TD 2003/28).

Small business CGT retirement exemption

Under Subdivision 152-D, a taxpayer may choose to disregard all or part of a capital gain from a small business CGT asset if the proceeds are used for retirement (s. 152-310(1)).

Note that a person does not actually have to retire from a business in order to access this concession (the reference to 'retirement' in the guide to Subdivision 152-D in s. 152-300 is misleading in this respect).

Lifetime limit

A lifetime limit of $500,000 (unindexed) applies to the small business retirement exemption (ss 152-315 and 152-320). The exemption may be used multiple times, provided the $500,000 cap is not exceeded. To help the ATO verify this requirement, taxpayers are obliged to keep written records of the exempt amount (ss 152-315(4) and (5)).

For companies and trusts claiming the exemption, the $500,000 cap applies to each CGT concession stakeholder (e.g. for a company that has four CGT concession stakeholders, the cap is effectively $2 million).

Application

The small business retirement exemption does not apply where the small business 15-year CGT asset exemption (Subdivision 152-B) applies (s. 152-330). As noted earlier, if the 15-year exemption applies, the gain is exempt and there are no further CGT consequences.

The retirement exemption applies only to the balance of any gain remaining after applying the general CGT discount: Steps 3 and 4 of working out a net capital gain in s. 102-5.

The small business 50% reduction (see above) applies before the small business retirement exemption, although the taxpayer can choose not to apply the 50% reduction (s. 152-220). As noted earlier, a company or trust may obtain a better outcome by using the retirement exemption in preference to the 50% reduction concession (see example below).

Finally, the retirement exemption can apply to all or part of the gain. It is therefore possible for a taxpayer to choose the small business rollover concession (discussed below) in conjunction with the small business retirement exemption and also the order in which these concessions are applied (s. 152-210).

Alternatively, the retirement exemption can apply to all or part of a crystallised gain arising under CGT event J5 or J2 arising after choosing the small business rollover relief in Subdivision 152-E (see 'Small business rollover relief' below). For example, where a replacement asset is not purchased in the replacement asset period, this effectively defers the gain for that period. Where the retirement exemption is claimed to reduce the CGT J5 event, the basic conditions do not have to be satisfied at that time (s.152-305(4)).

Example – Retirement exemption and 50% small business reduction

Small Pty Ltd (Small) is not eligible for the 15-year CGT asset exemption. However, the company is eligible to use the 50% reduction concession in Subdivision 152-C or, it can choose to apply the retirement exemption (s. 152-220).

Scenario 1 – Using both methods	
	$
Capital gain (basic eligibility conditions satisfied)	500,000
Less: 50% small business reduction	(250,000)
Less: Retirement exemption	(250,000)
Taxable capital gain	0

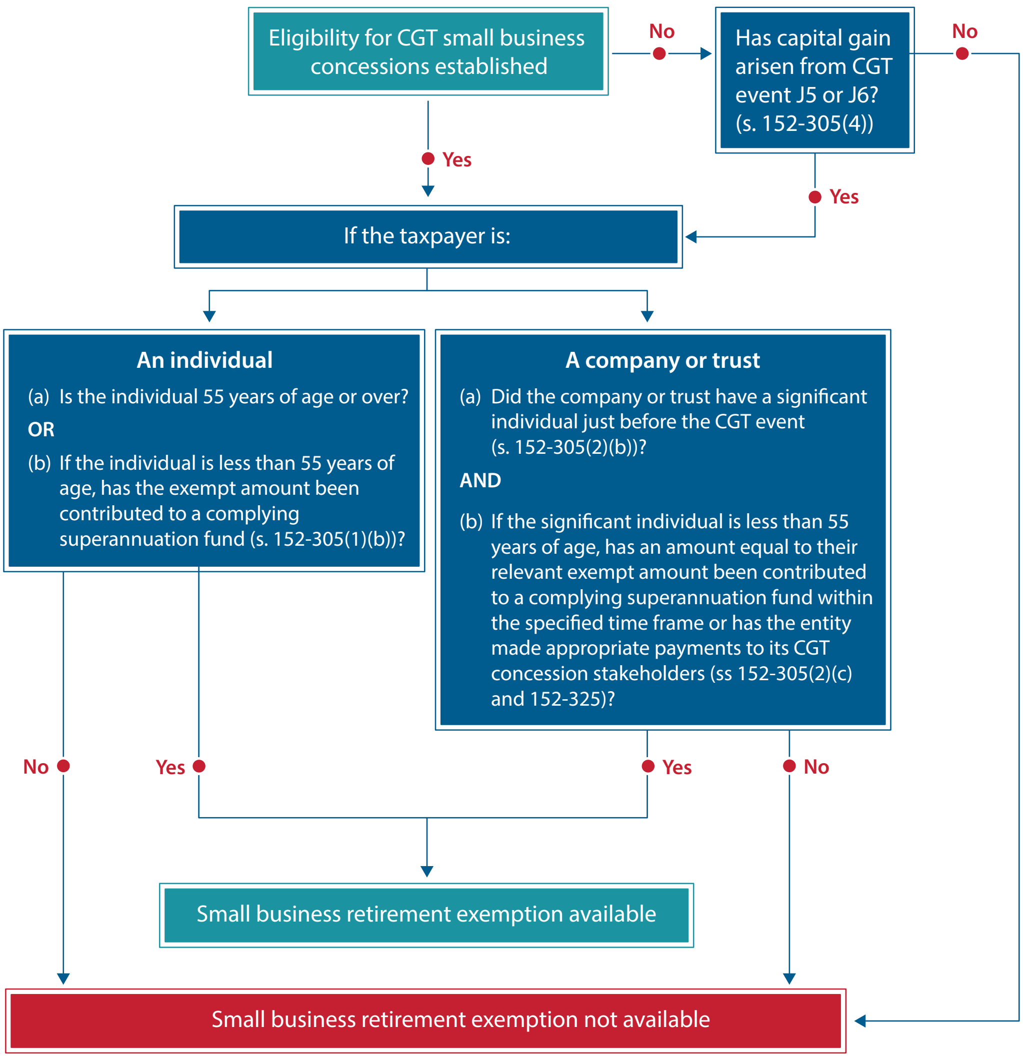
Scenario 2 – Using only the retirement exemption	
	$
Capital gain (basic eligibility conditions satisfied)	500,000
Less: Retirement exemption	(500,000)
Taxable capital gain	0

In Scenario 1, the untaxed $250,000 profit from applying the 50% small business reduction remains part of the distributable profits of the company. In the absence of other surplus franking credits generated by income tax payments, a distribution of this amount would be regarded as an unfranked dividend (i.e. the benefits of the CGT concession would be 'clawed back' by the payment of tax at the shareholder level). In any event, if the shareholder is in the highest tax bracket, leaving profits in the company (even if franked) would result in the imposition of 'top-up' tax for the shareholder when a dividend is paid.

Scenario 2 avoids this outcome, because the retirement exemption amount must be paid out to CGT concession stakeholders as a tax-free, unfranked distribution (see below) and ceases to be part of the company's distributable profits (the payment reduces Small's net assets).

Eligibility conditions

The following flow chart illustrates the conditions that must be satisfied for a taxpayer to qualify for the small business retirement exemption:



CGT events J5 and J6

Unlike other small business CGT concessions discussed above, the small business retirement exemption can apply to a capital gain arising from CGT events J5 or J6. These CGT events arise where the taxpayer has previously applied the CGT small business rollover provision in Subdivision 152-E (discussed below). Where a capital gain arises under either of these two CGT events, a taxpayer can choose the retirement exemption without having to re-satisfy the basic eligibility conditions for small business CGT relief (provided at the beginning of this section).

Individuals less than 55 years of age

If the individual is less than 55 years old just before choosing the rollover, they must contribute the CGT-exempt amount to a complying superannuation fund or retirement savings account (RSA) (s. 152-305(1)). A common planning strategy for those aged 53 or 54 is to roll their capital gain over, under the small business rollover relief (see below), and then access the retirement exemption once they turn 55.

Individuals aged 55 or over are not required to make any such contribution.

Distribution to CGT concession stakeholders

Section 152-325(1)–(6) requires that CGT concession stakeholders of companies and trusts must be paid their proportion of the lesser of the capital proceeds or the exempt amount (either in one lump sum payment or in instalments and either directly or via interposed entities) by the later of seven days after:

- the choice is made to disregard the capital gain, or
- an amount of capital proceeds is received by the company or trust.

If the CGT concession stakeholder is under 55 years of age just before making the choice, the stakeholder must contribute an amount equal to the asset's CGT-exempt amount to a complying superannuation fund or RSA by the later of seven days after the choice is made or the capital proceeds are received (s. 152-325(7)).

The payments do not have to be in accordance with the CGT concession stakeholders' small business participation percentage, but they must not exceed 100% in aggregate (ss 152-315(5) and 152-325(3)).

Consequences of choosing the small business retirement exemption			
Entity	**Element**	**Consequence**	**Section reference**
Individual	Capital gain	Capital gain equal to CGT-exempt amount is disregarded	152-310(1)
Company or trust	Capital gain	Capital gain equal to CGT-exempt amount is disregarded	152-310(1)
	On-payment by company or trust to the CGT concession stakeholder	Is non-assessable, non-exempt income (NANE) in the hands of the stakeholder[1]	152-310(2)(a)
		On-payment cannot be deducted by the company or trust from its assessable income	152-310(2)(b)
		On-payment is not a frankable dividend by a company, and is excluded from the deemed dividend provisions in s. 109 ITAA 1936 and Part III Division 7A ITAA 1936	152-325(10) and (11)

Note

1. NANE classification precludes any cost base erosion under CGT event G1 for the shareholder (s. 104-135(1A)(aa)) or CGT event E4 for the beneficiary/unit-holder (s. 104-71(1)(a)).

Small business CGT rollover

The final small business CGT concession is the small business rollover relief in Subdivision 152-E. This concession allows a taxpayer to roll over (i.e. defer) the capital gain, wholly or partly, from small business assets (s. 152-415). Alternatively, where a taxpayer is genuinely restructuring their small business on or after 1 July 2016, the taxpayer may roll over the tax gains and losses (including capital gains) that would otherwise arise from the small business assets under Subdivision 328-G (as discussed later), as opposed to under Division 152.

Using the concession

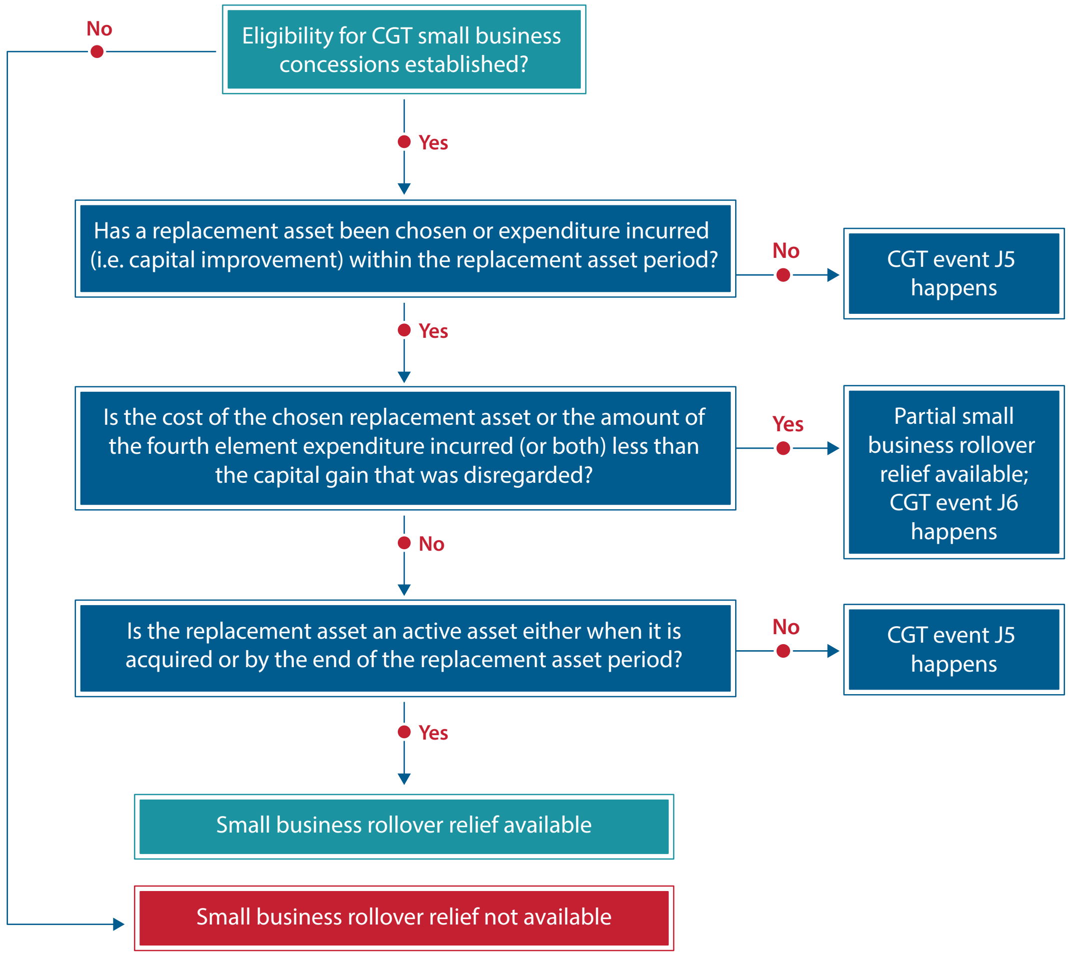
Small business rollover relief does not apply where the small business 15-year CGT asset exemption (Subdivision 152-B) applies (s. 152-430). As noted earlier, if the 15-year exemption applies, the gain is exempt and there are no further CGT consequences.

The small business 50% reduction (discussed above) applies **before** rollover relief, although the taxpayer can choose not to apply the 50% reduction (s. 152-220).

Rollover relief may be applied in conjunction with the small business retirement exemption outlined above (s. 152-210).

Eligibility conditions

The following flow chart illustrates the conditions that must be satisfied to qualify for small business rollover relief.



The eligibility conditions associated with small business rollover relief are ascertained from two sources in the ITAA 1997:

- Subdivision 152-E.
- CGT events J5 (s. 104-197) and J6 (s. 104-198).

(See Note 1 to s. 152-410.)

In summary, the **eligibility conditions** for small business rollover relief are as follows:

- Replacement assets are acquired or improvements are made to an existing asset within the replacement asset period. Failure to do so within the relevant period will result in CGT event J5 or J6 occurring at the end of the replacement asset period. The replacement asset period (s. 104-190) is the period:
  - which starts one year before the occurrence of the last CGT event in the income year for which small business rollover relief is claimed, and
  - which ends at the later of two years after that CGT event, and if relevant, six months after the latest time a financial benefit (i.e. receipt of further capital proceeds) could become due under a look-through earnout right relating to the CGT asset.
- The replacement asset (or the asset that was improved) must be an active asset when it is acquired, or become an active asset by the end of the replacement asset period. If the replacement asset is a share in a company or an interest in a trust:
  - the taxpayer or an entity connected with the taxpayer must be a CGT concession stakeholder in the company or trust, or
  - the CGT concession stakeholders of the company or trust must have a small business participation percentage in the interposed entity of at least 90%.

Example – Small business rollover: Shares

Where the replacement asset comprises shares in a company, small business rollover relief will only apply if:

- the shares satisfy the 80% active asset test, and
- a CGT concession stakeholder or 90% small business participation percentage requirement is satisfied.

Bob Brown owns 50% of the shares in Company A and Company B, and is therefore a CGT concession stakeholder in both companies (under s. 152-60). The companies are connected with Bob because he controls both of them (under s. 328-125).

Company A owns land (a passive asset) that it leases to Bob for use in his business. Company A sells the land at a profit and buys shares in Company B as a replacement asset. All of Company B's assets are active assets.

The replacement asset test in s. 104-197(2) – CGT event J5 – is satisfied because:

- the shares are active assets (under s. 152-40(3)), and
- Bob is both connected with Company A and a CGT concession stakeholder in Company B.

Small business rollover relief will therefore be available.

Consequence of rollover

The consequence of the small business rollover is that the capital gain is disregarded to the extent that it does not exceed the cost base of the replacement asset.

However, there are various ways in which a gain that is deferred under the small business rollover can crystallise. Two of these ways include:

- Where no replacement asset is acquired within the replacement period (CGT event J5).
- Where the replacement asset changes its status after the replacement period (CGT event J2).

Where no replacement asset acquired (CGT event J5)

Where no replacement asset is acquired within the replacement asset period (note that there is no requirement that a replacement asset be purchased), a deemed capital gain arises under CGT event J5 at the end of the replacement asset period (i.e. generally a two-year period). This effectively means that capital gains can be rolled forward for up to that amount of time.

When CGT event J5 happens, the taxpayer makes a capital gain equal to the amount of the capital gain previously disregarded under the small business rollover. The time of the event is at the end of the replacement asset period. The Commissioner may extend the replacement asset period.

As noted previously, a capital gain from CGT event J5 may be eligible for the small business retirement exemption if the relevant conditions of the exemption are satisfied. Note that where CGT event J5 or J6 applies and the small business retirement exemption is claimed, the basic conditions do not have to be re-satisfied at that time s. 152-305(4).

Where the replacement asset changes its status (CGT event J2)

CGT event J2 happens if, after the end of the replacement asset period, there is a change in the status of the replacement or capital-improved asset for which the small business rollover was chosen.

Examples of CGT event J2 include the following:

- The replacement or capital-improved asset stops being an active asset (e.g. the taxpayer disposes of the asset or stops using it in their business).
- The replacement or capital-improved asset becomes trading stock.

SBE asset rollovers

Small business restructure rollover

Overview

From 1 July 2016, under Subdivision 328-G, small businesses may be able to rollover (i.e. defer) the recognition of tax gains or losses that may arise from the transfer of active assets (e.g. CGT assets, trading stock, revenue assets and depreciating assets) to another small business as part of a genuine business restructure. The rollover relief is not available for artificial or inappropriately tax-driven schemes. It is also not available where small business owners are winding down or exiting their small business.

Eligibility conditions

Sections 328-430 to 328-445 outline the conditions that must be met for rollover relief to be available. The rollover will only apply where:

- The asset transfer is part of a **genuine restructure** of an **ongoing** business.

  LCR 2016/3 sets out the meaning of a genuine restructure of an ongoing business. In the ATO's view, a genuine restructure is one that 'could be reasonably expected to deliver benefits to small business owners in respect of their efficient conduct of the business going forward'. For example, a move to a more efficient tax structure.

  A safe harbour rule applies, to deem a transaction to be a genuine business restructure, if in the **three-year period** after the transaction takes effect there is no change in ultimate economic ownership, the asset continues to be an active asset, and there is no significant use of the assets for private purposes.
- Each party to the transfer must be a resident and is:
  - a small business entity (SBE),
  - an entity that has an affiliate that is an SBE,
  - an entity that is connected with an SBE, or
  - a partner in a partnership that is an SBE.

  This means that an entity not carrying on a business, but holding assets for an SBE, may be able to apply the rollover.

  Refer to 'SBE general concessions' above for the definition of an SBE.
- The transaction does not result in a change to the **ultimate economic ownership** of transferred assets. For example, where assets are rolled over from a partnership to a company, each partner in the partnership must hold the same ultimate proportionate share of the asset after the rollover. Note: There is a concession where assets are transferred between individuals and family trusts. In practice, this condition severely limits the attractiveness of Subdivision 328-G.
- The asset must be a CGT asset that is an **active asset**.

  Where a party to the transfer is itself an SBE, active asset is defined in s. 152-40, and broadly includes assets used in a business. Where a party to the transfer is an affiliate or connected entity, the active asset must satisfy s. 152-10(1A), which requires that the relevant SBE carries on business in relation to the asset; for example, a factory owned by Mrs Smith that is used by her husband Mr Smith to carry on his manufacturing business.

Assets such as loans to shareholders of a company are not active assets of the business carried on and therefore, cannot be rolled over. Having said that, such loans would not generally carry unrealised gains.

- The transferee and the transferor must both choose to apply the rollover.

Note: The Government has released draft legislation that proposes to amend s. 328-430 to allow an entity that is connected with, or an affiliate of, an SBE to access the small business restructure rollover if the SBE has aggregated turnover of between $2 million to $10 million.

Consequences

Section 328-450 to 328-475 outline the consequences of the restructure rollover. Where the rollover applies:

- The transferor is taken to have received an amount for the transferred asset equal to the transferor's cost of the asset for income tax purposes so that there is no taxable gain or loss.
- The transferee will be taken to have acquired the asset at the time of the transfer for an amount that equals the transferor's cost just before transfer.

For **CGT assets**:

- The rollover cost equals the cost base of the asset.
- Pre-CGT assets will retain their pre-CGT status after the transfer.
- To be eligible to claim the CGT discount for any subsequent sale of the asset, the transferee will need to wait at least 12 months before a CGT event happens to that asset.
- For the purposes of the 15-year CGT exemption (as discussed above), the transferee is taken to have acquired the asset when the transferor acquired it (s. 152-115(3)).

For **trading stock**, the rollover **cost** of an asset is either:

- The cost of the item for the transferor at the time of the transfer, or
- The value of the item for the transferor at the start of the income year, if the transferor held the item as trading stock at that time (i.e. the opening stock value).

For **depreciating assets,** rollover relief is available under s. 40-340. The rollover relief prevents the transferor from having to make a balancing adjustment. It allows the transferee to deduct the decline in value of the depreciating asset using the same method and effective life as the transferor was using (s. 40-345).

For **revenue assets**, the rollover **cost** is the amount that would result in the transferor not making a profit or loss on the transfer. The transferee will inherit the same cost attributes as the transferor just before transfer.

Where **membership interests are issued** as consideration for the transfer, the cost base/reduced cost base of those new membership interests is worked out using the following formula:

$$\text{Cost base} = \frac{\text{Sum of rollover costs and adjustable values of the rollover assets} - \text{liabilities the transferee assumes for the assets}}{\text{Number of new membership interests}}$$

Integrity rule

A loss-denial rule ensures that a capital loss on any direct or indirect membership interest in the transferor or transferee that is made subsequent to the rollover will be disregarded, except to the extent that the taxpayer can demonstrate that the loss is reasonably attributable to something other than the rollover transaction (s. 328-470).

Activity 6.5: Restructure rollover – SBE
[Available online in myLearning]

Other key resources

Quick reference guides
6.1: SBE taxpayer
6.2: Decline in value deductions – SBE taxpayers
6.3: Small business CGT relief
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

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Unit 7: Individuals

Contents

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Learning outcomes

At the end of this unit you will be able to:

1. Explain the general tax principles that apply to individuals.
2. Examine and apply the non-commercial loss provisions.
3. Examine and apply the personal services income provisions.

Introduction

This unit is the first in a series that considers the taxation treatment of different types of entities (i.e. taxpayers) and how the taxable income and/or tax payable calculation is modified. An entity, for taxation purposes, means any of the following: an individual, a company, a trust, a partnership or a superannuation fund.

The tax issues examined in this unit include the general tax principles applicable to individuals (including individuals carrying on a business as a sole trader); the deferral of losses from non-commercial business activities; and the alienation of personal services income (PSI) where an individual diverts income through an entity such as a company, trust or partnership.

Note:

- The income tax year end covered in this offering of the TAXAU module is 30 June 2019. Therefore, the amendments that are applicable from 1 July 2019 are outside the scope of the module.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Individual tax principles

Defining an individual

For taxation purposes, an individual means a natural person.

When an individual operates a business under their own name or with a registered business name, they are known as a sole trader. A sole trader is the simplest business structure. Often, a business may commence as a sole trader but later develop into a more complex structure, such as a company, as the business expands.

From an asset protection perspective, sole traders and partnerships do not offer the individual limited liability that is a feature of companies and trusts. While asset protection and succession planning are important issues to consider when providing advice to clients on appropriate tax structures, the focus of this unit is the tax issues.

Key features and tax attributes

A broad overview of the key features and tax attributes of an individual are set out below.

Tax issue	How the issue relates to individuals	Refer to
Features and tax attributes		
Taxpayer	An individual is a taxpayer for income tax purposes The 'sole trader' business structure is not a separate taxpayer; its taxation consequences are simply part of the individual's tax affairs	Unit 1
Residency	A resident individual is taxable in Australia on their worldwide income. However, to minimise the double taxation of foreign income, resident individuals may be entitled to exemptions or tax credits A non-resident individual is only taxable in Australia on their Australian sourced income. However, a further restriction applies for CGT purposes. A non-resident is only taxable in Australia on a capital gain (or loss) where the CGT asset is taxable Australian property (TAP) There are specific rules for determining the residency of an individual and the source of income	Unit 1, Unit 4 and Unit 14
Goods and services tax (GST)	An individual that carries on an enterprise can be registered for GST	Unit 2
Fringe benefits tax (FBT)	An individual that is an employer can provide a fringe benefit to an employee (or their associate) and may be subject to FBT Note: An individual cannot be an employee of their own sole trader business	Unit 3
Small business entity concessions	An individual that is a sole trader may be classified as an SBE and may choose to apply the available SBE concessions	Unit 6
Uniform administrative penalty regime	The penalty regime applies to individuals in the same way as other taxpayers	Unit 1
Amended assessments	The time frame for the Commissioner to amend an assessment that is applicable to an individual is generally two years	Unit 1

Individual taxable income and tax payable

Taxable income (s. 4-15)

Calculation method

Unit 1 outlines the framework for calculating taxable income and tax payable (or refundable) that is applicable to all taxpayers, including individuals. Under s. 4-15, an individual's taxable income is equal to their assessable income reduced by the deductions they incurred in deriving that income.

Assessable income

Many of the income tax issues covered in the TAXAU module are applicable to individuals. However, there are also tax provisions specific to this type of taxpayer. A broad overview of the general and specific provisions under which an individual determines their assessable income are set out below.

Tax issue	How the issue relates to individuals	Refer to
Assessable income		
Ordinary and statutory income	An individual's assessable income includes ordinary income under s. 6-5 and statutory income under s. 6-10. However, it excludes exempt income and non-assessable non-exempt (NANE) income • An individual's ordinary income includes income from personal exertion (e.g. salary or wages income), property (e.g. rent, interest, dividends and royalties), and business (e.g. operating as a sole trader) • The most common types of statutory income for an individual are a net capital gain, a share of the net income or loss of a partnership, and a trust distribution	Unit 1
Timing of inclusion in assessable income	An individual includes ordinary income in their assessable income when it is derived • Non-business ordinary income is derived on a cash basis (i.e. on receipt) • Business income is derived on a cash basis where it is all from the individual's own personal exertion. However, where they employ other individuals, an accruals basis is more appropriate An individual includes statutory income in their assessable income in accordance with the timing rules in the statutory income provision	Unit 1
Employment income	An individual includes gross salary and wages income (i.e. net income grossed-up for PAYG withheld) in their assessable income An individual includes payments on termination of employment in their assessable income. However, the tax-free component of a genuine redundancy payment is excluded	Unit 1 and Unit 3
Rental income	An individual includes rental income in their assessable income. Where the residential property is held as a passive investment (i.e. not as part of carrying on a business), the rental income is included when it is received (i.e. not when it is due)	Unit 1

Tax issue	How the issue relates to individuals	Refer to
Assessable income		
Dividend, interest and royalty income (i.e. passive income)	A resident individual that receives a franked dividend from an Australian company must include the dividend and a franking credit gross-up in their assessable income (they are also entitled to a franking tax offset) A resident individual includes gross foreign dividend, interest and royalty income (i.e. net income grossed-up for foreign taxes withheld) in their assessable income (they may also be entitled to a foreign income tax offset (FITO)) A non-resident individual is subject to withholding tax on their Australian sourced dividend (unfranked component), interest and royalty income. That income is then deemed to be NANE income	Unit 8 and Unit 14
Fringe benefits (i.e. generally non-cash benefits provided to an employee in respect of their employment)	In the hands of the individual employee: • A fringe benefit is deemed to be NANE income (s. 23L(1)) • An exempt benefit for FBT purposes is deemed to be exempt income (s. 23L(1A)), with the exception of car expenses reimbursed by an employer on a cents per kilometre basis that are included in assessable income (s. 15-70)	Unit 1 and Unit 3
Employee share schemes (ESS) benefits	An individual who acquires shares or rights under an ESS at a discount, includes that discount in their assessable income in the year of acquisition, subject to certain concessions	Unit 3
Net capital gains	An individual includes a net capital gain in their assessable income and can carry forward a net capital loss to a future income tax year. An individual may be eligible for various CGT concessions, including: • CGT 50% general discount under Division 115 • CGT main residence exemption under Subdivision 118-B • CGT rollover relief under Subdivision 122-A • CGT SBE concessions under Division 152 (subject to basic and specific eligibility conditions) • SBE restructure rollover under Subdivision 328-G (this also applies to trading stock and depreciating assets)	Unit 4 and Unit 6
Deemed dividends from a private company	An individual that is a shareholder in a private company may have to include deemed dividends under Division 7A in their assessable income	Unit 8
Partnership net income or loss	An individual that is a partner in a partnership must include their share of a partnership's net income or loss in their assessable income (limited to Australian sourced income where the partner is a non-resident) Note: Any capital gain or loss in relation to a partnership or one of its CGT assets is made by each partner individually (s. 106-5) (i.e. each partner must separately calculate their net capital gain or loss)	Unit 9
Trust distribution	An individual that is a beneficiary of a trust must include the assessable component of a trust distribution in their assessable income (subject to exceptions for certain taxpayers) Note: The non-assessable component of a trust distribution from a unit trust (i.e. a fixed trust) may result in a reduction to the cost base of the units or give rise to a capital gain for the beneficiary	Unit 10
Deemed personal services income (PSI)	An individual that attempts to alienate their PSI may be subject to the PSI rules contained in Divisions 84–87. These rules can deem amounts that are not promptly paid as salary and wages to be included in the individual's assessable income	See later in this unit

Note: From 1 July 2019, the Government has proposed legislative changes to ensure that all remuneration (including payments and non-cash benefits) provided for the commercial exploitation of a person's fame or image will be included in the individual's assessable income (i.e. cannot be licensed to another lower tax rate entity).

Allowable deductions

A broad overview of the general and specific provisions under which an individual determines their allowable deductions is set out below.

Tax issue	How the issue relates to individuals	Refer to
Allowable deductions		
General and specific deductions	An individual's allowable deductions include general deductions under s. 8-1 and specific deductions under s. 8-5 An individual is entitled to a general deduction under s. 8-1 for losses and outgoings: • Incurred in gaining or producing their assessable income (i.e. expenditure that has a direct nexus to the individual's assessable income) – for example, income protection insurance (as any compensation received is assessable income) and membership fees of a professional or trade organisation related to the industry in which the individual is currently employed • Incurred in carrying on a business (i.e. expenditure that simply relates to the business carried on by the individual as a sole trader) However, under s. 8-1, a general deduction is not available to the extent that: • It is of capital or a capital nature – for example, where an individual purchases a new computer, the cost of acquisition is capital in nature; however, a decline in value deduction may be available under the capital allowance rules • It is of a private or domestic nature – for example, home to work travel of an employee (subject to limited exceptions), work clothing that is not a registered uniform or occupation-specific, and childcare costs while an employee is at work • It is incurred in relation to deriving exempt or NANE income • A provision prevents the deduction	Unit 1
Timing of inclusion as an allowable deduction	An individual is entitled to a general deduction when the expenditure is incurred. Expenditure is incurred when there is a definitely committed obligation or a liability is enforceable at law (e.g. the invoice is received or paid). However, it does not have to be paid. This might broadly be thought of as an accruals basis; however, there is no income tax concept of a cash or accruals basis for expenditure Note: An individual is entitled to a specific deduction as determined by the timing rules in each specific deduction provision	Unit 1
Reduction for private use	An individual (or a partnership) can incur expenditure **partly** for private purposes. Where this applies: • General deductions under s. 8-1 are reduced to the extent that a loss or outgoing is of a private or domestic nature • Decline in value deductions under s. 40-25 are reduced to the extent that a depreciating asset is used for non-taxable purposes. This reduction may also result in a capital gain or loss under CGT event K7 on disposal of the asset	Unit 1, Unit 4 and Unit 5
Prepayments	An individual who is not carrying on a business, or carrying on a business that is an SBE, is entitled to an exclusion from the prepayment rules (applicable to expenditure that would be otherwise deductible under s. 8-1), provided the period covered by the expenditure is 12 months or less (s. 82KZM ITAA 1936) Where the expenditure is excluded from the prepayment rules, it is deductible to the individual when incurred (i.e. at the time of the prepayment) and does not have to be spread over the eligible service period	Unit 1 and Unit 6

Tax issue	How the issue relates to individuals	Refer to
Allowable deductions		
Residential rental property expenses	Where an individual (or partnership) is not carrying on a business: • Travel expenses related to a residential rental property are denied a deduction under s. 26-31 – for example, travel to inspect the property or collect rent. The travel expenses are also specifically excluded from the property's cost base under s. 110-38 • Second-hand assets used in a residential rental property (excluding those provided as part of new residential premises) are denied a decline in value deduction under s. 40-27. This reduction may result in a capital gain or loss under CGT event K7	Unit 1, Unit 4 and Unit 5
Substantiation of deductions	All individuals, including sole traders, need to ensure that they have complied with the substantiation provisions in order to claim their expenses as a tax deduction. There are specific substantiation rules for: • Work expenses – for example, invoices (subject to exclusions) • Car expenses – for example, maintaining a log book • Business-related travel – for example, maintaining a travel diary	Unit 1
Goods and services tax (GST)	Where an individual is **not** entitled to claim an input tax credit for the GST component of an acquisition (e.g. because the individual is not registered or required to be registered for GST, or is making input-taxed supplies), the GST component is included in: • The amount incurred under s. 8-1 • The cost of a depreciating asset under s. 40-175 • The cost base of a CGT asset under s. 110-25 For example, the owner of the residential rental property pays $110 (GST-inclusive) to repair a kitchen stove. The supply of a residential rental property is an input-taxed supply for GST purposes and thus, the GST component of any expenditure incurred in the making of that supply cannot be claimed as an input tax credit. The owner can claim an income tax deduction for the repair under s. 25-10 for the GST-inclusive cost of $110 The interaction between GST and deductions for individuals that are registered for GST is discussed further below	Unit 2, Unit 4 and Unit 5
Employee contributions related to fringe benefits	An employee contribution to reduce the taxable value of a fringe benefit provided by their employer (or an associate of their employer) is not deductible to the individual (s. 51AJ)	Unit 3
Capital allowances and capital works	An individual is entitled to a deduction for the decline in value of depreciating assets to the extent they are used for a taxable purpose (see above reduction for private use). Special capital allowance rules may apply for: • An individual that qualifies for the SBE general concessions • Second-hand assets in a residential rental property (see above) An individual is entitled to a capital works deduction for a building (or structural improvement) to the extent it is used to produce assessable income (e.g. an individual that owns a residential rental property may be entitled to a capital works deduction)	Unit 5 and Unit 6
Losses	An individual is entitled to a general deduction for tax losses, subject to the general carry forward tax loss rules in Division 36 that are applicable to all taxpayers The current and prior period tax losses incurred by an individual in carrying on a business are also subject to the non-commercial loss rules in Division 35	Unit 1 and later in this unit

Note: The specific deduction provisions that are applicable to all taxpayers, including individuals, are analysed in detail throughout the TAXAU module materials. The above table does not provide a summary of all deductions available to an individual.

Example – Taxable income from a rental property

Carolyn Anderson, an Australian resident individual taxpayer, owns a two-bedroom apartment located in Australia that she holds as an investment property (i.e. a residential rental property). The apartment is rented (or available for rent) on an arm's-length basis at all times (i.e. the property is used solely for producing assessable income and there is no private use).

During the income year ended 30 June 2019, Carolyn received rent of $30,000 and has the following expenses:

- Interest on a loan used to acquire the property of $10,000. The 10-year loan was entered into when the property was purchased two years ago (on the first day of that income year). At that time, Carolyn also paid borrowing costs of $1,000 and stamp duty of $7,000.
- Travel costs of $2,000 to inspect the condition of the property.
- Repair costs of $100 to stop a water leak for the apartment's dishwasher.
- Costs of $900 to purchase a replacement fridge for the apartment. She purchased the replacement fridge online from a seller who had previously used it in their home.
- Other expenses for the property included council rates of $2,000, building insurance of $1,200 and land tax of $1,500. Assume there are no other expenses related to the property.

At the time Carolyn acquired the apartment for $400,000, the seller provided documentation to Carolyn showing that the apartment had a construction cost of $300,000 (fully undeducted).

Carolyn calculated her taxable income in respect of her rental property as follows.

Details	Explanation	$	$
Assessable income			
Rent	Assessable under s. 6-5 as ordinary income		30,000
Deductions			
Interest	Deductible under s. 8-1 (as it has a direct nexus to a property used solely for income-producing purposes)	10,000	
Borrowing costs	Deductible over 5 years under s. 25-25 (as this is less than the loan term). $1,000 ÷ 5 = $200 **Note**: The borrowing costs are not included in the cost base of the property under s. 110-25 as they are otherwise deductible (i.e. the specific deduction provision applies)	200	
Stamp duty	Stamp duty is capital in nature and included in the cost base of the property under s. 110-25	0	
Travel costs	Travel costs (despite having a direct nexus to a property used solely for income producing purposes) are specifically non-deductible under s. 26-31 as Carolyn is an individual taxpayer and is not carrying on a business **Note**: The travel costs are also specifically excluded from the cost base of the property under s. 110-38	0	
Dishwasher cost	Repairs are specifically deductible under s. 25-10	100	
Fridge cost	The fridge is a depreciating asset, but it is specifically denied a decline in value deduction under s. 40-27 as Carolyn is an individual taxpayer and it is a second-hand asset used in a residential rental property	0	
Other expenses	Deductible under s. 8-1 (as they have a direct nexus to a property used solely for income producing purposes)	4,700	
Building cost	Capital works deduction for undeducted construction costs under s. 43-10. $300,000 × 2.5% = $7,500	7,500	22,500
Taxable income			7,500

Interaction between GST and deductions

GST-registered taxpayers are entitled to claim an input tax credit for the GST component of creditable acquisitions (see Unit 2). For income tax purposes:

- Subdivision 27-A deals with the effect of input tax credits on deductions. The GST component for creditable acquisitions is effectively recouped from the government and is therefore not deductible (s. 27-5).
- Subdivision 27-B deals with the effect of input tax credits on decline in value deductions (see Unit 5).

Example – Effect of input tax credits on business deductions

Peter Jones carries on a business as a sole trader and is registered for GST. Peter buys stationery for $1,100. As the stationery is a creditable acquisition, $100 (or $^{1}/_{11}$ of the cost of $1,100) is allowable as an input tax credit. The balance of $1,000 (or the cost reduced by the input tax credit) is allowable as an income tax deduction under s. 8-1.

An individual or a partnership may incur expenditure partly for business purposes and partly for private purposes. The implications for a GST-registered taxpayer are as follows:

- The taxpayer is not entitled to an input tax credit to the extent that the expenditure is of a private or domestic nature (i.e. it is not made for a creditable purpose).
- Under s. 8-1, the individual is not entitled to an income tax deduction to the extent the loss or outgoing is of a private or domestic nature. In accordance with s. 27-20, when calculating an amount a taxpayer may be able to deduct, the amount paid is treated as not including an amount equal to any input tax credit.

Example – Effect of input tax credits on deductions partly incurred for private purposes

Peter Jones carries on a business as a sole trader and is registered for GST. Peter incurs telephone costs of $1,100. The telephone is used 90% for business purposes.

Input tax credit

As 90% of the telephone costs are a creditable acquisition, Peter is entitled to an input tax credit of $90 (i.e. $^{1}/_{11} \times$ $1,100 × 90%).

Income tax deduction – ATO view

Peter's allowable deduction under s. 8-1, before the application of s. 27-5 is $990 (i.e. $1,100 × 90%). Therefore, Peter's allowable deduction after the application of this section is $900 (i.e. $990 – $90). The ATO's view is commonly adopted in practice. However, the interpretive decision containing this view has recently been withdrawn.

Income tax deduction – alternate view

Under s. 27-20, the amount that Peter may be able to deduct (before apportioning for private expenditure) is treated as $1,010 (i.e. $1,100 – $90). Therefore, Peter's allowable deduction under s. 8-1 is $909 (i.e. $1,010 × 90%).

Income tax payable/(refundable) (s. 4-10)

Calculation method

Under s. 4-10, an individual's income tax is equal to their taxable income multiplied by the applicable tax rate, plus Medicare levy and reduced by tax offsets (see Unit 1).

Tax rates

Income year ended 30 June 2019

The tax rates applicable to the calculation of income tax payable for an individual taxpayer (including an individual carrying on a business as a sole trader) for the income year ended 30 June 2019 are as follows.

- **General income tax rates for residents**

  The general marginal tax rates that are applicable for resident individuals are set out in the table below (see Schedule 7 ITRA 1986):

Income tax rates 2018–2019 – resident individual		
Taxable income $	**Tax rate %**	**Tax**
0–18,200	0	$nil
18,201–37,000	19	19c for each $1 over $18,200
37,001–90,000	32.5	$3,572 plus 32.5c for each $1 over $37,000
90,001–180,000	37	$20,797 plus 37c for each $1 over $90,000
180,001 and over	45	$54,097 plus 45c for each $1 over $180,000

- **General income tax rates for non-residents**

  The general marginal tax rates that are applicable for non-resident individuals are set out in the table below (see Schedule 7 ITRA 1986):

Income tax rates 2018–2019 – non-resident individual		
Taxable income $	**Tax rate %**	**Tax**
0–90,000	32.5	32.5c for each $1
90,001–180,000	37	$29,250 plus 37c for each $1 over $90,000
180,001 and over	45	$62,550 plus 45c for each $1 over $180,000

- **Special income tax rate for non-resident working holiday-makers**

  An income tax rate of 15% applies to taxable income of up to $37,000 of working holiday-makers in a year of income. Taxable income above this amount in a year of income is subject to the general marginal income tax rates for non-resident taxpayers. Broadly, under these rules:

  - An individual is a working holiday-maker at a particular time if the individual holds at that time a working holiday visa (Subclass 417), a work and holiday visa (Subclass 462), or certain bridging visas.
  - An individual's working holiday taxable income for a year of income is the individual's assessable income for the year of income derived from sources in Australia and while the individual is a working holiday-maker, less so much of any amount the individual can deduct for the year of income as relates to that assessable income.

  - If the non-resident taxpayer is a working holiday-maker at any time during the year of income, count the taxpayer's working holiday taxable income for the year of income as the first part (starting from $0) of the taxpayer's ordinary taxable income for the purposes of calculating their income tax payable.

- **Special income tax rates for minors**

  There are special rates that apply to the eligible taxable income of resident and non-resident minors (i.e. individuals less than 18 years of age on the last day of the year of income – see ss 102AA–102AGA, Division 6AA ITAA 1936 and Schedule 11 ITRA 1986). Broadly, under these rules:

  - The 'eligible taxable income' of minors is taxed at the highest marginal tax rate (i.e. 45% plus Medicare levy for the 2018–2019 income year).

    'Eligible taxable income' includes all types of assessable income **except** for employment income, business income, income resulting by way of death of another person and lottery winnings. Therefore, 'eligible taxable income' commonly **includes** dividends, interest, rent, royalties and capital gains. An individual can derive these types of income either directly or via a trust distribution.
  - Any taxable income of a minor that is **not** 'eligible taxable income' is taxed at the general tax rates (i.e. resident and non-resident rates, as applicable).
  - Where the 'eligible taxable income' of a resident minor is $416 or less, the special rates do **not** apply and the whole of their taxable income is taxed at the general tax rates.
  - The special rates do not apply to a minor who is engaged in a full-time occupation.

  Note: From 1 July 2019, the Government has proposed to limit the application of general tax rates for minors receiving testamentary trust distributions, to income generated from assets that are transferred from a deceased estate, or the proceeds of the disposal or investment of those assets. Currently, income received by minors from a testamentary trust is taxed at general tax rates rather than the higher tax rate that normally applies to minors.

- **Tax-free threshold**

  Individuals who are residents enjoy a tax-free threshold. For the 2018–2019 income year, the tax-free threshold amount is $18,200. This threshold needs to be apportioned where the individual's residency either ceases or commences during the year. Individuals who are non-residents are not entitled to the tax-free threshold.

- **Medicare levy and surcharge**

  The Medicare levy and Medicare levy surcharge are deemed to be a tax and are added to net income tax payable. The applicable rates are as follows:

  - With limited exceptions, most individual **resident** taxpayers are liable to pay a Medicare levy of 2% on their taxable income for the income year ended 30 June 2019.

    Low-income earners are entitled to reduced rates, depending on family income and the number of children in the family.

    High-income earners who do not have appropriate private health insurance pay an additional Medicare levy surcharge (of either 1%, 1.25% or 1.5% depending on their income).
  - **Non-resident** individuals are not liable for either levy.

As shown above, an individual pays tax on their taxable income, including business income, at their marginal rate. Therefore the main tax disadvantage for an individual who is operating a business as a sole trader (rather than a company) is that a higher tax rate is paid once income exceeds a certain level.

Note: The phase-in rates of the Medicare levy and determining the application of the Medicare levy surcharge are outside the scope of the TAXAU module.

Income years commencing on or after 1 July 2019

There is a number of legislated changes to the income tax rates applicable to individual taxpayers. These changes are summarised below for information purposes only. They are not applicable for the income year ended 30 June 2019, and therefore are outside the scope of this offering of the TAXAU module.

- The legislated tax rate changes for **resident individuals** are set out in the table below:

Income tax rates and thresholds – resident individuals			
Tax rate	**Taxable income – 1 July 2019 to 30 June 2022**	**Taxable income – 1 July 2022 to 30 June 2024**	**Taxable income – 1 July 2024 onwards**
0	0–18,200	0–18,200	0–18,200
19	18,201–37,000	18,201– **45,000**	18,201–45,000
30	**Not applicable**	**Not applicable**	**45,001**– **200,000**
32.5	37,001–90,000	**45,001**– **120,000**	**Not applicable**
37	90,001–180,000	**120,001**–180,000	**Not applicable**
45	180,001 and over	180,001 and over	**200,001** and over

- The legislated tax rate changes for **non-resident individuals** are set out in the table below:

Income tax rates and thresholds – non-resident individuals			
Tax rate	**Taxable income – 1 July 2019 to 30 June 2022**	**Taxable income – 1 July 2022 to 30 June 2024**	**Taxable income – 1 July 2024 onwards**
30	**Not applicable**	**Not applicable**	0 – **200,000**
32.5	0 – 90,000	0 – **120,000**	**Not applicable**
37	90,001–180,000	**120,001**–180,000	**Not applicable**
45	180,001 and over	180,001 and over	**200,001** and over

- The legislated tax rate change for **working holiday makers** from 1 July 2022 increases the income threshold to which the 15% tax rate applies from $37,000 to $45,000.

Note: The above tables are accurate at the time of writing. However, legislated changes can be retrospectively amended.

Tax offsets

Tax offsets reduce the amount of income tax payable by a taxpayer.

Some of the key tax principles applicable to the calculation of tax offsets for an individual taxpayer (including an individual carrying on a business as a sole trader) are as follows:

- Certain tax offsets are only available to individual taxpayers, for example, the low income tax offset (LITO) and the low and middle income tax offset (LMITO). A detailed understanding of these offsets is outside the scope of the TAXAU module.
- Franking tax offset – resident individuals are able to claim a refund for excess franking tax offsets (see Unit 8).
- Foreign income tax offset – resident individuals are **not** able to claim a refund for excess foreign income tax offsets. They either use it or lose it (see Unit 14).
- SBE tax offset – where the business operations of an individual satisfy the requirements of being an SBE, the individual may be entitled to an additional offset (see Unit 6).

Example – Income tax payable: Resident individual

John Smith is a young accountant working for ABC Accountants and is a resident for tax purposes. John's taxable income for the year ended 30 June 2019 is:

	$	$
Assessable income		
ABC Accountants – salary (grossed up for PAYG tax of $14,662)	67,000	
Bank interest	100	67,100
Deductions (work-related)		
Tax textbook	80	
Stationery	250	330
Taxable income		66,770

John has eligible private health insurance and is not liable for the Medicare levy surcharge. Assume that John is entitled to a refundable tax offset under Division 67 of $250.

John's tax payable/(refundable) calculation for the year ended 30 June 2019 is:

	$		$
Tax on taxable income			
Tax on first $18,200	0		
Tax on ($37,000–$18,200) at 19%	3,572		
Tax on balance ($66,770–$37,000) at 32.5%	9,675		13,247
Medicare levy (2%)			1,335
Less:			
ABC Accountants – PAYG withholding			(14,662)
Tax offset (refundable)			(250)
Tax payable / (refundable)			(330)

Example – Income tax payable: Non-resident individual

Rosie Smith is a non-resident and earns a $60,000 salary while she is a working holiday-maker. She also earns $32,000 while holding a non-qualifying class of visa.

- The $60,000 salary is Rosie's working holiday taxable income and is the first part of her ordinary taxable income. She pays tax at the rate of 15% on $37,000 of that salary, and tax at the rate of 32.5% on the remaining $23,000 of that salary.
- The $32,000 income makes up the remaining part of Rosie's ordinary taxable income. Under the normal rates applicable to non-residents, she pays tax at the rate of 32.5% on $30,000 of that income (i.e. as this rate only applies for up to $90,000 in taxable income), and tax at the rate of 37% on the remaining $2,000 of that income.

Assuming Rosie has no PAYG withholding and is not entitled to any tax offsets, her tax payable is: (15% × $37,000) + (32.5% × $23,000) + (32.5% × $30,000) + (37% × $2,000) = $23,515. Rosie is not liable for the Medicare levy as she is a non-resident.

Note: If Rosie were not a working holiday-maker, then all her Australian-sourced income would be taxable at the general marginal rates for non-resident individuals. In that situation, her tax payable would be: (32.5% × $90,000) + (37% × $2,000) = $29,990.

Tax loss (s. 36-10)

Unit 1 also outlines the framework for calculating a tax loss and the general carry forward tax loss rules in Division 36 that are applicable to all taxpayers, including individuals.

The following example applies the general tax loss rules to an individual taxpayer.

Example – Rental property losses and a change of residence

Note: Ignore double taxation agreements and CGT.

Carolyn Anderson has a negatively geared rental property in Australia (i.e. the expenses incurred in relation to the rental property exceed the rental income derived). She is about to leave Australia for three years to work in the United States (US) for a multinational company, after which time she will return to Australia.

If Carolyn remains an Australian resident for taxation purposes while working in the US, the US salary income and the Australian rental property income will be assessable under s. 6-5(2), while the rental property expenses will be deductible under s. 8-1(1).

Alternatively, if Carolyn becomes a non-resident of Australia for taxation purposes while in the US, the US salary will not be assessable in Australia if it is not sourced in Australia (s. 6-5(3)).

A tax loss only arises when allowable deductions exceed both assessable income (rental property income in this case, where Carolyn is a non-resident) and net exempt income.

'Net exempt income' is defined in broadly s. 36-20 as follows:

- For a resident, under s. 36-20(1) – exempt income derived from all sources, less losses and outgoings incurred in deriving that income and taxes payable in respect of that income outside Australia.
- For a non-resident, under s. 36-20(2) – exempt income derived from sources in Australia, less expenses incurred in deriving that income.

Therefore, if Carolyn remains an Australian resident while in the US, her negative gearing losses will be offset against her US salary in working out her Australian taxable income. The provisions in respect of calculating a tax loss would not be applicable (unless her negative gearing losses exceed her US salary).

However, if Carolyn becomes a non-resident, then her US salary will not be classified as 'net exempt income' under s. 36-20, and her accumulated Australian negative gearing losses will be tax losses under s. 36-10. The tax losses can be carried forward to future income tax years under s. 36-15 and used as a deduction against future assessable income (i.e. when either her rental property ceases to be negatively geared and/or she returns to Australia).

Individual income tax returns

As noted in Unit 1, each year the Commissioner requires taxpayers, including individuals, to lodge an income tax return which explains how their taxable income and any claims for tax offsets have been calculated.

An individual taxpayer must lodge their income tax return in the approved format (e.g. individual tax return form 2019 or online at myGov, etc.) within certain time frames. Generally, the due date for lodgement of an individual income tax return is by 31 October (e.g. the income tax return for the year ended 30 June 2019 is due by 31 October 2019).

Each year the ATO releases forms and instructions to assist taxpayers.

Activity 7.1: Taxable income – individual
[Available online in myLearning]

Non-commercial losses

Overview

Division 35 contains the specific anti-avoidance rules for non-commercial losses. These rules broadly restrict the deduction of individual non-commercial business losses from other sources of income such as salary income.

To understand why the legislation was introduced, consider the following scenario, which examines an individual's tax position before and after the introduction of Division 35.

Example – High net worth individual with personal exertion income and business losses

Assume an individual taxpayer is a lawyer in a large firm with a salary of $400,000. The taxpayer buys a farm on the outskirts of the city and visits the farm on weekends. There is a business plan for the farm that would satisfy the requirements of carrying on a business. The taxpayer makes substantial losses in the first few years of operation. Assume in Year 1 that the activity generates losses of $100,000, that the activity constitutes the carrying on of a business and that the individual has no other income or deductions.

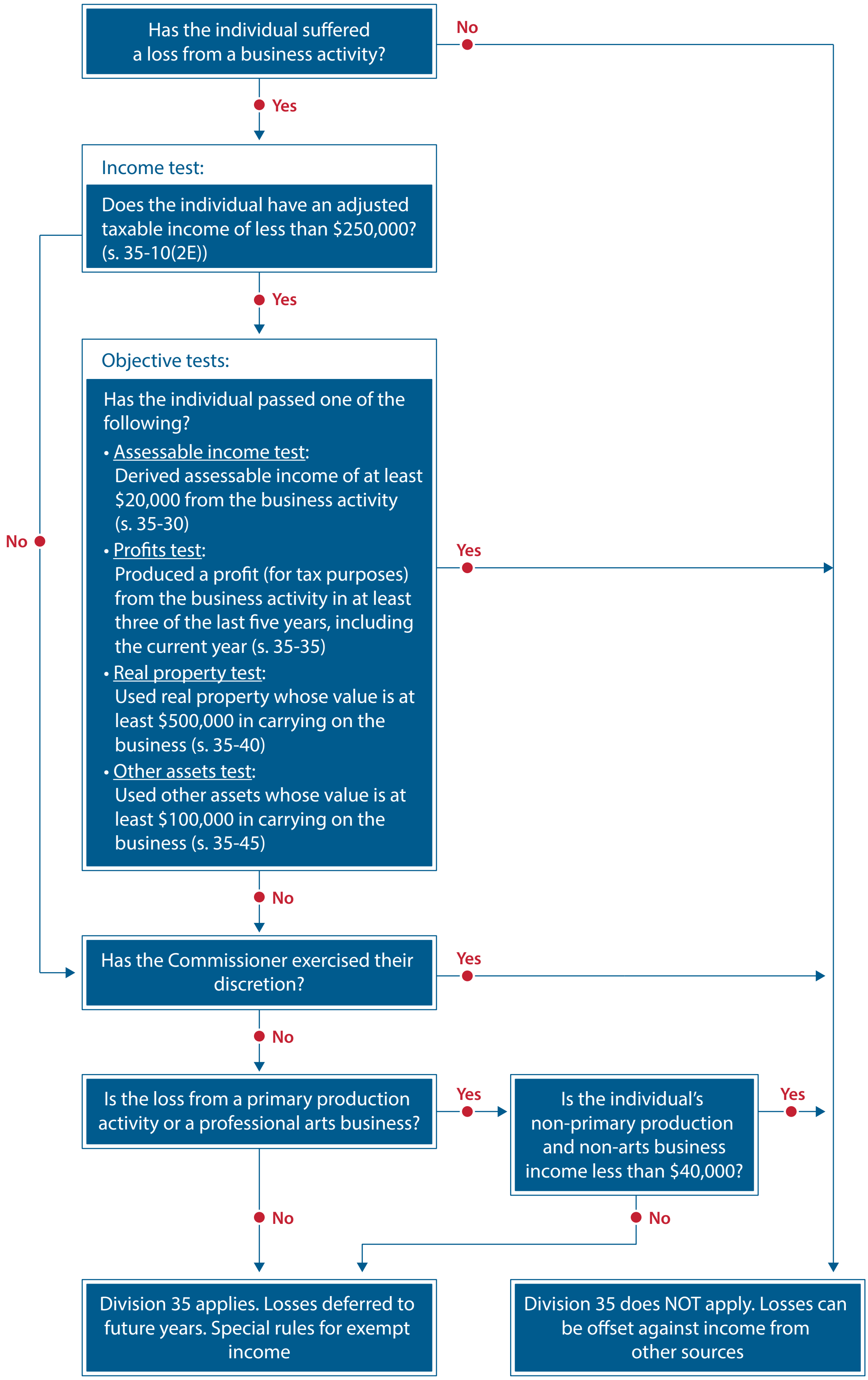
Clearly, the tax payable on a taxable income of $400,000 would be greater than the tax payable on $300,000 (being $400,000 less $100,000). If the losses were allowed as a deduction, the individual taxpayer would pay $47,000 less tax (i.e. $100,000 × 47% = $47,000).

While the farming activity genuinely constitutes the carrying on of a business, it is a non-commercial activity, as the expenses exceed the assessable income generated by it (s. 35-10(2)). If applicable, the non-commercial loss provisions would restrict the deduction of the individual business losses in the current income year.

Application

The first step in applying the non-commercial loss rules is to establish that the individual is conducting a **business** (s. 35-5(2)). For the Commissioner's view on what amounts to a business, refer to TR 97/11 (business of primary production), TR 2005/1 (business as a professional artist) and TR 2008/2 (horse industry). If the activity is passive or a hobby, Division 35 is not applicable in the first place and the expenses would not otherwise be deductible under s. 8-1 unless there is a nexus with assessable income.

The following flow chart may be used to determine whether the rules apply to a particular taxpayer.



Note:

- 'Value' for the purposes of the real property test includes the reduced cost base of the CGT assets that are real property (i.e. land and buildings) or an interest in real property.
- 'Value' for the purposes of the other asset test includes the written down value of the depreciating assets, reduced cost base of the CGT assets and s. 70-45 value of the closing stock.

Consequences

If an individual does not satisfy one of the exceptions outlined in the flow chart, then Division 35 will apply. The consequences are set out below (s. 35-10(2)):

- The loss for the business activity for the year is deemed not to have been incurred in that year.
- The loss is treated as an amount attributable to the business activity that can be deducted in the next income year that the business activity is carried on.

Losses that are deferred in the manner outlined can be offset against:

- Any profits of the relevant business activity in a future year.
- The other income of the individual if the business activity meets the income test and one of the four objective tests, or the Commissioner exercises their discretion.

Exceptions

Section 35-10(1) identifies that the Division 35 rules apply to an individual unless one of the following three exceptions below is satisfied.

Exception 1: The income test and one of the objective tests are satisfied

The income test

The income requirement must be satisfied before applying one of the four objective tests. The income requirement is satisfied if the individual's adjusted taxable income is less than $250,000 (s. 35-10(2E)). If adjusted taxable income is $250,000 or more, any loss from the non-commercial activities is quarantined unless the Commissioner exercises their discretion.

An individual's adjusted taxable income is the sum of the following amounts:

- Their taxable income for the year (disregarding the losses generated from the business activity).
- Their reportable fringe benefits total for the year.
- Their reportable superannuation contributions for the year (note that this does not include superannuation guarantee contributions, but does include salary sacrifice contributions).
- Their total net investment losses for the year.

For example, assume a taxpayer has salary of $260,000, tax fees of $7,000 and a donation to a tax deductible gift recipient of $5,000. Because their adjusted taxable income is less than $250,000 (i.e. $248,000) the income test is passed. The fact that the gift is voluntary does not prevent it from reducing taxable income below $250,000.

The objective tests

At least one of the four objective tests identified in the flow chart above must be satisfied in addition to the income test.

Exception 2: The Commissioner has exercised discretion

Section 35-55 provides the Commissioner with the discretion to not apply the non-commercial loss rules. It identifies that where circumstances exist beyond a taxpayer's control (such as drought, flooding or other natural disasters), the discretion may be applied.

Exception 3: Primary production or professional arts business

This exception applies where the individual is carrying on a primary production business or professional arts business, as defined by the legislation, and their assessable income for the current year (excluding any net capital gains) from other sources is less than $40,000 (s. 35-10(4)).

Other notes

Division 35 also applies to blackhole expenditure (s. 35-5(1)(b) and ss 35-10(2B), (2C) and (2D)).

There may be deductible amounts under s. 8-1 (e.g. interest) incurred after a business ceases but which relate to the ceased business (see *Placer Pacific Management Pty Limited v. FCT* and *FCT v. Brown*). These amounts are not subject to Division 35 because it only applies to businesses (TR 2001/14).

Where a business is sold, a quarantined loss under Division 35 remains permanently quarantined (i.e. it is permanently non-deductible). In this circumstance, the taxpayer should consider whether the undeducted amount could be included in the third element of the cost base under s. 110-25(4) (see Unit 4).

Division 35 losses are not a once-only deduction for FBT purposes, and do not satisfy the otherwise deductible rule regarding expense payment fringe benefits (TR 2013/6) (see Unit 3).

Required reading

Division 35 ITAA 1997.

Activity 7.2: Non-commercial loss rules – individual

[Available online in myLearning]

Personal services income

Overview

The issue of personal services income (PSI) has been topical for many decades. This is because a person earning income from their own efforts and paying tax at high marginal individual tax rates can potentially save large amounts of tax by diverting that income into or through an entity (a personal services entity, or PSE) such as a trust or a company. There are two potential benefits in doing this:

1. First, the income can be diverted to family members or associates who are on lower marginal rates. This is readily achieved, for example, with a discretionary trust by making income distributions.
2. Second, the income can be retained in a company where the flat tax rate is currently 30% (or 27.5% if the company is a base rate entity).

The source of the controversy is in determining whose income is being considered: the individual's or the entity's. If a person is operating a small consultancy business from home and charging fees for their own efforts, does that income become a trust's income by simply forming a trust, opening a bank account and changing the stationery?

To understand why the legislation was introduced, consider the following scenario, which considers an individual's tax position before the introduction of the PSI rules.

Example – Sole trader carrying on business and considering operating through a company

Compare the tax payable by an individual in business with a taxable income of an extra $100,000 with the tax payable by a company that is not a small business entity (SBE) having the same extra income.

The tax payable by the individual (assuming no offsets are available and they attract the top marginal tax rate) would be an extra $47,000. The extra tax payable by the company would be $30,000. The net tax difference of having the same extra taxable income routed through a different entity structure is therefore $17,000.

Note: This may only be a timing advantage. Once the profit is paid out as a franked dividend, the shareholder would pay $17,000 in 'top-up' tax where they are in the top marginal tax bracket. However, there is considerable benefit (if only in timing) for the individual to transfer their personal exertion income to a company in order to take advantage of the lower corporate tax rate. A company may also be able to access deductions (e.g. superannuation) which may not be available to a sole trader.

The use of a company to provide the services of an individual was fairly common up until the introduction of the PSI legislation.

Prior to the introduction of the PSI legislation, attempts to divert income from personal exertion to an entity (i.e. a company or trust) could be rejected by the court using the general anti-avoidance provisions in Part IVA ITAA 1936 (see *Tupicoff v. FCT* and *Pincus v. FCT*). Despite the application of the general anti-avoidance provisions in court decisions, specific statutory provisions were introduced to constrain the diverting (i.e. alienation) of PSI.

Note: The general anti-avoidance provisions in Part IVA ITAA 1936 may still apply to arrangements that satisfy the PSI rules (see Unit 15).

Application

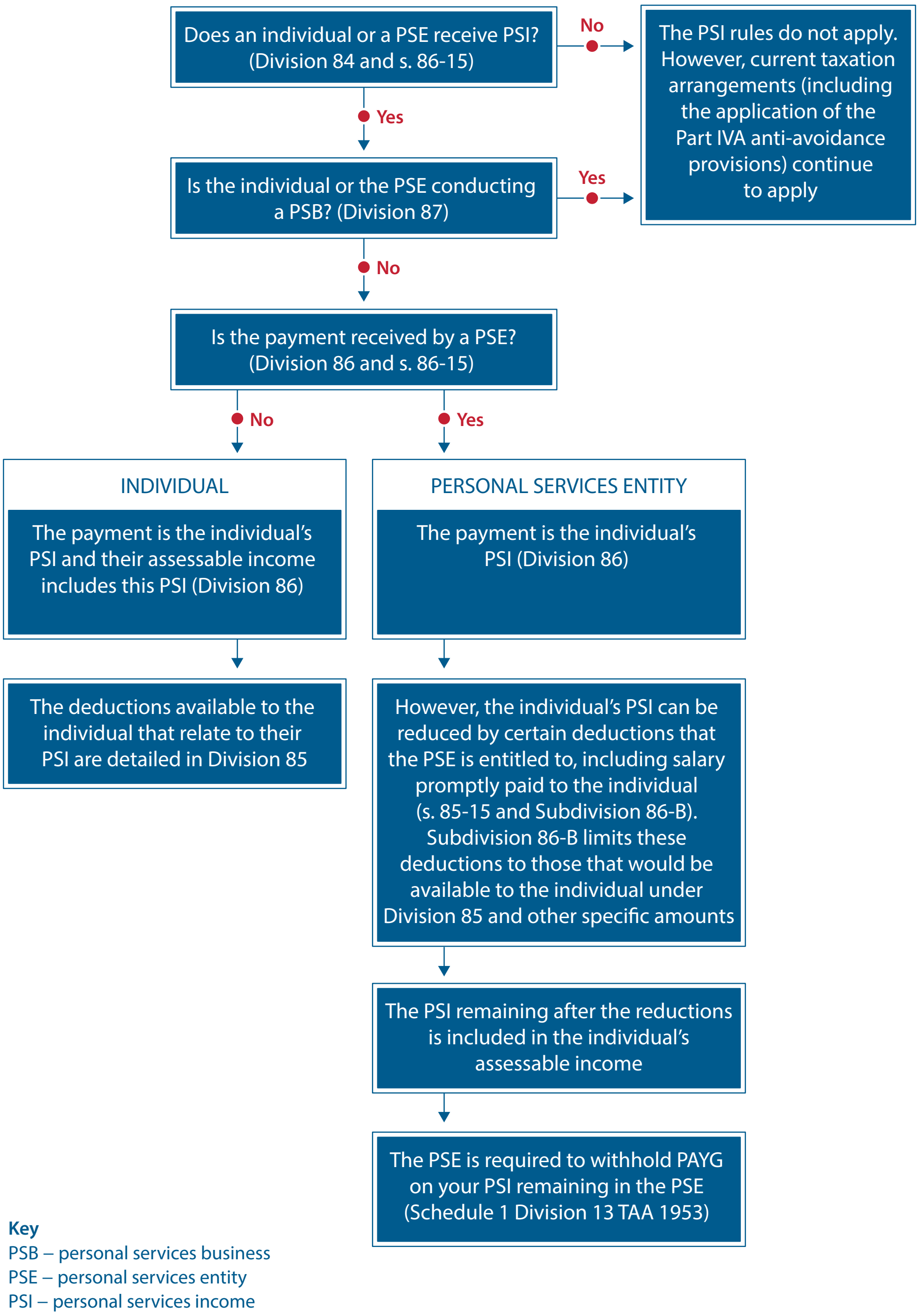
Divisions 84–87 contain provisions for the treatment of PSI. These provisions deal with two primary issues relating to PSI, and aim to:

- Limit the entitlement of individuals to deductions relating to their PSI (Division 85).
- Prescribe tax consequences where PSI is diverted to other entities, a practice that is referred to as 'alienation of income' (Division 86).

The provisions **do not**:

- Apply where an individual or interposed entity is conducting a 'personal services business' (PSB) (defined in Division 87).
- Affect the legal status of an interposed entity or deem an individual to be an employee for any other purpose.

The following diagram summarises the rules for the application of the PSI provisions.



Source: Adapted from Explanatory Memorandum to *New Business Tax System (Alienation of Personal Services Income) Act 2000* (Cth).

Personal services income (PSI)

PSI is defined in s. 84-5 to be the income (ordinary or statutory) of an individual or of any other entity, if the income is **mainly a reward for the individual's personal efforts or skills** (or would mainly be such a reward if it was the individual's income).

Therefore, PSI **excludes** income resulting **mainly** from:

- the supply or sale of goods (i.e. the supply or sale of goods where the labour is incidental)
- granting a right to use an asset (i.e. the use of an asset where labour is incidental), or
- a substantial profit-yielding business structure (e.g. where there are a large number of employees and assets (including goodwill) used to produce income).

For detailed ATO guidance on the meaning of PSI, see TR 2001/7.

Only an individual can have PSI (s. 84-5(2)). However, the treatment of the PSI as income of the individual does not imply that the individual is an employee for any other purpose (s. 84-10).

Personal services entity (PSE)

A PSE is defined in s. 86-15(2) to be a company, partnership or trust whose ordinary income or statutory income includes the PSI of one or more individuals.

Personal services business (PSB)

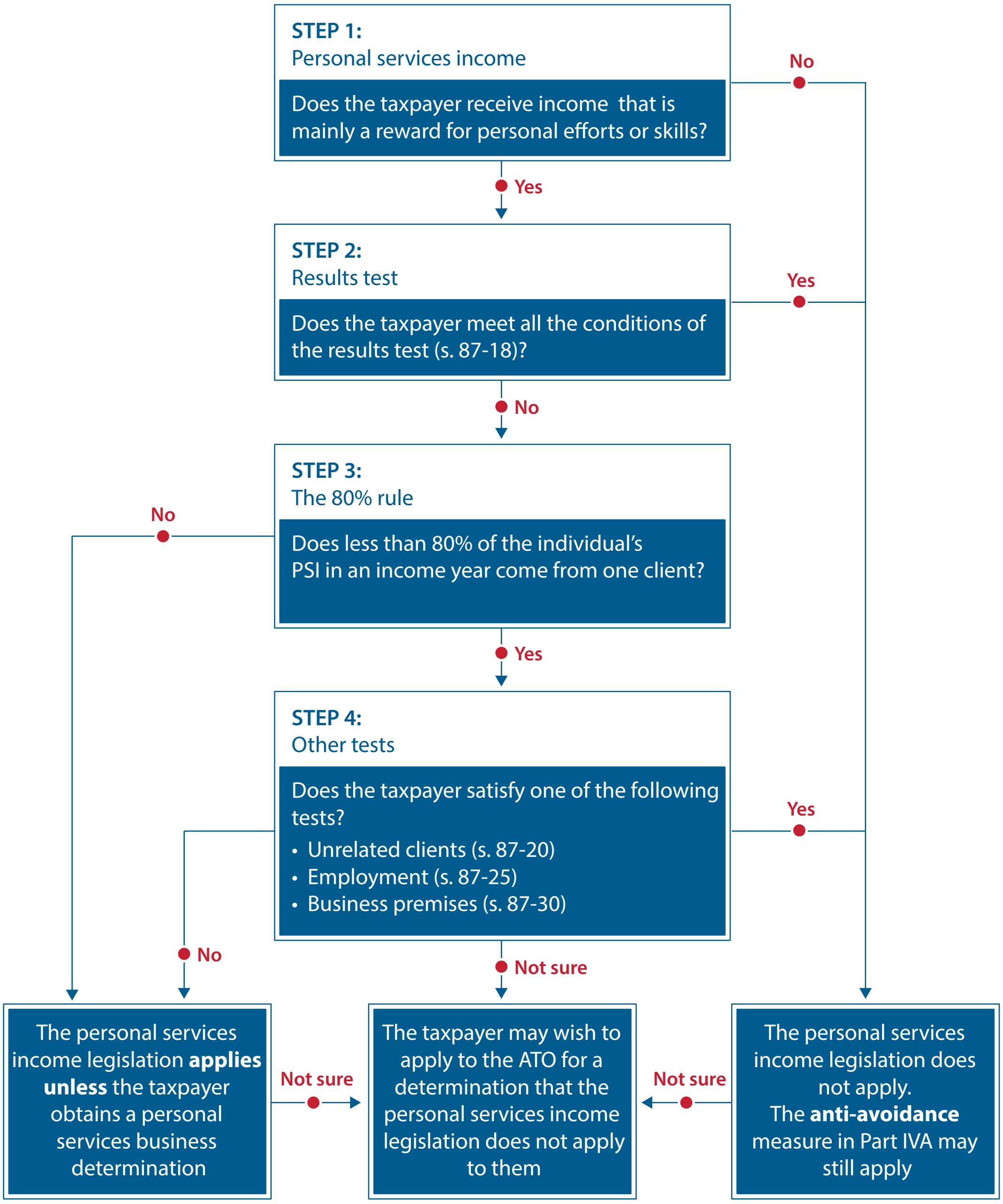
The consequences that would otherwise arise when income is defined as PSI **do not occur** when the income is from conducting a PSB.

Under s. 87-15, a PSB exists where either:

- There is a PSB determination.
- The conditions of one or more of the following four tests are satisfied:
  - **Results test** (s. 87-18), which is satisfied where:
    - at least 75% of the PSI is for producing a result, and
    - the individual or PSE is required to supply the plant and equipment, or tools of trade, needed to perform the work, and
    - the individual or PSE is liable for the cost of rectifying any defect in the work performed.
  - **Unrelated clients test** (s. 87-20), which is satisfied where:
    - the income is from two or more entities that are not associates, and
    - the services are provided as a direct result of making offers or invitations (e.g. by advertising) to the public.
  - **Employment test** (s. 87-25), which is satisfied where:
    - one or more entities (e.g. employees or other contractors) that are not associates are engaged to perform work, and
    - that work is at least 20% (by market value) of the principal work for that year.
  - **Business premises test** (s. 87-30), which is satisfied where:
    - business premises are maintained for their exclusive use at all times in the income year, and
    - services are mainly conducted at the business premises, and
    - the business premises are physically separate from any premises used for private purposes, and from client premises.

  However, the PSB tests, apart from the results test, **do not apply if 80% or more** of an individual's PSI is from one source (i.e. a single client).

The following diagram shows how Division 87 operates to ascertain whether PSI is income from conducting a PSB and if the PSI legislation applies.



For detailed ATO guidance on what constitutes a PSB, see TR 2001/8.

Required reading

Sections 84-5, 86-15(2), 87-18, 87-20, 87-25 and 87-30 ITAA 1997.

Worked example 7.1: Personal services income – individual

[Available online in myLearning]

Consequences

Individuals deriving PSI

Division 85 applies to limit or deny deductions where an individual derives PSI in a non-employee capacity (e.g. as a sole trader) and is not conducting a PSB.

Deduction entitlements

Section 85-10(1) **limits the deductions** the individual (i.e. the taxpayer) can claim against their PSI to the amount the individual **would have been able to claim if they had derived the income as an employee.**

For example, expenditure would only be deductible under s. 8-1 (the general deduction provision) where it has a direct nexus to the individual's assessable income (i.e. satisfies the first limb of this provision).

The individual (i.e. the taxpayer) is also **specifically denied deductions** on:

- Rent, mortgage interest, rates or land tax relating to the taxpayer's or an associate's residence (i.e. ownership costs) (s. 85-15).
- Payments to associates (including superannuation) unless they relate to work that forms part of the principal work undertaken by the taxpayer (s. 85-20).

However, s. 85-10 **does not stop** the individual (i.e. the taxpayer) from claiming a deduction (that would otherwise be deductible) to the extent it relates to:

- Gaining work (e.g. advertising).
- Insuring against loss of income or income-earning capacity.
- Insuring against liability arising from the taxpayer's acts or omissions in the course of earning income (e.g. professional indemnity insurance).
- Engaging an unrelated party to perform work **or** an associate where the work forms part of the principal work for which the taxpayer gains or produces the PSI.
- Superannuation contributions for the taxpayer.
- Meeting obligations under workers' compensation law.
- Meeting obligations or exercising rights under the GST law.

Personal services entity (PSE) deriving PSI

Division 86 applies where a PSE that is not conducting a PSB has been interposed (e.g. a company). Division 86:

- Limits deduction entitlements for the PSE (s. 86-60).
- Treats the PSI as if it was derived by the individual as assessable income, except where it is promptly paid out of the PSE as salary and wages (s. 86-15).
- Reduces the amount included in the individual's assessable income by certain deductions that the PSE is entitled to claim (s. 86-20).

Deduction entitlements

Section 86-60 **limits the deductions** of the PSE **to the amounts the individual would have been able to claim** had they incurred the expenditure (s. 86-60).

However, s. 86-60 **does not stop** the PSE from claiming a deduction to the extent it relates to:

- Entity maintenance deductions (e.g. tax-related expenses, costs of preparation and lodgement of forms) (s. 86-65).
- Car expenses for a car of which there is no private use (s. 86-70).
- Superannuation contributions for an individual whose PSI is included in the PSE's ordinary income or statutory income (s. 86-75).

- Salary or wages promptly paid (s. 86-80).
- Decline in value of certain depreciating assets (s. 86-85).

However, the PSE **cannot deduct** a net PSI loss (as it is available to the individual under s. 86-27).

PSI included in assessable income

As noted above, the amount of the PSI to be included in the individual's assessable income:

- excludes amounts promptly paid as salary and wages (s. 86-15), and
- is reduced by deductions allowable to the PSE (s. 86-20(1)).

The reduction amount is calculated using the method statement contained in s. 86-20(2). The steps in the method statement are as follows:

Step 1: Work out the deductions to which the PSE is entitled relating to the PSI (other than entity maintenance deductions or deductions for salary and wages paid to the individual).

Step 2: Work out the amount of the PSE's entity maintenance deductions (s. 86-65(2)).

Step 3: Work out the PSE's assessable income other than PSI.

Step 4: Subtract the Step 3 amount from the Step 2 amount.

Step 5: If the Step 4 amount is greater than $nil (i.e. entity maintenance deductions exceed non-PSI income), the amount of the reduction in s. 86-20(1) is the sum of the amounts in Steps 1 and 4.

Step 6: If the Step 4 amount is not greater than $nil, the amount of the reduction in s. 86-20(1) is the amount in Step 1.

Note: Step 4 ensures that before entity maintenance deductions can reduce the amount included in the individual's assessable income they are first exhausted against any income of the PSE that is not PSI.

Example – PSI included in assessable income

NewIT Pty Ltd (NewIT) provides computer programming services, but Ron (an Australian resident taxpayer) does all the work involved in providing those services. Ron uses the clients' equipment and software to do the work. NewIT's ordinary income from providing the services is Ron's PSI because it is a reward for his personal efforts or skills.

For the year ended 30 June 2019:

- $120,000 of NewIT's income is Ron's PSI.
- NewIT has deductions (including superannuation contributions) of $50,000 relating to Ron's PSI.
- NewIT has entity maintenance deductions of $8,000.
- NewIT has investments that produce income. NewIT's non-PSI income is $20,000.

The amount of PSI included in Ron's assessable income must be reduced. The reduction is calculated by applying the method statement in s. 86-20(2) as follows:

Step 1: Deductions relating to PSI = $50,000.

Step 2: Entity maintenance deductions = $8,000.

Step 3: Income other than PSI = $20,000.

Step 4: Calculation is $8,000 – $20,000 = –$12,000.

Step 5: Does not apply because the Step 4 amount is less than zero.

Step 6: As Step 5 does not apply, the reduction under s. 86-20(1) is equal to the Step 1 amount of $50,000.

Therefore, the PSI amount included in Ron's assessable income under s. 86-15 is:

	$
Ron's PSI	120,000
Less: Salary and wages promptly paid to Ron	0
Less: Reduction amount under s. 86-20	50,000
PSI included in Ron's assessable income	70,000

Source: Sections 84-5 and 86-20 ITAA 1997.

The ATO's views on the application of Divisions 85 and 86 relating to deductions under the PSI rules can be found in TR 2003/6.

Required reading

Sections 86-15, 86-20 and 86-60 ITAA 1997.

Activity 7.3: Personal services income – individual

[Available online in myLearning]

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 8: Companies

Contents

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Learning outcomes

At the end of this unit you will be able to:

1. Explain what is a company and the general tax principles.
2. Explain and calculate the tax payable by a company.
3. Explain and apply the franking account provisions.
4. Explain the trans-Tasman tax arrangements.
5. Explain and calculate the taxation consequences of company distributions.
6. Explain and apply the general and specific anti-avoidance provisions in relation to company distributions.
7. Explain and apply the company loss provisions.

Introduction

A business can be operated by a sole trader (i.e. individual), company, trust or partnership. Similarly, private investments can be held individually, or through a company, trust or partnership. However, each entity has a different tax profile, which affects how the income or loss of the entity from the business or private investment is distributed and taxed.

In Australia, the most common structure through which a taxpayer conducts a business is a company. However, companies are also commonly used to hold investments (i.e. in a non-business investor type capacity).

This unit examines the specific tax rules applicable to companies, including those in respect of the calculation of taxable income and tax payable, franking accounts, company distributions, and company losses.

Note:

- The income tax year end covered in this offering of the TAXAU module is 30 June 2019. Therefore, the amendments that are applicable from 1 July 2019 are outside the scope of the module.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Company tax principles

Defining a company

For taxation purposes, a company is not only a registered company or an incorporated body but may also be a club, association or society.

'Company' is defined in s. 995-1(1) as:

(a) a body corporate; or

(b) any other unincorporated association or body of persons, but does not include a partnership.

Public and private

Companies are characterised for taxation purposes as either **'public' or 'private'**. This characterisation is different from that used in the *Corporations Act 2001* (Corporations Act). The characterisation of a company as either public or private is relevant for determining, for example:

- The application of s. 109 and Division 7A ITAA 1936, which operates to deem certain amounts to be dividends.
- Whether an asset held by a company stops being a pre-capital gains tax (CGT) asset due to a change of majority underlying interests, as the rules differ depending on the company's tax status (covered in Unit 4).

The main test for determining whether a company is a **public** company for a year is if its ordinary shares are listed on a stock exchange on the last day of the year of income (s. 103A(2)(a) ITAA 1936).

A company that is wholly owned by a public company for the whole year of income will also be treated as a public company provided that no person is in a position to affect the parent company's ability to exercise its rights in that subsidiary (ss 103A(2)(d)(v), (4)–(4E) ITAA 1936). Similarly, a company that is more than 50% owned by a public company will also be treated as a public company (refer s. 103A(4B)).

A **private** company is one that is not a 'public company in relation to the year of income' (s. 103A(1) ITAA 1936).

This means that a private company that lists on the stock exchange on the last day of the financial year will have been a public company for the whole year. This may be relevant in applying the deemed dividend provisions. For example, a private company with a Division 7A loan which lists on the last day of the year would not be subject to Division 7A in that year (see the section in this unit on Division 7A).

It should also be noted that the Commissioner has the discretion to treat:

- A private company as if it were a public company (s. 103A(5) ITAA 1936).
- A public company as if it were a private company (s. 103A(6) ITAA 1936).

Example – Defining a company

Subsidiary Pty Ltd (Subsidiary) is a private company under the Corporations Act. It is wholly owned by Parent Limited (Parent), a company listed on the Australian Securities Exchange, which incorporated this new entity during the most recent income year.

As Subsidiary has been wholly owned by Parent since its incorporation, it is characterised as a public company for taxation purposes.

Key features and tax attributes

A broad overview of the key features and tax attributes of a company are set out below.

Tax issue	How the issue relates to companies	Refer to
Features and tax attributes		
Taxpayer	A company is a taxpayer. Unlike many other types of taxpayers, it is also a separate legal entity	Unit 1
Residency	A resident company is taxable in Australia on its worldwide income. However, to minimise the double taxation of foreign income, resident companies may be entitled to exemptions or foreign tax offsets A non-resident company is only taxable in Australia on its Australian sourced income. However, a further restriction applies for CGT purposes. A non-resident is only taxable in Australia on a capital gain (or loss) where the CGT asset is taxable Australian property (TAP) There are specific rules for determining the residency status of a company	Unit 1
Goods and services tax (GST)	A company that carries on an enterprise can be registered for GST	Unit 2
Fringe benefits tax (FBT)	A company that is an employer can provide a fringe benefits to an employee (or their associate) and may be subject to FBT Note: A company cannot be an employee, but s. 21A ITAA 1936 may apply to non-cash benefits received	Unit 3
Small business entity (SBE)	A company may be classified as an SBE and choose to apply the available SBE concessions in the calculation of its taxable income	Unit 6
Personal services entity (PSE)	A company may be classified as a PSE and subject to the personal services income (PSI) rules where it is not a personal services business (PSB). When this occurs: • Certain deductions to which the company would otherwise be entitled are denied or limited • Net PSI that has not been promptly paid as salary and wages will be deemed to be the assessable income of the individual (rather than the company)	Unit 7
Treatment of profits	A company distributes its accounting profits (after tax) to shareholders through the payment of dividends. Dividends may be franked (where the company is a resident) or unfranked for tax purposes Note: A resident company maintains a franking account and is subject to dividend franking rules	See later in this unit
Tax consolidated group	An Australian resident company and its wholly owned Australian subsidiaries may choose to form a tax consolidated group. When this occurs: • Intra-group transactions (including dividends) are excluded from the head company's taxable income • A single franking account is maintained by the head company (i.e. dividends between members cannot be franked) • Losses are transferred to and carried forward by the head company	Unit 12
Uniform administrative penalty regime	The penalty regime applies to a company in the same way as other taxpayers. However, significant global entities may be subject to increased amounts	Unit 1
Amended assessments	The time frame for the Commissioner to amend an assessment that is applicable to a company is generally four years (except where the company is an SBE)	Unit 1

Special types of companies, such as cooperatives and credit unions, may be subject to specific taxation treatment. These companies are outside the scope of the TAXAU module.

Company taxable income and tax payable

Taxable income

Calculation method

A company's taxable income is calculated under the income tax framework in a similar way to other taxpayers. However, there are some special rules that may apply. The income tax framework is analysed in Unit 1.

Like other business taxpayers, the method most companies use to calculate taxable income is to prepare a reconciliation of its accounting profit to taxable income (sometimes called a statement of taxable income). This methodology is also required when preparing the disclosures in a company income tax return.

You should be familiar with this approach and have the basic accounting skills to analyse financial information from your undergraduate studies. A comprehensive case study utilising this approach is included in Unit 16.

Note: For examination purposes, you are expected to know how to prepare a reconciliation from accounting profit to taxable income in detail. In an exam, if you are asked to prepare a reconciliation from accounting profit to taxable income, you must answer the question in this format.

Assessable income and allowable deductions

Many of the income tax issues covered in the TAXAU module are applicable to companies. However, there are also tax provisions specific to this type of taxpayer. A broad overview of the general and specific tax provisions under which a company determines its taxable income are set out below.

Tax issue	How the issue relates to companies	Refer to
Taxable income		
Assessable income and allowable deduction general rules	Like other taxpayers, most of the assessable income and allowable deduction provisions apply to a company A company includes ordinary income in its assessable income when it is derived • Non-business income is derived on a cash basis. For example, income from passive investments including rent, interest, dividend and royalty income are derived when received • Business income is generally derived on an accruals basis. For example, sales and other income that results from carrying on a business are derived when earned A company includes statutory income in its assessable income in accordance with the timing rules in the statutory income provision A company is entitled to a general deduction under s. 8-1 for losses and outgoings it incurs in carrying on its business, subject to the normal limitations and exclusions A company is entitled to specific deductions in accordance with the timing rules in the specific deduction provision	Unit 1

Tax issue	How the issue relates to companies	Refer to
Taxable income		
Net capital gains/(losses)	Like most taxpayers, a company must follow the method in s. 102-5 to determine the net capital gain included in its assessable income or the net capital loss carried forward Most CGT events are applicable to companies A company cannot discount a capital gain (i.e. it is not entitled to the 50% general CGT discount even if it is a resident taxpayer). However, if the company is an SBE, there are a number of CGT and rollover concessions that may apply A company can index the cost base of certain assets (i.e. to September 1999, when indexation ceased) when calculating a capital gain A capital loss can only be used to reduce a capital gain (i.e. it is not a general or specific deduction). To use a capital loss, a company needs to satisfy additional tests	Unit 4, Unit 6 and later in unit under 'Company losses and bad debts'
Distributions received (i.e. in capacity as a shareholder, partner, or beneficiary)	A company can be a shareholder in another company, a partner in a partnership, or a beneficiary of a trust. Thus, assessable income and allowable deductions arising from these investments must be considered Note: There is an exception from the application of the deemed dividend rules under Division 7A where the shareholder is a company	Unit 9, Unit 10 and later in this unit
Australian sourced dividend, interest and royalty income	A resident company that receives a franked dividend from another Australian company must include the dividend and a franking credit gross-up in its assessable income (they are also entitled to a franking tax offset) A non-resident company is subject to withholding tax on its Australian sourced dividend (unfranked component), interest and royalty income. That income is then deemed to be NANE income	See later in this unit under 'Dividends and franking' and Unit 14
Foreign income	An exemption may apply in respect of the foreign income of a resident company (e.g. the foreign branch exemption or the foreign equity distribution exemption). Where an exemption applies, the foreign income is NANE income (i.e. excluded from the resident company's assessable income) and the company is not entitled to a foreign income tax offset (FITO) Where an exemption does not apply, a resident company includes gross foreign dividend, interest and royalty income (i.e. net income grossed-up for foreign taxes withheld) in its assessable income and it may be entitled to a FITO A non-resident company is not subject to tax in Australia on its foreign sourced income. However, the income of a controlled foreign company (CFC) may be included in the assessable income of an Australian resident company (or other taxpayer) on an attribution basis	Unit 14
Bad debt deduction	The specific deductibility rules for bad debts apply to companies However, to claim a bad debt deduction a company needs to satisfy additional tests	Unit 1 and later in this unit under 'Company losses and bad debts'

Tax issue	How the issue relates to companies	Refer to
Taxable income		
Substantiation of deductions	The substantiation rules in Division 900 ITAA 1997 do not apply to companies in claiming a deduction However, the substantiation requirements of the FBTAA 1986 need to be considered	Unit 1 and Unit 3
Capital allowances, capital works and blackhole expenditure deductions	A company can claim a decline in value deduction and balancing adjustment for a depreciating asset. However, a company that is an SBE may choose to apply the SBE capital allowance pooling rules A company can claim a capital works deduction for buildings and structural improvements A company can claim a blackhole expenditure deduction for certain business-related capital expenditure costs	Unit 5 and Unit 6
Tax loss deduction	To utilise a tax loss, a company needs to satisfy additional tests A company can choose the amount of carry forward tax losses it claims as a deduction (subject to integrity measures that prevent the 'refreshing' of tax losses) Note: There are specific rules under the tax consolidation regime for grouped companies with losses	Unit 1 and later in this unit under 'Company losses and bad debts' Unit 12
Debt–equity rules	The debt–equity rules are applicable to companies and can impact the calculation of taxable income. They can apply to: • Allow a deduction for certain dividends (i.e. on a non-equity share that is classified as a debt interest) • Disallow a deduction for interest payments (i.e. on a non-share equity that is classified as an equity interest)	Unit 13
Thin capitalisation	A company may be subject to the thin capitalisation provisions which may limit the deductibility of debt deductions (e.g. interest and things in the nature of interest)	Unit 14
Tax consolidated groups	A resident company that is a member of a tax consolidated group (but is not the head company of that group) generally does not prepare a separate income tax calculation. The assessable income and allowable deductions of the company are included in the head company's income tax calculations A resident company that is the head company of a tax consolidated group prepares a single income tax calculation for the group. Intra-group transactions (including dividends) are excluded from the head company's taxable income	Unit 12

Tax payable

Calculation method

Gross tax payable is calculated by applying the company's tax rate to its taxable income.

Net tax payable/(refundable) is calculated by reducing the gross tax payable by tax offsets (subject to eligibility conditions and limitations) and the company's tax instalments paid.

Tax rate and offsets

A broad overview of the general and specific tax provisions under which a company determines its tax payable is set out below.

Tax issue	How the issue relates to companies	Refer to
Tax payable		
Tax rate	Companies generally pay a flat tax rate. The tax rate does not alter even if the company is a non-resident. Companies are not liable to pay the Medicare levy	See below
Franking tax offset	A company may be entitled to a franking tax offset Excess franking tax offsets cannot be refunded. However, they can be converted into tax losses	See later in this unit under 'Dividends and franking'
Foreign income tax offset (FITO)	A company may be entitled to a FITO Like other taxpayers, excess FITOs cannot be refunded or converted into tax losses (i.e. use it or lose it)	Unit 14
Other incentives and offsets	Companies may have different incentives or offset entitlements to other taxpayers	See below
Payment of tax	Companies pay tax instalments under the PAYG regime	Unit 1

Tax rate

The rate of tax in respect of the taxable income of a company is (s. 23(2) ITRA 1986):

Income year ended	Small business entity (see below)	Base rate entity (see below)	Other
30 June 2015 and earlier	30%	N/A	30%
30 June 2016	28.5%	N/A	30%
30 June 2017	27.5%	N/A	30%
30 June 2018 to 30 June 2020	N/A	**27.5%**	**30%**
30 June 2021	N/A	26%	30%
30 June 2022	N/A	25%	30%

Where:

- **Small business entity** (s. 328-110 ITAA 1997) is an entity that carries on business and has an 'aggregated turnover' of less than **$10 million** (for the income year ended 30 June 2016 and earlier income years it was $2 million) (see Unit 6 for further details).

- **Base rate entity** (s. 23AA ITRA 1986) is an entity where:
  - no more than 80% of its assessable income for the income year is 'base rate entity passive income' (BREPI), and
  - its 'aggregated turnover', worked out as at the end of the income year, is less than the relevant threshold amount. The threshold amount is **$50 million** for the income year ended 30 June 2019 and later income years (for the income year ended 30 June 2018 it was $25 million).
- **Base rate entity passive income** is assessable income that is any of the following (net of related expenses):
  - Dividends and franking credits: As defined under s. 960-120 and s. 205-15. However, it excludes amounts in respect of a non-portfolio investment as defined under s. 317 ITAA 1936 (i.e. ownership interest of 10% or more).
  - Interest and amounts in the nature of interest: However, it excludes amounts where the taxpayer is a financial institution (i.e. where the interest is business income).
  - Royalties: As defined under s. 6(1) ITAA 1936.
  - Rent: There is no specific definition included in the legislation. Therefore, rent means the consideration payable by a tenant to a landlord. There are no exclusions. Thus, even if rent is business income it will be included.
  - Net capital gains: As defined under s. 102-5 (see Unit 4).
  - A partnership or trust distribution of 'base rate entity passive income': The taxpayer's share of BREPI that flows via a partnership or trust. However, dividends and franking credits in respect of non-portfolio investments are treated as BREPI.

  For draft ATO guidance on base rate entities and base rate entity passive income see LCR 2018/D7.
- **Aggregated turnover** has the meaning given by s. 328-115 ITAA 1997 (see Unit 6).

Example – Company tax rate

Doner Pty Limited (Doner) is an Australian resident company. Assume Doner has no connected or affiliated entities. Doner has provided the following information in respect of its operations for the income year ended 30 June 2019:

- Sales income $40 million and related expenses of $5 million.
- Interest and rental (non-business) income of $35 million. There are no related expenses.

On the basis of the above information, for the income year ended 30 June 2019:

- Doner has aggregated turnover of $40 million (i.e. total ordinary business income). As this is not less than $10 million, Doner does not satisfy the additional test for being a small business entity (SBE) and is unlikely to qualify for the SBE general concessions (see Unit 6).
- Doner has base rate entity passive income of $35 million (i.e. the interest and rental income net of related expenses) and assessable income of $75 million.
- Applying the base rate entity definition:
  - Doner satisfies the first condition, as its percentage of base rate passive income to assessable income is $35 million ÷ $75 million = 47% (which is less than 80%).
  - Doner satisfies the second condition, as its aggregated turnover is $40 million (which is less than $50 million).

Therefore, Doner **is** a base rate entity for the income year ended 30 June 2019 and has a tax rate of **27.5%**.

Note: Assuming Doner had similar income for the income year ended 30 June 2018, it would not have satisfied the conditions for being a base rate entity in that year. The aggregated turnover threshold was previously only $25 million. Its tax rate would therefore have been 30%.

Example – Company tax payable

Doner Pty Limited (Doner) is an Australian resident company that is **not** a base rate entity. Doner derived a taxable income of $100 million for the year ended 30 June 2019. This amount includes some foreign income for which Doner is entitled to claim a foreign income tax offset of $2 million. During the year, the company paid PAYG instalments of $10 million.

The balance of Doner's company tax payable for the year ended 30 June 2019 is:

Item	**Calculation**	**$ million**
Tax on taxable income	$100 million × 30%	30
Less: Foreign income tax offset		(2)
Less: PAYG instalments paid		(10)
Company tax payable		18

Tax incentives for innovation

The tax legislation contains a number of tax incentives for businesses and their investors to encourage innovation. Key tax incentives include the following:

- Research and development (R&D) tax incentive. This incentive provides a tax offset where an eligible R&D company incurs expenditure of at least $20,000 on eligible R&D experimental activities. The tax offset is refundable for eligible R&D companies with aggregated turnover of less than $20 million. In all other cases, the tax offset is not refundable.

  A detailed understanding of the R&D tax incentive is outside the scope of the TAXAU module.
- Early stage investor tax incentives. From 1 July 2016, investors in early stage investment companies (ESIC) are entitled to:
  - A 20% non-refundable tax offset on innovation-related investments, capped at $200,000 per investor per year. For example, if an ESIC company issues $200,000 in shares to an investor, the investor can claim a $40,000 non-refundable tax offset that reduces their tax payable. Any excess can be carried forward (see s. 360-15).
  - A 10-year CGT exemption on innovation-related investments, provided they are held for at least one year but less than 10 years. For example, if an investor in an ESIC sells shares for $500,000 that were acquired four years prior for $200,000, the full capital gain of $300,000 is disregarded for CGT purposes.

  The incentives are available for investments in companies that undertake an 'innovation business', were incorporated in the last three years, are not listed on any stock exchange, and have expenditure of less than $1 million and income of less than $200,000 in the prior income year.

  A detailed understanding of the early stage investor incentives is outside the scope of the TAXAU module.

Major Bank levy

From 1 July 2017, authorised deposit-taking institutions (ADIs) with total liabilities of greater than $100 billion must pay an additional Major Bank levy on a quarterly basis. The levy is imposed at a rate of 0.015% on certain liabilities of an ADI that are reported to the Australian Prudential Regulation Authority (APRA) on a quarterly basis under a reporting standard.

The application of the Major Bank levy is outside the scope of the TAXAU module.

Company income tax return

As noted in Unit 1 on Australian tax fundamentals, each year the Commissioner requires taxpayers, including companies, to lodge an income tax return (and related schedules depending on the transactions of the entity) which explains how its taxable income and any claims for tax offsets have been calculated. The schedules attaching to the income tax return contain significant levels of disclosures related to the company's transactions.

A company must lodge its income tax return (and related schedules) for the income tax year ended 30 June 2019:

- in the approved format – for example, company tax return, capital gains tax schedule, international dealings schedule, losses schedule, reportable tax positions schedule, etc., and
- within certain time frames – generally, the due date for lodgement for:
  - small companies is by 28 February 2020
  - medium or large companies (i.e. with annual turnover of more than $10 million) is by 15 January 2020
  - companies with any prior year returns outstanding is by 31 October 2019.

  However, in practice most tax agents get lodgement extensions for their clients.

A company must pay its income tax periodically under the PAYG system. Companies with a turnover of $20 million or more have to pay PAYG monthly, rather than quarterly. The balance of a company's income tax liability for a particular income tax year (i.e. income tax payable less PAYG instalments) is due and payable by 1 December. For example, using the facts above for Doner, Doner would have to pay the balance of its income tax liability of $18 million to the ATO no later than 1 December 2019.

Each year the ATO releases forms and instructions to assist taxpayers. The completion of an income tax return and its related schedules is outside the scope of the TAXAU module. However, the instructions are used regularly in practice when preparing, reviewing or auditing income tax.

Dividends and franking

Overview

A company distributes its accounting profits (after tax) to its shareholders through the payment of dividends. The franking provisions were introduced to eliminate the effective double taxing of those profits – that is, once at the company level at the corporate tax rate and again at the shareholder level when shareholders receive their share of company profits as dividends. It does this by allowing a **resident** company to attach franking credits to the dividends it pays to its shareholders.

A dividend with a franking credit attached to it is known as a **franked dividend** and the extent to which it is franked is known as the **franked amount of the dividend**.

With the exception of certain trans-Tasman companies, a **non-resident** company cannot pay a franked dividend. Where a non-resident company pays a dividend to an Australian resident shareholder, the Australian resident shareholder may be entitled to a foreign income tax offset (FITO) in respect of foreign tax paid by the non-resident company. The taxation of foreign income of an Australian resident taxpayer is analysed in detail in Unit 14.

Consequences for shareholders

Under the franking provisions, in most cases, shareholders receive a credit (i.e. franking tax offset or reduction in withholding tax rate) for income tax paid by a resident company. Thus, the effective total tax rate on company profits (calculated as the aggregate of both company tax and effective tax after a franking tax offset in the shareholder's hands) will not exceed the top individual marginal rate of tax.

Resident shareholders include the total amount of the dividend received (i.e. the cash component) and the attached franking credit in their assessable income, but are entitled to a franking tax offset equal to that credit. In addition, any franking tax offsets that cannot be used by a resident shareholder are either refunded to the shareholder (excluding shareholders that are a company) or converted into a tax loss (for shareholders that are a company).

A non-resident shareholder is subject to withholding tax on dividends it receives. However, the withholding tax is reduced to nil to the extent the dividend is franked. The dividend income is deemed to be non-assessable, non-exempt (NANE) income of the non-resident shareholder. The taxation of Australian sourced income of a non-resident taxpayer is analysed in detail in Unit 14.

Example – Franking a dividend

AC Toys Pty Ltd (AC Toys) is a resident company that pays tax at a rate of 30% (i.e. it is not a base rate entity) and also has a tax rate for imputation purposes of 30%. It pays a fully franked dividend of $700 to each of its two resident shareholders, Colin and Amanda Anderson.

Colin's tax rate is 47% (i.e. top marginal tax rate plus levies), while Amanda's tax rate is 21%.

The tax payable or refundable at the company and shareholder level is calculated as:

Item	Colin $	Amanda $
Company level (AC Toys)		
Taxable income	1,000	1,000
Less: Company tax (30%)	(300)	(300)
After-tax income (paid as a dividend)	700	700

Item	Colin $	Amanda $
Shareholder level		
Dividend received	700	700
Franking credit (s. 207-20(1))	300	300
Taxable income	1,000	1,000
Tax assessed (47%/21%)	470	210
Less: Franking tax offset (s. 207-20(2))	(300)	(300)
Tax payable	170	nil
Excess imputation offset available to offset tax on other income or refundable (s. 67-25)	nil	90

Consequences for company

Franking account

To keep track of the amount of franking credits a **resident company** has at any particular time, it keeps a franking account (s. 205-10). The franking account records the amount of franking debits and franking credits that are attributable to the resident company. This enables the company to ascertain the franking account balance at any time, particularly when paying dividends.

The following are key points to note about a franking account:

- Franking credits most commonly arise when a resident company makes a payment of **Australian income tax** or **receives a franked dividend** (i.e. from another Australian resident company).
- A franking debit commonly arises when a resident company **pays a franked dividend** or **receives an Australian income tax refund**.
- A company's franking account is said to be in surplus at a particular time if, at that time, its franking credits are greater than its franking debits (s. 205-40(1)). The amount of the excess is the amount of the surplus.
- Conversely, a company's franking account is said to be in deficit at a particular time if, at that time, the sum of its franking debits is greater than its franking credits. The amount of the deficit is the amount of the excess (s. 205-40(2)).
- A franking account operates on a **tax-paid basis**. For example, if a company pays income tax of $30, it will generate a $30 credit in its franking account.

Franking a dividend

A resident company franks a dividend under s. 202-5 where the distribution is a 'frankable distribution' and the entity allocates a 'franking credit' to the distribution.

The major restrictions on the allocation of franking credits to distributions are:

- The maximum franking credit rule in s. 202-55.
- The benchmark rule in Division 203.
- The 'anti-streaming' provisions in Division 204.

To apply the maximum franking credit rule and the benchmark rule the company must first determine its 'corporate tax rate for imputation purposes'. For the income year ended 30 June 2019, where certain conditions are satisfied this rate will be 27.5%. In all other cases it will be 30%. A company cannot choose which rate to apply. A company's 'corporate tax rate for imputation purposes' and 'corporate tax rate' may not be the same for a particular income year. For example, this may happen when a company is changing its operations.

Dividends

General rules

'Dividend' is defined widely in s. 6(1) ITAA 1936 to include:

(a) **any distribution** made by a company to any of its shareholders, whether in money or other property; and

(b) any amount credited by a company to any of its shareholders as shareholders.

A dividend does **not** include:

- Distributions from the share capital account (but note s. 6(4) ITAA 1936 and tainted share capital accounts in this regard).
- Certain distributions in relation to the redemption or cancellation of redeemable preference shares (s. 6(1)(d) ITAA 1936).

Thus, dividends may include payments of cash, dividends reinvested in further shares (under a dividend reinvestment plan) and bonus shares in certain limited circumstances.

On the other hand, a debt forgiveness in favour of a shareholder would generally not give rise to a dividend under ordinary concepts because a debt forgiveness does not give rise to a distribution and no amount is credited as a lender, nor as a shareholder – see *DCT v. Black* and *Lonsdale Sand and Metal Pty Ltd v. FCT*.

The assessable income of a **shareholder** in a company (regardless of whether that company is a resident or non-resident) includes:

- Where the shareholder is a **resident**, **all** dividends (including non-share dividends) paid by the company (s. 44(1)(a) ITAA 1936).
- Where the shareholder is a **non-resident**, dividends (including non-share dividends) paid by the company to the extent they are paid out of profits derived by the company from **sources in Australia** (s. 44(1)(b) ITAA 1936).
- Where the shareholder is a **non-resident with a permanent establishment** (PE) in Australia (see Unit 14) and the **company is a resident**, **all** dividends (including non-share dividends) paid by the company that are attributable to the PE (s. 44(1)(b) and (c) ITAA 1936).

In applying s. 44(1) ITAA 1936, it is important to appreciate that certain dividends are deemed to be paid out of profits (refer s. 44(1B) ITAA 1936).

Prior to the amendments to s. 254T of the Corporations Act, dividends could legally only be paid out of profits of a company. The amendments to s. 254T broadly mean that a company may legally pay a dividend if its assets exceeds its liabilities. In response to the amendments to s. 254T, the ATO issued TR 2012/5, outlining its view on what gives rise to a dividend for tax purposes. The ATO believes that a dividend requires there to be profits in a company in the first place. This includes dividends paid out of current-year profits even if there are accumulated losses brought forward.

Special deeming rules

While the definition of a 'dividend' catches most distributions by companies, the ITAA 1936 also deems distributions to be dividends in a number of circumstances. The five most common circumstances where company distributions or payments are 'deemed' dividends are as follows:

1. Streaming of bonus shares and other capital benefits (ss 45–45D ITAA 1936) (see later in this unit).
2. Distributions made under a liquidation (s. 47 ITAA 1936) (see Unit 4).
3. Distributions from private companies (Division 7A ITAA 1936) (see later in this unit).
4. Excessive payments to shareholders, directors and associates (s. 109 ITAA 1936).
5. Off-market share buy-backs (s. 159GZZZP ITAA 1936) (see below).

Share buy-backs

The tax issues for the two types of share buy-backs are as follows:

- On-market share buy-backs (i.e. shares in itself are simply acquired by a listed company on the stock market).
  - No amount of the purchase price is treated as a dividend.
- Off-market share buy-backs (i.e. a company buys back shares from discrete shareholders).
  - If the purchase price exceeds the amount debited to the company's share capital account, the excess is considered to be a dividend.
  - If the purchase price exceeds the market value of the shares, the excess over market value is not frankable, even if it is a dividend.
  - The amount debited to the company's share capital account is generally the consideration for the disposal of the shares for CGT purposes.

A detailed understanding of share buy-backs is outside the scope of the TAXAU module.

Frankable distributions

Inclusions

A frankable distribution is generally a distribution that is paid out of the profits of the company. Under s. 202-40, a distribution is **frankable** unless it is specified as an unfrankable distribution.

Although the corporations law no longer requires a company to have profits to pay a dividend (see s. 254T of the Corporations Act), in TR 2012/5, the Commissioner considers that profits are a necessary requirement to there being a dividend for tax purposes.

Exclusions

- Under s. 202-45, the following distributions are unfrankable: The part of a share buy-back that is treated as a dividend under s. 159GZZZP ITAA 1936 which exceeds the market value of the share bought back.
- Deemed dividends under Division 7A ITAA 1936 (in limited circumstances, the Commissioner has a discretion to still allow it to be franked).
- Deemed dividends under s. 109 ITAA 1936.
- Dividends debited against share capital accounts.

Corporate tax rate for imputation purposes

The corporate tax rate for imputation purposes (s. 995-1) is:

- The company's corporate tax rate for the income year:
  - worked out on the assumption that its 'aggregated turnover', 'assessable income', and 'base rate entity passive income' are the same as the previous income year, and
  - applying the corporate tax rates of the current income year.
- If the company did not exist in the prior income year, it is the lower corporate tax rate of 27.5% for the income year ended 30 June 2019.

Maximum franking credit rule

Application

The maximum franking credit under s. 202-55 is equal to the maximum amount of tax that the company could have paid on the profits underlying that distribution.

If a distribution is franked in excess of the 'maximum franking credit', the amount of franking credits is limited by s. 202-65 to the maximum amount calculated under s. 202-60.

Calculation method

The maximum franking credit amount is calculated using the formula from s. 202-60, as follows:

$$\text{Amount of frankable distribution} \times \frac{1}{\text{Applicable gross-up rate}}$$

Where:

- Applicable gross-up rate means the corporate tax gross-up rate of the entity making the distribution for the income year in which the distribution is made.
- Corporate tax gross-up rate as defined in s. 995-1 is:

$$\frac{\text{100\% – Corporate tax rate for imputation purposes for the entity for the income year}}{\text{Corporate tax rate for imputation purposes of the entity for the income year}}$$

  The overall outcome of applying the above formula and definitions for the maximum franking credit amount is:

$$\text{Amount of frankable distribution} \times \frac{\text{Corporate tax rate for imputation purposes of the entity for the income year}}{\text{(100\% – Corporate tax rate for imputation purposes of the entity for the income year)}}$$

Therefore, the maximum franking credit amount for the income year ended 30 June 2019 is:

- For a company whose tax rate for imputation purposes is the base rate entity corporate tax rate:

$$\text{Amount of frankable distribution} \times \frac{27.5\%}{(100\ \% - 27.5\%)}$$

- For all other companies:

$$\text{Amount of frankable distribution} \times \frac{30\%}{(100\% - 30\%)}$$

Example – Maximum franking credit rule

AC Toys Pty Ltd (AC Toys) has after-tax profits of $14,000 available for distribution. On 1 November 2018, the company decides to pay $7,000 of the after-tax profit (i.e. a frankable distribution) to its shareholders. Assume AC Toys is not a base rate entity and has a tax rate for imputation purposes of 30%.

The maximum franking credit that AC Toys can attach to this distribution is calculated as:

$$\$3{,}000 = \$7{,}000 \times \frac{30\%}{(100\% - 30\%)}$$

If a fully franked dividend of $7,000 was paid, the shareholder would include $10,000 in their assessable income.

Benchmark rule

Application

The benchmark rule in s. 203-25 provides that all dividends paid within a franking period must be franked to the same benchmark franking percentage. This rule ensures that one shareholder of a company is not preferred over another when distributions are franked.

The benchmark rule applies to a non-share dividend in the same way as it applies to a normal dividend (see Unit 13).

The franking percentage for the first frankable distribution made in the franking period will establish the 'benchmark franking percentage' for that franking period (s. 203-30). If the company does not make any frankable distributions within a franking period, it will not have a benchmark franking percentage.

Exceptions

Exceptions to the benchmark rules exist for (s. 203-20):

- Companies that are, at all times during the franking period, listed public companies and the distribution and franking rights attaching to each class of membership interest are the same.
- Wholly owned subsidiaries of companies that satisfy the first exception (this includes 100% owned Australian subsidiaries of companies that are listed on overseas stock exchanges).
- Companies for which the Commissioner has exercised their discretion to make a determination in writing permitting an entity to depart from the benchmark rule in extraordinary circumstances.

Franking period

A **private** company's 'franking period' is the same as its income year (generally, a twelve-month period) (s. 203-45).

A **public** company has the following franking periods (s. 203-40):

- The six-month period commencing at the start of its income year.
- The remainder of its income year (also generally a six-month period).

Calculation method

The 'franking percentage' of a distribution is calculated using the following formula from s. 203-35:

$$\frac{\text{Franking credit allocated to the frankable distribution}}{\text{Maximum franking credit for the frankable distribution}} \times 100$$

The franking percentage cannot exceed 100%.

Example – Benchmark franking percentage

On 1 July 2018, AC Toys Pty Ltd (AC Toys), a private company, has a franking account balance of $30,000 credit. On the same date, the company makes a frankable distribution of $70,000 to its shareholders. Assume AC Toys is not a base rate entity and has a tax rate for imputation purposes of 30%.

The maximum franking credit that can be allocated to this distribution is $30,000, being:

$$\$30{,}000 = \$70{,}000 \times \frac{30\%}{(100\% - 30\%)}$$

If AC Toys chooses a 100% franked distribution and allocates franking credits of $30,000 to the distribution, this will establish the benchmark franking percentage for the company for the 2019 franking year at 100%.

If, however, the company chooses a 50% franked distribution, by allocating $15,000 in franking credits to the distribution, this will establish the benchmark franking percentage for the company for the 2019 year at 50%.

The benchmark period is 12 months because AC Toys is a private company.

Consequences of breaching

Certain tax consequences arise if the benchmark rule is not applied.

Consequences of breaching the benchmark rule	
Franking percentage less than the benchmark	**Franking percentage more than the benchmark**
Known as 'underfranking'	Known as 'overfranking'
Entity required to debit its franking account with the shortfall	Franking credit distributed to members remains at the level distributed (subject to the maximum franking rate for the frankable distribution)
Debit arises on the day of distribution and members do not receive the benefit of any additional franking credits as a consequence of the debit to the franking account (s. 203-50)	Entity is liable for 'overfranking tax' which is determined based on the 'franking percentage differential' (s. 203-50)
Value of any franking credit shortfall is forfeited	Overfranking tax is a penalty for breaching the benchmark rule and is neither creditable against the entity's future tax liability nor recorded as a credit in the entity's franking account

Overfranking tax

When a company makes a distribution in breach of the benchmark rule, the amount of the overfranking tax payable (when the dividend is overfranked) is calculated using the following formula from s. 203-50(2):

$$\text{Amount of frankable distribution} \times \frac{\text{Franking \% differential}}{\text{Applicable gross-up rate}}$$

Where:

- Applicable gross-up rate, corporate tax gross-up rate, and corporate tax rate for imputation purposes are as defined under the maximum franking credit rule above.
- The franking percentage differential is equal to the difference between the franking percentage for the frankable distribution and the entity's benchmark franking percentage (or such other rate as allowed by the Commissioner).

The overall outcome of applying the above formula and definitions for the amount of overfranking tax payable is:

$$\text{Amount of frankable distribution} \times \text{Franking percentage differential} \times \frac{\text{Corporate tax rate for imputation purposes of the entity for the income year}}{\text{(100\% – Corporate tax rate for imputation purposes of the entity for the income year)}}$$

Therefore, overfranking tax payable for the income year ended 30 June 2019 is:

- For a company whose tax rate for imputation purposes is the base rate entity corporate tax rate:

Amount of frankable distribution	×	Franking percentage differential	×	$\frac{27.5\%}{(100\,\% - 27.5\%)}$

- For all other companies:

Amount of frankable distribution	×	Franking percentage differential	×	$\frac{30\%}{(100\,\% - 30\%)}$

Example – Overfranking a dividend

On 30 September 2018, AC Toys Pty Ltd (AC Toys), a private company, pays a dividend that is franked to 40%. This sets the benchmark franking percentage at 40% for the franking period, being the 12-month period ended 30 June 2019. On 31 March 2019, AC Toys pays another dividend of $70,000 that is franked to 60%. Assume AC Toys is not a base rate entity and has a tax rate for imputation purposes of 30%.

There is a debit to the franking account on 31 March 2019 of $18,000, being:

$18,000	=	$70,000	×	$\frac{30\%}{(100\% - 30\%)}$	×	60%

The 31 March 2019 dividend is overfranked. The franking percentage differential is 20%, being:

20%	=	60%	–	40%

Therefore, AC Toys has an overfranking tax liability of $6,000, being:

$6,000	=	$70,000	×	20%	×	$\frac{30\%}{(100\% - 30\%)}$

AC Toys must pay the overfranking tax to the ATO. However, unlike other tax payments, this amount is not included in the franking account.

Underfranking debit

When a company makes a distribution in breach of the benchmark rule, the amount of the underfranking debit to the franking account is calculated using the formula from s. 203-50(2). This is the same formula that is applied to determine an overfranking tax liability (see above for details).

Worked example 8.1: Benchmark rule

[Available online in myLearning]

Franking a dividend

A company may choose the extent to which it wants to allocate franking credits to a distribution. It does not have to allocate the maximum franking credit (however, it cannot exceed this amount) and it may choose not to apply the benchmark franking percentage (thus resulting in a payment of overfranking tax or additional debit to its franking account).

It generally makes this choice based on the existing and expected surplus in its franking account and the rate at which earlier distributions have been franked. However, other factors may influence this choice, such as the requirements of shareholders to receive franked or unfranked dividends.

Example – Allocating franking credits (when the franking account balance is $nil)

AC Toys, a private company, wishes to distribute $70,000 of profits to its shareholders on 9 August 2018. The company has not made, and does not intend to make, any other distributions to shareholders during the income year. As at 9 August 2018, the balance in the company's franking account is $nil. AC Toys will, however, lodge its tax return and pay its expected tax liability of $30,000 in March 2019. This will give rise to a surplus in its franking account of $30,000 (all other things being equal).

The company may take into account the anticipated franking surplus of $30,000 during the same income year (being the franking period for a private company) when deciding to what extent it will frank the distribution to be made on 9 August 2018.

Assuming AC Toys is not a base rate entity and has a tax rate for imputation purposes of 30%, the maximum franking credit that AC Toys can attach to this distribution is calculated as:

$$\$30{,}000 = \$70{,}000 \times \frac{30\%}{(100\% - 30\%)}$$

Overfranking tax is not payable because this is the first distribution, which establishes the benchmark franking percentage (s. 203-50)).

Alternatively, the company may choose to ignore these anticipated franking credits and make an unfranked distribution.

Distribution statements

Section 202-75 requires corporate tax entities that make frankable distributions to provide distribution statements to members within the following time frames:

- For private companies, within four months after the end of the year in which the distribution is made.
- For other entities, on or before the day on which the distribution is made.

For the purposes of s. 202-80, a distribution statement will be taken to be in the approved form if it states the following:

- The name of the entity making the distribution.
- The date on which the distribution was made.
- The amount of the distribution.
- The amount of franking credit allocated to the distribution.
- The franking percentage for the distribution.
- The amount of any withholding tax that has been deducted from the distribution.
- The name of the shareholder.
- Where the distribution is unfranked – a statement to that effect.
- Where the distribution is franked – the franked amount and the unfranked amount of the distribution.

Franked amount

The franked amount of a distribution is the amount calculated using the following formula from s. 976-1:

$$\text{Franking credit on the distribution} \times \text{Applicable tax gross-up rate}$$

Where:

- Applicable gross-up rate, corporate tax gross-up rate, and corporate tax rate for imputation purposes are as defined under maximum franking credit rule above
- The franking credit on the distribution is the lesser of:
  - the amount stated on the distribution statement, and
  - the amount calculated using the formula:

$$\text{Amount of frankable distribution} \times \frac{1}{\text{Applicable gross-up rate}}$$

The overall outcome of applying the above formula and definitions for the franking credit amount is:

$$\text{Amount of frankable distribution} \times \frac{\text{Corporate tax rate for imputation purposes of the entity for the income year}}{(100\% - \text{Corporate tax rate for imputation purposes of the entity for the income year})}$$

Therefore, the franking credit amount for the income year ended 30 June 2019 is:

- For a company whose tax rate for imputation purposes is the base rate entity corporate tax rate:

$$\text{Amount of frankable distribution} \times \frac{27.5\%}{(100\ \% - 27.5\%)}$$

- For all other companies:

$$\text{Amount of frankable distribution} \times \frac{30\%}{(100\% - 30\%)}$$

Unfranked amount

The unfranked amount of a distribution is the amount calculated using the following formula:

$$\text{Amount of frankable distribution} - \text{Franked amount}$$

Example – Partially franking a distribution

On 20 February 2019 AC Toys, a private company, made a frankable distribution of $100,000 to its shareholders and allocated franking credits of $15,000 to the distribution. Assume AC Toys is not a base rate entity and has a tax rate for imputation purposes of 30%.

The franked amount of the distribution is calculated as follows:

$$\$35{,}000 = \$15{,}000 \times \frac{100\% - 30\%}{30\%}$$

The unfranked amount of the distribution is calculated as:

$$\$65{,}000 = \$100{,}000 - \$35{,}000$$

Franking account

The following tables outline the most common debit and credit entries in a franking account.

Credits

The most common **franking credits** come from s. 205-15, as follows.

Franking credits		
Situation	**Amount of credit**	**When credit arises**
Company pays a PAYG instalment (s. 205-15 item 1)	Amount of instalment	Day on which the payment is made
Company pays income tax (s. 205-15 item 2)	Amount of payment	Day on which the payment is made
Franked distribution is received by the company and the company is entitled to a tax offset (s. 205-15 item 3) (Note 1)	Franking credit on the distribution	Day on which the distribution is made
Franked distribution flows indirectly to the company through a partnership or trust and the company is entitled to a tax offset (s. 205-15 item 4) (Note 2)	Company's share of the franking credit on the distribution	At the end of the income year of the last partnership or trust interposed between the entity and the company that made the distribution
The payment of franking deficit tax under s. 205-45 or s. 205-50 (Note 3)	Amount of the franking deficit tax liability	Immediately after the liability is incurred

Notes

1. Under Division 207, a company is entitled to a tax offset even if it has current year or prior year tax losses.
2. This is often a mistake in practice. The franking credit is often included at the time of receipt from a partnership or trust distribution. This is incorrect. The franking credit arises at the year end of the entity making the distribution.
3. Because the franking deficit tax liability is incurred at the end of each tax year, the franking credit arises on the first day of the next financial year (which means that a deficit is technically carried forward to the next year if only for a split second).

Debits

The most common **franking debits** come from s. 205-30, as follows.

Franking debits		
Situation	**Amount of debit**	**When debit arises**
Company makes a franked distribution (s. 205-30 item 1)	Amount of franking credits allocated to distribution	Time at which distribution is made
Entity receives a refund of income tax (s. 205-30 item 2)	Amount of refund	When entity receives the refund or Commissioner applies it against another tax liability
Entity makes an under-franked distribution (s. 205-30 item 3)	$\boxed{\text{Amount of frankable distribution}} \times \boxed{\dfrac{\text{Franking \% differential}}{\text{Applicable gross-up rate}}}$	Day on which the distribution is made

Franking debits		
Situation	**Amount of debit**	**When debit arises**
Entity makes a linked distribution or issues tax-exempt bonus shares instead of making a distribution (s. 205-30 items 5 and 6)	Amount equal to the franking debit if the entity had made a distribution with franking credits equal to its benchmark	Day on which the linked distribution is made or the shares are issued
Commissioner determines that dividend streaming has occurred (s. 205-30 item 7)	Amount of Commissioner's determination	Day on which the determination is made
On-market share buy-back (s. 205-30 item 9)	Amount equal to debit that would have arisen if the buy-back had been off-market equal to its benchmark franking percentage (if applicable) or 100%	Day on which the interest is purchased

Franking deficit tax liability

General rule

A company may be liable for franking deficit tax if its franking account is in deficit at the end of the income year (s. 205-45). If this occurs, the company has imputed more tax to its shareholders than it has paid. The payment of franking deficit tax is intended to account for this over-imputation of tax. In practice, a franking deficit typically arises where a company expects to get franking credits by year end (e.g. by paying income tax or by receiving a franked dividend) but this does not happen for whatever reason.

The amount of franking deficit tax payable is the amount of the entity's franking deficit at the end of the year. Franking deficit tax is not a penalty and can be offset against a company's future income tax liabilities (i.e. franking deficit tax payable for a year end can be offset against the income tax liability for that year end).

A franking credit will arise if franking deficit tax is payable. This credit arises in the year after the franking deficit tax liability arises, which means that a deficit is momentarily carried forward from one year to the next. The timing of this credit may be relevant in applying the 10% franking deficit tax offset rule, discussed below.

Anti-avoidance rule

Payments of company tax instalments before year end generate franking credits out of which franked dividends can be paid. In cases where company tax instalments are paid before year end and a refund of that company tax is subsequently received, the franking deficit tax rules may still apply.

If a franking deficit would have arisen but does not because of a tax payment and a refund arises in the following year (within three months of the end of the previous year), the refund that arises in the following year will be treated, for the purpose of the franking deficit tax, as though it had been paid at the end of the preceding income year (s. 205-50). This results in a recalculation of franking deficit tax. The franking deficit tax, or additional amount of franking deficit tax, is payable within 14 days of the day the refund is paid (s. 205-45).

Note that under s. 205-70(6), the Commissioner has a discretion to determine that the penalty does not apply if it is due to circumstances outside the control of the company.

Franking deficit tax offset

General rule

Normally, if a company pays franking deficit tax, it is entitled to a tax offset (franking deficit tax offset) equal to the amount of the franking deficit tax paid. For example, a company pays franking deficit tax of $20,000 in respect of the deficit balance in its franking account as at 30 June 2019. In December 2019, when the company prepares and lodges its income tax return for the income year ended 30 June 2019, it reduces the amount of tax payable by the $20,000 franking deficit tax it paid.

Excessive over-franking rule application

Excessive over-franking occurs if a company's franking deficit at the end of the income year is more than 10% of the total of the franking credits arising during an income year (s. 205-70).

However, for the purposes of determining whether this penalty applies, only debits to the franking account caused by certain items of s. 205-30 are taken into account in determining whether a deficit exists and, if so, the size of the deficit. These are items 1, 3, 5 and 6, and sometimes item 2 (this item will only be taken into account if there has been a debit caused by items 1, 3, 5 or 6).

Consequence

When excessive over-franking occurs, the company's franking deficit tax offset will be reduced by 30% (i.e. the tax offset is only 70% of the franking deficit tax paid). This is essentially a penalty for the company.

However, the 30% reduction in the franking deficit tax offset only applies to that part of the franking deficit caused by items 1, 3, 5 and 6 (and sometimes item 2).

Note: The Commissioner has a discretion to reduce the 30% penalty if the over-franking was outside of the taxpayer's control.

Exception

Section 205-70(5) allows private companies to frank their dividends during their first year of operation. This is achieved by allowing the companies an offset for the full amount of franking deficit tax paid (i.e. the company's franking deficit tax offset will not be reduced by 30%) if the company has an income tax liability in its first taxable year that is sufficient to generate franking credits equal to at least 90% of the deficit in the company's franking account at the end of that year.

Example – Franking deficit at year end

AC Toys is a private company that is not a base rate entity and has a tax rate for imputation purposes of 30%. It has the following franking account for the year:

Date	Account description	Debit $	Credit $	Balance $
01.07.2018	Opening balance			0
03.03.2019	Payment of $70,000 dividend franked to 100% ($70,000 × 30 ÷ 70) (s. 205-30 item 1)	30,000		(30,000)
04.05.2019	Determination made by the Commissioner under s. 204-30 for streaming (s. 205-30 item 7)	5,000		(35,000)
21.05.2019	Receipt of $35,000 dividend franked to 100% from an entity that has a tax rate for imputation purposes of 30% ($35,000 × 30 ÷ 70) (s. 205-15 item 3)		15,000	(20,000)
30.06.2019	Determination made by the Commissioner under s. 204-30 for streaming (s. 205-30 item 7)	20,000		(40,000)

As the franking account is in deficit as at 30 June 2019, AC Toys must pay franking deficit tax of $40,000 and it needs to determine whether excessive over-franking has occurred. Normally, AC Toys would also be entitled to a franking deficit tax offset equal to the amount of the franking deficit tax it has paid. However, if it has engaged in excessive franking, it will only be able to claim 70% of the franking deficit tax paid as a tax offset.

AC Toys recalculated franking account is:

Date	**Account description**	**Debit $**	**Credit $**	**Balance $**
01.07.2018	Opening balance			0
03.03.2019	Payment of $70,000 dividend franked to 100% ($70,000 × 30 ÷ 70) (s. 205-30 item 1)	30,000		(30,000)
04.05.2019	Streaming determination	N/A*		(30,000)
21.05.2019	Receipt of $35,000 dividend franked to 100% ($35,000 × 30 ÷ 70) (s. 205-15 item 3)		15,000	(15,000)
30.06.2019	Streaming determination	N/A*		(15,000)

* As these are not items 1, 2, 3, 5 or 6 of s. 205-30, they are not taken into account when determining the amount of the franking deficit in order to ascertain whether excessive franking has occurred.

The total franking credits arising during the income year are $15,000, 10% of which represents $1,500. The franking deficit of AC Toys (taking into account debits caused by items 1, 3, 5 and 6 only) is $15,000. As the $15,000 franking deficit is greater than 10% of the total credits (i.e. $1,500), excessive franking has occurred.

The company is still liable to pay $40,000 in franking deficit tax as this is the actual deficit. Although AC Toys is liable to pay $40,000 in tax to the ATO, it is only entitled to claim $35,500 ($40,000 – [$15,000 × 30%]) as the tax offset (i.e. the offset is reduced by 30% of the franking deficit as recalculated above for excessive franking purposes). This means that $4,500 in additional tax will be paid by AC Toys as a penalty for excessive over-franking for which it will not receive any offsets.

Where AC Toys has taxable income of $1,000,000 for the year ended 30 June 2019, its tax payable calculation is as follows:

Item	**Calculation**	**$**
Tax on taxable income	$1,000,000 × 30%	300,000
Less: Franking deficit tax offset	$40,000 – ($15,000 × 30%)	(35,500)
Tax payable		264,500

Note: if the over-franking was caused by circumstances outside of AC Toy's control, a request should be made to reduce the 30% penalty.

Activity 8.1: Dividend franking

[Available online in myLearning]

Gross-up and tax offset for shareholders

Overview

Dividends (including amounts that are deemed to be dividends) are included as part of a taxpayer's assessable income under s. 44(1) ITAA 1936 (see earlier in this unit).

All resident entities (excluding partnerships and trusts) that receive franked distributions:

- Include the attached franking credits in assessable income (s. 207-20(1)).
- Obtain a tax offset equal to the amount of franking credits included in assessable income (s. 207-20(2)). Any excess franking offsets are refundable to taxpayers (other than companies) (s. 67-25).

This process is referred to as the 'gross-up and offset' approach.

Non-resident shareholders are not entitled to franking offsets. However, where a franked dividend is paid to a non-resident, the rate of withholding tax applied to the franked amount of the dividend is reduced to 0% (s. 128B(3)(ga) ITAA 1936). The dividend is then NANE income of the non-resident under s. 128D ITAA 1936. This is discussed further in Unit 14.

Note: The Government has announced that it intends to consult on the implications of removing refundable franking credits.

Individuals

The treatment of franked dividends received by a shareholder who is a resident individual is explained in the following example.

Example – Franked dividend received by individual shareholder

An individual shareholder receives a $100 fully franked dividend that is paid out of profits taxed at the 30% company tax rate (i.e. has franking credits of $43 allocated to it).

The $100 dividend is included in the taxpayer's assessable income (s. 44(1) ITAA 1936), along with the attached franking credit of $43 (s. 207-20(1)). This extra $43 is not received, but included in assessable income and entitles the individual to a franking tax offset of $43 (s. 207-20(2)).

The individual shareholder is entitled to a refund of any excess franking tax offset (s. 67-25).

The impact for individual shareholders with different tax rates are as follows:

Marginal tax rate (including Medicare levy)	**47% $**	**39% $**	**34.5% $**	**21% $**	**Nil $**
Dividend	100	100	100	100	100
Gross-up	43	43	43	43	43
Taxable income	143	143	143	143	143
Tax payable	67	56	49	30	nil
Less: Franking offset	(43)	(43)	(43)	(43)	(43)
Additional tax payable/(refundable)	24	13	6	(13)	(43)

Trusts and partnerships

A franked distribution paid to a trust or partnership is treated as flowing indirectly to members of the trust or partnership (Subdivision 207-B). Each member's share of the franking credit on the distribution is included in their assessable income. Each member is then given a tax offset equal to that share of the franking credit, provided the member is not itself a trust or partnership through which the distribution flows indirectly. Certain eligible members may be entitled to a refund if the tax offset allowed exceeds the member's basic income tax liability.

If the trustee, rather than a member, is the taxpayer in respect of a share of the distribution, it is the trustee in that capacity that is given the tax offset for the share of the franking credit.

If the member is a company, it can pass on the benefit of having received a franking credit on the distribution to its own members by making franked distributions to its own members.

Example – Franked dividend received by a partnership

The AB partnership receives from a company, (that is not a base rate entity and has a tax rate for imputation purposes of 30%), a fully franked distribution of $70,000 with franking credits of $30,000 allocated to it. The partnership also earns other income of $280,000 and has allowable deductions of $50,000. The partnership has two equal partners: Alpha and Beta.

The partnership's net income is calculated first. (As covered in Unit 9 on partnerships, this type of entity does not pay tax and therefore net income is calculated rather than taxable income.)

Net income of the AB partnership	
Item	**$**
Other income	280,000
Franked dividend (s. 44(1) ITAA 1936)	70,000
Franking credit (gross-up) (s. 207-35(1))	30,000
Assessable income	380,000
Less: Allowable deductions	(50,000)
Net income	330,000

As they are equal partners, Alpha and Beta will include an amount of $165,000 in their respective assessable incomes, under s. 207-35. Under s. 207-45, they are entitled to a tax offset for their share of the franking credit on the distribution.

Each partner's share of the franking credit on the franked distribution is calculated using the formula in s. 207-57(2), as the distribution has only flowed through one entity (being the AB partnership). This calculation can be worked through in four steps:

Step 1: Calculate the numerator – as much of the individual interest of Alpha in the net income/loss of the partnership as is attributable to the distribution

Share of cash amount of distribution = $70,000 ÷ 2 = $35,000

Step 2: Calculate the denominator – as much of the net income/loss of the partnership as is attributable to the distribution = $70,000 (total cash amount of the franked distribution)

Step 3: Calculate the franking credit on the distribution = $30,000

Step 4: Apply the formula in s. 207-57(2) to calculate Alpha's share of the franking credit

Share of franking credit = $30,000 × $35,000 ÷ $70,000 = $15,000

Alpha's share of the franking credit on the franked distribution is therefore $15,000, as is Beta's.

Superannuation funds

The treatment of franked dividends received by a complying superannuation fund is explained in the following example.

Example – Franked dividend received by a superannuation fund

On 31 August 2018, Live It Up Superannuation Plan (Live It Up), a complying fund, received a fully franked distribution of $7,000, with franking credits of $3,000 allocated to it. Its other assessable income was interest of $6,000. Live It Up incurred allowable deductions of $1,000.

First, the superannuation fund's taxable income is calculated:

Taxable income of Live It Up	
Item	**$**
Interest income	6,000
Franked dividend (s. 44(1) ITAA 1936)	7,000
Franking credit (gross-up) (s. 207-20(1))	3,000
Assessable income	16,000
Less: Allowable deductions	(1,000)
Taxable income	15,000

Next, the superannuation fund's tax payable is calculated:

Calculation of income tax liability	
Item	**$**
Gross tax on $15,000 at 15%	2,250
Less: Franking offset (s. 207-20(2))	(3,000)
Net tax refundable (s. 67-25: excess offsets refundable)	(750)

Companies

The treatment of franked dividends received by a shareholder that is a resident company is explained in the following example.

Example – Franked dividend received by a company

On 31 August 2018, Invest Now Pty Ltd (Invest Now) received a fully franked distribution of $7,000, with franking credits of $3,000 allocated to it. The company's other assessable income was interest of $6,000. Invest Now incurred allowable deductions of $1,000. Assume Invest Now is not a base rate entity and has a tax rate for imputation purposes of 30%.

The company's taxable income is calculated first:

Taxable income of Invest Now	
Item	**$**
Interest income	6,000
Franked dividend (s. 44(1) ITAA 1936)	7,000
Franking credit (gross-up) (s. 207-20(1))	3,000
Assessable income	16,000
Less: Allowable deductions	(1,000)
Taxable income	15,000

Next, the company's tax payable is calculated:

Calculation of income tax liability	
Item	**$**
Gross tax on $15,000 at 30%	4,500
Less: Franking offset (s. 207-20(2))	(3,000)
Net tax payable	1,500

Unlike other shareholders, a shareholder who is an Australian resident company maintains a franking account. Therefore, a $3,000 franking credit would also arise in the company's franking account (refer to Item 3 of s. 205-15).

Note: In the above scenario, the company has fully used its franking tax offsets to reduce its tax payable. Where a company has excess franking tax offsets, a refund is generally not available. However, the company can convert the excess franking offsets into a tax loss (s. 67-25(1C)–(1E)). See below on dividends and tax losses.

Interaction of franking tax offset with other provisions

Carry forward tax loss utilisation

Under s. 36-17 a **company** can choose the amount of carry forward tax losses it wishes to deduct in an income year. A company might choose not to deduct a carry forward tax loss to:

- Avoid wasting tax losses against franked dividends.
- Pay tax on its profits, so that they can pay franked dividends to its shareholders.
- Avoid wasting foreign income tax offsets (FITOs). FITOs are analysed in detail in Unit 14.

This ability to choose not to claim a tax deduction for a carry forward tax loss is an exception to the general principle that allowable deductions are compulsory (i.e. they must be claimed). The choice can only be made by companies, not by other entities such as individuals.

There are anti-avoidance rules which are designed to prevent companies from 'refreshing' their carry forward tax losses. Under s. 36-17(5), a company must choose not to claim a deduction for a carry forward tax loss to the extent that it has an amount of excess franking tax offsets.

Note also that under s. 36-17(10)–(13), a revised choice can be made if circumstances change (e.g. taxable income changes).

Example – Franked dividend received by a company: Carry forward tax loss

OzZee Pty Ltd (OzZee) is a resident company that received a fully franked dividend of $100 with franking credits of $43 allocated to it during the income year. It earned no other income and incurred no deductions. The company has a carried forward tax loss of $500. Assume OzZee is not a base rate entity and has a tax rate for imputation purposes of 30%.

First, the company's taxable income is calculated:

Taxable income of OzZee	
Item	**$**
Dividend	100
Franking credit (gross-up)	43
Assessable income	143
Tax loss recouped	Nil
Taxable income	143

Next, the company's income tax liability is calculated:

Calculation of income tax liability	
Item	**$**
Gross tax on $143 at 30%	43
Less: Franking offset	(43)
Net tax payable/(refundable)	Nil

The company must choose, per s. 36-17(5), to apply a carry forward tax losses of $nil.

After applying this section, the company would still have carried forward tax losses of $500. This methodology prevents the carry forward loss from being converted into a current year loss (i.e. being 'refreshed') by taking advantage of the excess franking tax offset rules – see below.

Order of application of tax offsets

Section 63-10 sets out the order in which tax offsets must be applied. Broadly, tax offsets that are non-refundable to the taxpayer are applied before tax offsets that are refundable. Thus:

- Franking offsets are applied **after** FITOs for an individual. This is because an individual is entitled to a refund of excess franking offsets.
- Franking offsets are applied **before** FITOs for a company. This is because a company is not entitled to a refund of excess franking offsets (see below).

Excess franking tax offsets

Under s. 36-55, a company can convert any excess franking tax offsets to the equivalent amount of a tax loss for the year, which can be carried forward and deducted in later income years. The excess franking offset is the difference between the total of tax offsets on franked dividends and the amount of income tax the company would have to pay if it did not have those offsets.

The excess franking tax offsets are converted to a tax loss by dividing them by the company's corporate tax rate for imputation purposes.

Required reading

Sections 36-55 and 63-10.

Example – Franked dividend received by a company: excess franking tax offsets

During the income year ended 30 June 2019, AC Toys, a private company, received a fully franked dividend of $210 with franking credits of $90 allocated to it. AC Toys has allowable deductions of $600 and net exempt income of $80. In addition, the company makes a gift of $50 cash to a Sydney-based public hospital which is deductible. Assume AC Toys is not a base rate entity.

Generally a tax loss for an income year is calculated under s. 36-10 as the excess of deductions over the sum of assessable income and net exempt income. However, when calculating the tax loss, a donation, which would otherwise be deductible, is not allowable (s. 26-55). Therefore, AC Toys' tax loss for the year would be $220 (i.e. $210 franked dividend + $90 gross-up – $600 deductions + $80 net exempt income).

Where a company has excess franking offsets, a tax loss for an income year is calculated under s. 36-55(2) following a four-step method statement. For AC Toys, this method would be:

Step 1: Tax loss ignoring net exempt income:

= $210 franked dividend + $90 gross-up – $600 deductions = $300

Step 2: Divide the amount of the excess franking offset by the entity's corporate tax rate for imputation purposes for that year.

The excess franking offset under s. 36-55(1) = Franking offsets ($210 × 30%/70%) – Income tax payable on taxable income ignoring franking offsets ($0) = $90

Therefore, the result of this step is = $90 ÷ 30% = $300

Step 3: Add the results of Steps 1 and 2 = $300 + $300 = $600

Step 4: Reduce the result of Step 3 by the company's net exempt income for the year. This amount is AC Toys' tax loss for the year = $600 – $80 = $520

Therefore, AC Toys is taken to have incurred a $520 tax loss for the year ended 30 June 2019.

Note: The tax loss for the income year of $520 is equal to the tax loss under s. 36-10 of $220 plus the tax loss on conversion of the excess franking offsets of $300 (i.e. $90 ÷ 30%).

Worked example 8.2: Excess franking offsets

[Available online in myLearning]

Anti-avoidance and integrity measures

Due to the differing treatment of franking credits received by different entities and differing tax rates applied to entities, not all shareholders benefit equally from a distribution being franked (e.g. non residents). As a consequence, there is an incentive for shareholders to transfer, provide or sell franking credits to those shareholders who will receive a greater benefit. A range of anti-avoidance and integrity measures apply to prevent this occurring. Dividend streaming rules

Division 204 of Part 3-6 includes four anti-streaming rules aimed at preventing the streaming of franking credits to some shareholders in preference to others.

1. **The disclosure rule**

   This rule, in s. 204-75, operates in conjunction with the benchmark rule. It requires a company to notify the Commissioner in writing if its benchmark franking percentage for a period 'differs significantly' from the last franking period in which a frankable distribution was made.

   A significant difference is one where the benchmark franking percentage has changed by an amount greater than the amount calculated using the following formula from s. 204-70:

Number of franking periods starting immediately after the last relevant franking period and ending at the end of the current franking period	×	20%

2. **Linked distributions rule**

   This rule is found in s. 204-15. It is aimed at distributions made by more than one entity where the distributions are linked in some way. It deals with the situation where a member of an entity who would otherwise receive a distribution from that entity chooses instead to receive a distribution from a linked entity with a higher or lower franking percentage.

   Where this occurs, a penalty franking debit arises in the franking account of the entity with the higher benchmark percentage. The debit is equal to the amount that would have been debited if the entity with the higher benchmark percentage had made a distribution with a franking percentage equal to the benchmark percentage for that entity.

3. **Substituting tax-exempt bonus shares for franked distributions rule**

   This rule, found in s. 204-25, applies where a member is provided with a choice to receive a tax-exempt bonus share(s) in lieu of a franked distribution. Where the rule applies, the entity is required to debit its franking account with a penalty amount on the day the shares are issued. The debit is equal to the debit that would otherwise have arisen if the entity had made the substituted distribution at its benchmark franking percentage.

4. **Streaming distributions rule**

   This rule, found in s. 204-30, applies where an entity streams distributions in such a way as to give those members who benefit most from imputation credits (e.g. resident taxpayers) a greater imputation benefit than those who benefit less (e.g. non-resident taxpayers).

   When this rule applies, the Commissioner may determine that a franking debit arises in the franking account of the entity, or that no imputation benefit arises in the hands of the 'favoured member'.

Imputation system manipulation rules (i.e. no gross-up or offset)

Under s. 207-145 and s. 207-150, where the imputation system has been manipulated, the franking credit on a distribution (i.e. dividend) is **not** included in the assessable income of the entity, and the entity is **not** entitled to a franking offset.

Manipulation includes circumstances where:

- The entity is not a qualified person in relation to the distribution.
- The Commissioner has made a determination under the dividend imputation general anti-avoidance rule in s. 177EA ITAA 1936 that no imputation benefit is to arise.
- The Commissioner has made a determination under the dividend streaming rule in s. 204-30 that no imputation benefit is to arise (see above).
- The distribution is made as part of a dividend-stripping operation.
- The distribution is one to which the dividend-washing rule in s. 207-157 applies.
- The distribution is one to which the foreign income tax deduction rule in s. 207-158 applies.

Qualified person rule (i.e. minimum holding period rule)

As noted above, manipulation arises where the entity is not a qualified person. Thus, to be entitled to a franking offset in relation to a particular dividend, a taxpayer must be a '**qualified person**' in relation to the dividend.

If the dividend is received through a trust or partnership, the taxpayer does not receive the dividend as such but rather receives a trust or partnership amount that is attributable to the dividend (except for beneficiaries of a widely held trust). The taxpayer needs to determine what component of a trust or partnership distribution is attributable to a particular dividend and then determine whether, in relation to that dividend, the taxpayer is a 'qualified person'.

The ITAA 1997 has not specifically enacted a definition of 'qualified person'. However, s. 207-145 and s. 207-150 both link to the repealed imputation regime and qualified person requirements contained in Division 1A ITAA 1936. Therefore, the repealed qualified person requirements continue to apply to shares (and interests in shares) that were acquired on or after 1 July 1997 (TD 2007/11).

A taxpayer is a **qualified person** in relation to a dividend if they **satisfy one of the following** four requirements:

1. The taxpayer satisfies the 45-day holding period rule (90-day rule for preference shares) in relation to the dividend. The rule requires the taxpayer to hold the shares 'at risk' for at least 45 days, not counting the day of acquisition or disposal, to be eligible for any franking tax offset (so it is effectively a 47-day rule). The franked dividend can be received during this period, provided that the shares are held in total for 47 days.
2. The taxpayer is a certain type of institutional investor that elects to have a franking credit or franking offset ceiling applied, calculated according to a prescribed formula.
3. The taxpayer is a natural person whose franking offset entitlement for the year is less than $5,000 (this is not indexed).
4. The dividend is paid on certain shares issued in connection with winding up a company.

A taxpayer, however, will **not be a qualified person** in relation to a particular dividend if they are under an obligation to make, or are likely to make, a related payment in respect of the dividend or distribution attributable to the dividend. If the related payment rule applies and the taxpayer has not held the shares at risk for at least 45 days (90 days for preference shares), no franking offset is available, even if the franking offset entitlement for the year is less than $5,000.

Dividend imputation general anti-avoidance rule

Section 177EA was inserted into Part IVA ITAA 1936 (i.e. the general anti-avoidance rules) to deal with schemes that provide a tax advantage for franking credits. The operation of Part IVA ITAA 1936 generally is explained in further detail in Unit 15.

The conditions necessary for the application of the general anti-avoidance rule to franking credits are set out in s. 177EA(3) ITAA 1936:

> This section applies if:
>
> (a) there is a scheme for a disposition of membership interests, or an interest in membership interests, in a corporate tax entity; and
>
> (b) either:
>
> (i) a frankable distribution has been paid, or is payable or expected to be payable, to a person in respect of the membership interests; or
>
> (ii) a frankable distribution has flowed indirectly, or flows indirectly or is expected to flow indirectly, to a person in respect of the interest in membership interests, as the case may be; and
>
> (c) the distribution was, or is expected to be, a franked distribution or a distribution franked with an exempting credit; and
>
> (d) except for this section, the person (the relevant taxpayer) would receive, or could reasonably be expected to receive, imputation benefits as a result of the distribution; and
>
> (e) having regard to the relevant circumstances of the scheme, it would be concluded that the person, or one of the persons, who entered into or carried out the scheme or any part of the scheme, did so for the purpose (whether or not the dominant purpose but not including an incidental purpose) of enabling the relevant taxpayer to obtain an imputation benefit.

If the above conditions are satisfied and the company and the person deriving the dividend or distribution are parties to the scheme, the Commissioner has a choice whether to post a debit to the company's franking account or deny the franking credit benefit to the recipient of the dividend or distribution. Section 177EA(3) ITAA 1936 was successfully applied in *Electricity Supply Industry Superannuation (Qld) Ltd v. FCT*, but not in *Mills v. FCT*.

Note that the Commissioner can consider whether a distribution is sourced from unrealised or untaxed profits when applying s. 177EA ITAA 1936.

TD 2014/10 sets out the Commissioner's view on the application of the general anti-avoidance provision in s. 177EA ITAA 1936 to dividend-washing arrangements.

Dividend-washing

As noted above, manipulation arises where a distribution is one to which the dividend-washing rule in s. 207-157 applies. Taxpayers that obtain additional franking credits as a result of dividend-washing are denied a franking offset for the additional credits.

Dividend-washing occurs when shareholders seek to claim two sets of franking credits on what is effectively the same parcel of shares by selling an interest and then immediately purchasing an economically equivalent interest. The original interest is sold after an entitlement to a franked distribution has accrued, referred to as trading ex-dividend (i.e. the franked dividend is paid to the seller even though the shares have been sold). The economically equivalent interest is purchased with a further entitlement to a corresponding franked distribution, referred to as trading cum-dividend (i.e. the franked dividend is paid to the purchaser).

An entity engaging in dividend-washing is able to satisfy the holding period rule in respect of both interests without breaching the last-in-first-out (LIFO) rules (i.e. the original interest is held at least 45 days prior to dividend date and new interest at least 45 days after its acquisition).

Foreign income tax deduction

As noted above, manipulation arises where a distribution is one to which the foreign income tax deduction rule in s. 207-158 applies.

Section 207-158 applies to foreign equity distributions made on or after 1 January 2019 where all or part of that distribution gives rise to a foreign income tax deduction. In other words, where there is a mismatch between its treatment in Australia as a foreign dividend received by an Australian entity (i.e. taxpayer) and its treatment in a foreign jurisdiction as a deductible amount.

Note: The foreign equity distribution exemption in s. 768-5 generally does not apply to distributions that give rise to a foreign income tax deduction (see Unit 14).

Tainted share capital accounts

As discussed earlier, if a company distributes an amount from its share capital account to its shareholders (by debiting the payment against that account), the payment is generally treated under the CGT rules, not as a dividend.

The exception to this rule is where the company's share capital account is tainted (Division 197). Where this is the case, it is treated as a profit account. This means that any subsequent distributions from that account will be treated as distributions of profits (and unfrankable) rather than returns of capital.

A company's share capital account will become tainted if the company **transfers** an amount to its share capital account from any other account, other than:

- An amount that can be identified as share capital.
- Certain amounts that are transferred under certain debt–equity swaps.
- An amount that is transferred by a non-Corporations Act company to remove shares with a par value.
- Certain amounts that are transferred from an option premium reserve.
- Certain amounts that are transferred in connection with the demutualisation of a non-insurance company.
- Certain amounts that are transferred in connection with the demutualisation of an insurance company at the time of the demutualisation.
- Certain amounts that are transferred in connection with the demutualisation of a life insurance company but after the demutualisation.

A **transfer** generally requires one account to go down and the share capital account to go up. Therefore, a transfer would not arise if an expense account is debited (i.e. goes up) and the share capital account is credited (i.e. goes up). However, a journal that debits retained earnings and credits the share capital account will generally taint the share capital account.

When a share capital account is tainted, a franking debit (equal to the benchmark franking percentage or 100% if there is none) arises in the company's franking account at the end of the franking period when the transfer occurs and is calculated based on the amount transferred to the share capital account.

Once a share capital account is tainted, it is possible for a company to make an irrevocable choice to 'untaint' its share capital account. If the company chooses to untaint its share capital account, an additional franking debit may arise at the end of the franking period, when the choice to untaint is made. Untainting tax may also be payable at that time.

Schemes to provide benefits – capital returns

A capital return generally results in a reduction in the cost base of the shares for CGT purposes (see Unit 4). However, s. 45B ITAA 1936 may apply to deem a dividend to be paid for certain payments, allocations and distributions made in substitution for dividends. Section 45B ITAA 1936 is applicable where there is a scheme for the purpose of enabling a taxpayer to obtain a tax benefit.

Therefore, whenever a company makes a distribution out of share capital, the potential application of s. 45B ITAA 1936 should be considered. Section 45B ITAA 1936 would generally be relevant if there are realised or unrealised profits when the capital return is made. If it applies, the capital return could be deemed to be an unfranked dividend. Given the broad scope of this section, a ruling from the ATO is generally required in relation to the potential application of s. 45B ITAA 1936.

Worked example 8.3: Claiming franking offsets

[Available online in myLearning]

Trans-Tasman imputation

Overview

The trans-Tasman imputation measures in Division 220 allow a New Zealand (NZ) resident company to choose to enter the Australian dividend imputation system. This allows the NZ company to maintain an Australian franking account and to attach Australian franking credits to dividends it pays.

Generally, a NZ company that chooses to use the trans-Tasman imputation rules will be subject to the existing Australian imputation rules in the same way as they apply to an Australian company (see above). However, there are special rules for NZ companies to ensure the Australian imputation rules operate appropriately and to preserve the integrity of the Australian imputation system.

Anti-avoidance mechanisms contained in the Australian provisions will prevent the streaming of a disproportionate amount of Australian franking credits to Australian shareholders. The result will be that Australian franking credits will be allocated on a pro rata basis, taking into account the relative interests of Australian and NZ shareholders.

The imputation measure does not allow the recognition of NZ imputation credits attached to dividends that are received by Australian resident shareholders.

Note: Australian companies are able to maintain a NZ imputation credit account and pay dividends with NZ imputation credits attached. However, the operation of NZ tax laws is outside the scope of the TAXAU module.

Franking account

The Australian franking account of a NZ resident company operates on a tax-paid basis, which means that if the NZ company pays $30 of Australian tax, it would generate a credit of $30 in its franking account.

Typically, a franking credit would arise in the Australian franking account when the NZ resident company pays Australian income tax; when it receives a dividend with Australian franking credits attached; or when the Australian dividend, interest or royalty withholding tax liability of the NZ resident company has been paid.

Franking debits typically arise in the Australian franking account when the NZ resident company pays a dividend with Australian franking credits attached, or when it receives a refund of Australian income or withholding taxes.

Further guidance on franking accounts is discussed above.

Franking distributions

Only distributions that are frankable can have franking credits allocated to them. This may require a NZ resident company to consider the Australian debt–equity rules (see Unit 13).

Frankable distributions can only be franked up to the maximum franking credit amount. Further guidance on franking distributions is discussed above.

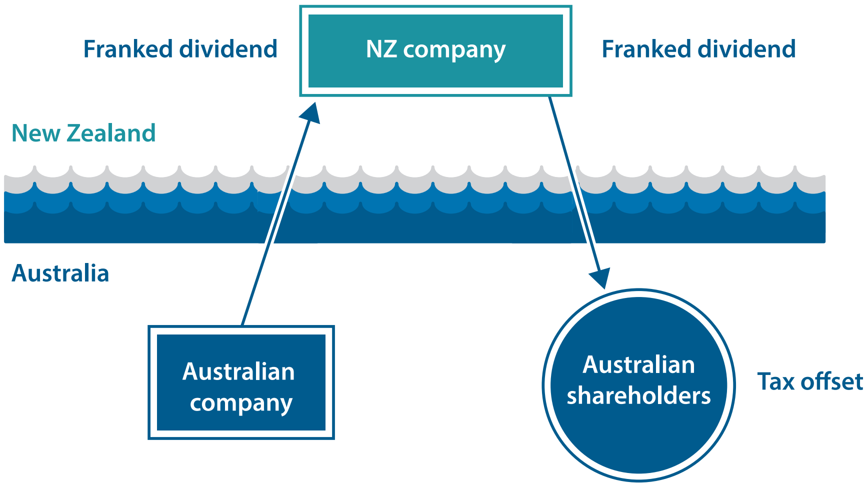
Note: A NZ resident company is able to attach both Australian franking credits and NZ imputation credits to the same dividend.

Application

The application of the imputation measure is best demonstrated by the following example.

Example – Trans-Tasman imputation

NZ Co receives a fully franked dividend of A$70 from Aus Co, an Australian resident company that has a tax rate for imputation purposes of 30%. A franking credit of A$30 arises in NZ Co's Australian franking account. NZ Co is therefore able to frank dividends to its shareholders, and the Australian shareholders of NZ Co are eligible for a tax offset reflecting Australian tax paid by the Australian company on Australian-sourced income (see diagram below).



A NZ company will be able to frank dividends, so that Australian shareholders receive a tax offset for the franking credits arising from Australian tax paid by the Australian company

NZ Co pays a franked dividend of A$70 to Bob, an Australian shareholder. The dividend is fully franked, which means that a A$30 franking credit is attached. NZ non-resident withholding tax is applied at the rate of 15%. Bob therefore receives a cash dividend of A$59.50 net of NZ non-resident withholding tax (A$70 – (A$70 × 15%)).

The consequences for Bob of receiving a franked dividend from NZ Co are set out below.

Tax payable by Bob	
Description	**Amount A$**
Assessable income	
Distribution	59.50
Foreign tax paid	10.50
Franking credit	30.00
	100.00
Tax payable (assume a rate of 47%)	47.00
Less:	
Foreign income tax offsets (see Unit 14)	(10.50)
Australian tax offsets	(30.00)
Tax payable by Bob	6.50

Adapted from: Explanatory Memorandum to *Tax Laws Amendment Act (No 6) 2003*, Diagram 5.1 and Example 5.2.

Private company loans and other payments (Division 7A ITAA 1936)

Overview

Division 7A (ss 109B-109ZE) ITAA 1936 aims to prevent private companies from making tax-free distributions of profits to shareholders or their associates. Payments, loans and debts forgiven to shareholders or their associates on or after 4 December 1997 will be deemed to be dividends to the extent the private company has a distributable surplus, unless they are specifically excluded. If deemed to be a dividend, the amount will be assessable to the shareholder or their associate.

The definition of 'associate' is important. For example, for an individual, it includes a relative. But relative is a defined term and certain people may be excluded (e.g. cousins).

> **Required reading**
>
> Section 109B ITAA 1936.

Application

Payments and use of company assets

Section 109C ITAA 1936 treats **payments** to shareholders (and associates) as deemed dividends to the extent the private company has a distributable surplus. Payments include any amount given, excluding a loan. For example:

- Payment of the private expenses of a shareholder such as a family holiday or private health insurance (subject to the application of the FBT rules for shareholders that are also employees).
- Transfers of property for less than the amount that would have been paid in an arm's-length dealing. TR 2014/5 states that transfers of property by a company under a family law settlement will trigger Division 7A if distributed to an associate. The fact that a spouse is a former spouse is not relevant because of their past association.

Section 109CA(1) ITAA 1936 treats the **use of company assets** (e.g. cars, holiday homes, boats etc.) by shareholders (and associates) as deemed dividends to the extent the company has a distributable surplus. For example, if a shareholder uses a company holiday house each weekend, the value of the benefit would be a deemed dividend. In working out the value of the benefit, the whole week's rental value (not just the weekend) would be used if the holiday house has the shareholder's possessions in it and it is not available for rent to third parties during the non-use periods. There are a limited number of exceptions to these provisions, a common one being where the use of the asset is considered minor and infrequent (the same rules apply as the minor benefit exemption in FBT). There are also exceptions for the provision of certain kinds of dwellings.

Exclusions

Payments **not** treated as dividends include:

- Payments of genuine debts of the private company (s. 109J) – for example, where a shareholder sells an asset to the company for an arm's length amount.
- Payments to other companies (s. 109K) – for example, where a company pays an expense on behalf of a shareholder that is a company.
- Payments that are otherwise assessable to the shareholder (s. 109L).
- Certain liquidator's distributions in respect of the private company (s. 109NA).

Loans

Under s. 109D ITAA 1936, loans that are not fully repaid by the earlier of lodgement and the due date for the lodgement of the company's income tax return for the income year in which the **loan was made** are treated as dividends to the extent the private company has a distributable surplus.

Under s. 109E ITAA 1936, in **subsequent years** if the minimum yearly repayment on an amalgamated loan is not made, the shortfall is treated as a dividend to the extent the private company has a distributable surplus.

Exclusions

Loans **not** treated as dividends include:

- Loans to other companies (s. 109K) – for example, where a company makes a loan to a shareholder that is a company.
- Loans that are otherwise assessable to the shareholder (s. 109L).
- Loans made by the private company in the ordinary course of business on commercial terms (s. 109M) – for example, where a company that operates a banking business makes a loan to a shareholder under the same terms and conditions as the loans it makes to the public.
- Loans that meet the criteria for minimum interest rate and maximum term in the year they are made (s. 109N).
- Certain liquidator's distributions in respect of the private company (s. 109NA).
- Loans to purchase qualifying shares or rights under an employee share scheme (s. 109NB).
- Amalgamated loans in the year they are made (s. 109P).
- Where undue hardship is caused (s. 109Q).

Refer below for detailed analysis of the application of Division 7A to loans.

Debts forgiven

Section 109F ITAA 1936 deals with debts forgiven on or after 4 December 1997, regardless of the date that the debt was incurred. Under s. 109F(6), a debt is taken to be forgiven for the purposes of Division 7A if a reasonable person would conclude that the private company would not insist on the entity paying the amount, or rely on the entity's obligation to repay that amount.

Section 109F describes what types of forgiven debts are treated as dividends. For example, a debt forgiveness to a shareholder that is a superannuation fund or individual (i.e. a company to superfund or individual debt forgiveness) is specifically included under s. 109F, and therefore gives rise to a deemed dividend.

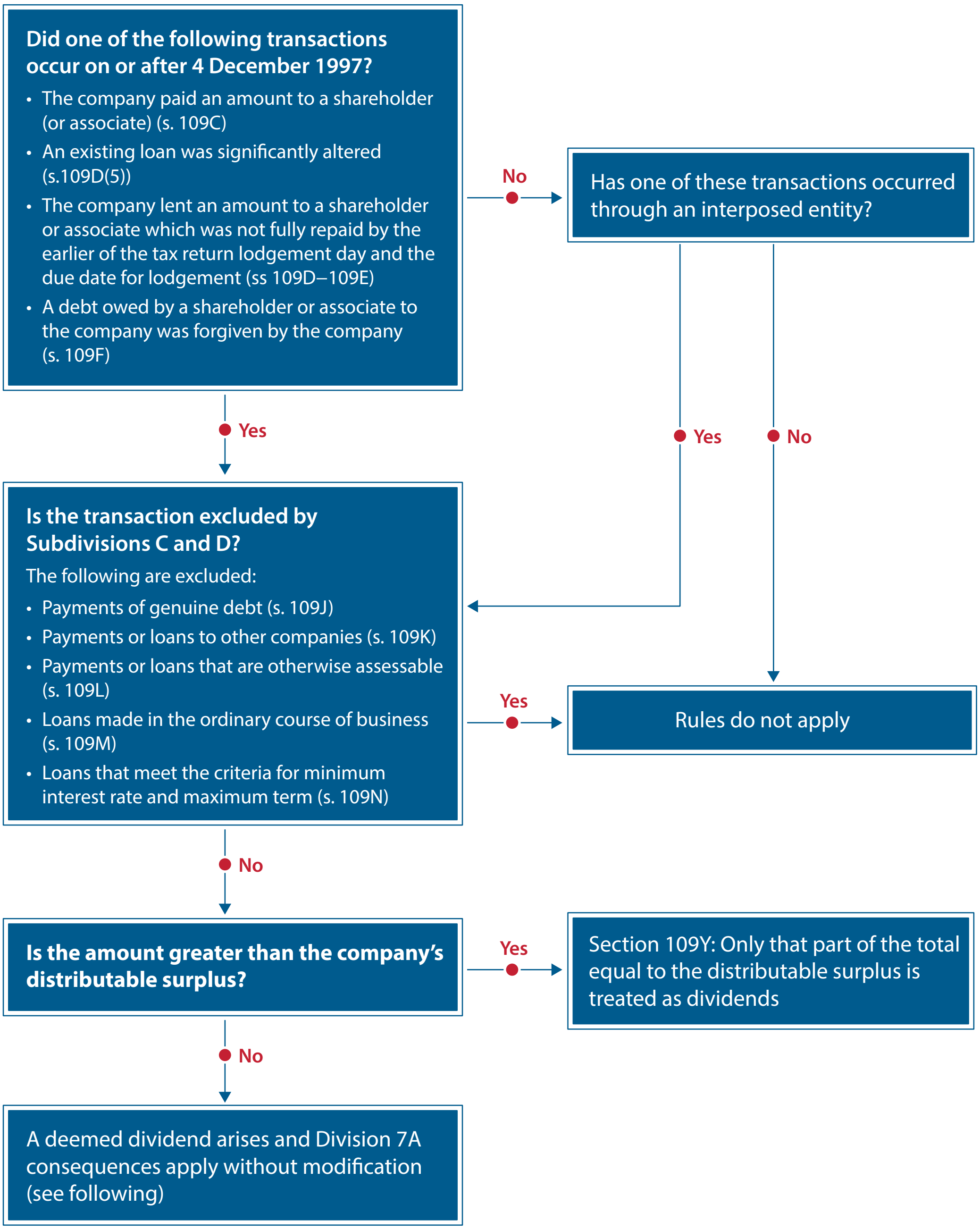
Section 109G ITAA 1936 describes what types of debt forgiveness are **not** caught by these rules. For example, a debt forgiveness to a shareholder that is a company (i.e. a company-to-company debt forgiveness) is specifically excluded under s. 109G, and therefore does **not** give rise to a deemed dividend.

Commissioner's discretion

The Commissioner has the discretion to disregard the application of Division 7A, or allow a Division 7A dividend to be franked where a taxpayer has triggered the operation of the provisions through an honest mistake or inadvertent omission (s. 109RB ITAA 1936).

Summary

The following flow chart helps to determine whether Division 7A applies.



Note:

The Government has released a consultation paper on proposed amendments to the Division 7A rules, including amendments to:

- Allow a self-correction mechanism without penalty for inadvertently triggering Division 7A.
- Introduce new safe harbour rules, such as for the use of assets, to provide certainty and simplify compliance.
- Amend the maximum loan term to 10 years for all loans and to better align the calculation of the minimum interest rate with commercial transactions.
- Clarify the unpaid present entitlement rules and improve integrity.

The proposed amendments are outside the scope of the TAXAU module.

Consequences

Deemed dividends

Where Division 7A applies, amounts taken to be dividends are:

- **Not deductible** to the company under s. 8-1.
- **Included in the assessable income** of the shareholder or their associate as an **unfranked dividend** under s. 44(1) ITAA 1936. However, dividends arising due to a family law obligation may be franked (s. 109RC ITAA 1936) and the Commissioner can allow a dividend to be franked in special circumstances (s. 109RB ITAA 1936). Refer to para. (g) of the definition of 'unfrankable distribution' in s. 202-45 ITAA 1997.
- **Not subject to withholding tax** if deemed to be paid to a non-resident (s. 109ZA ITAA 1936). The exclusion from withholding tax means the deemed dividend is subject to ordinary income tax (i.e. the exception to withholding tax in s. 128D ITAA 1936 does not apply).

Subsequent dividends

To prevent double taxation, if a subsequent dividend is actually distributed (i.e. a dividend is declared by a private company under the Corporations Act) and some or all of that dividend is offset against the deemed dividend under Division 7A, the amount offset is (to the extent that it is unfranked) not taken to be a dividend (s. 109ZC ITAA 1936).

For example, in Year 1, a shareholder borrows $100,000 from a private company and the loan is deemed to be a dividend under Division 7A in that income year. In Year 1, the shareholder includes the deemed dividend in their assessable income under s. 44(1) ITAA 1936. In Year 2, the private company declares an unfranked dividend of $100,000 and reduces the loan owed by the shareholder. In Year 2, the shareholder does not include any amount in their assessable income under s. 44(1) ITAA 1936.

Interaction with FBT

Loans and debts forgiven

Division 7A applies to a loan or debt forgiven even if it is made or owed by a shareholder in their capacity as an employee or in respect of their employment (s. 109ZB(1) and (2) ITAA 1936).

The FBT rules do not apply to a loan or debt forgiven (which are otherwise in respect of employment) which are deemed to be a dividend under Division 7A or meet the excluded loan criteria of s. 109N ITAA 1936 (see the definition of 'fringe benefit' in s. 136(1) FBTAA 1986).

Payments

Division 7A does not apply to a payment made to a shareholder in their **capacity as an employee** (s. 109ZB(3) ITAA 1936). These payments would be subject to the FBT rules.

A director will be an employee of a company if they receive salary or wages, directors' fees or other non-cash benefits provided as remuneration for services. Non-cash benefits provided in connection with the performance of their duties as an employee (e.g. a restaurant meal with clients of the company) will be subject to the FBT rules. However, for benefits not expressly linked to the carrying out of the employee's duties, all facts and circumstances should be examined to determine whether it was provided as remuneration for services or in the capacity of a shareholder (MT 2019). An investment company does not have employees. Thus Division 7A will apply and FBT cannot apply to payments even where the shareholder does work for the company (MT2016).

For the purposes of the TAXAU module, assume all non-cash benefits provided to a shareholder/employee are remuneration for services and therefore subject to the FBT rules unless otherwise stated.

Distributable surplus

The amount that is deemed to be a dividend cannot exceed the company's 'distributable surplus' (s. 109Y ITAA 1936).

Calculation method

A company's distributable surplus is calculated under s. 109Y(2) ITAA 1936. It is broadly equal to its **net assets reduced by its share capital**, and adjusted for certain excluded amounts.

The exclusions (which are outside the scope of the TAXAU module) relate to:

- Anti-avoidance measures, which are designed to prevent the company manipulating its profits by paying shareholder expenses, transferring property or forgiving debts.
- Tainted share capital accounts, which are deemed not be a share capital account under s. 975-300.
- Amounts under the former private company distribution rules.

Assets and liabilities included in the calculation of net assets are brought to account at their **book value**. Book value is the amount shown in the company's accounting records, unless the Commissioner considers that the company's accounting records significantly undervalue or overvalue its assets or provisions (see the final paragraph of the definition of 'net assets' in s. 109Y(2)).

The following are key points to note:

- The Commissioner is not empowered to alter the value of a present legal obligation (e.g. a loan), even if it is likely to be released.
- In TD 2009/5, the Commissioner states that the ATO will not generally take into account internally generated goodwill in the distributable surplus calculation if it is not required to be disclosed for Accounting Standards purposes. Only if there are intentions to circumvent the operation of Division 7A will the Commissioner impute a value for internally generated goodwill.
- In *FCT v. H* , the Full Federal Court held that the accrued year-end tax liability and the accrued general interest charge were present legal obligations even though the tax return had not yet been lodged and the assessment was not yet issued. The ATO has now accepted the position that the obligation to pay income tax is a present legal obligation of the company at the end of that year of income and that these values can be taken into account in the distributable surplus calculation (TD 2012/10).

Relevance of accounting policies

An interesting outcome of the definitions in s. 109Y(2) related to the distributable surplus calculation is that ITAA 1936 is tied back to the company's accounting records. However, it is silent on whether those accounting records must be prepared in accordance with the Accounting Standards.

In deciding whether there is a deemed dividend, policies on asset recognition and valuation will have a material influence on the outcome. Therefore, the Commissioner can substitute a different value if the assets or provisions are significantly understated or overstated (e.g. see TD 2009/5 above).

Required reading

Section 109Y ITAA 1936.

Loans in the year made (s. 109D ITAA 1936)

Application

For the income year in which a loan was made:

- If the loan is **fully repaid** by the earlier of the **relevant time** (i.e. the actual lodgement or the due date for the lodgement of the company's income tax return), Division 7A does not apply (s. 109D ITAA 1936).
- If the loan is **partly repaid** by then, the unpaid year-end balance, subject to there being available a distributable surplus (see above), is treated as the amount of the deemed dividend unless one of the exceptions noted below is satisfied (e.g. the minimum interest rate and maximum term conditions in s. 109N ITAA 1936 are satisfied).
- If a loan is **repaid after the relevant date** (even if by one day), the full amount of the loan will be deemed a dividend.
- If a loan satisfies the **conditions in s. 109N ITAA 1997**, no amount is deemed to be a dividend in the year it was made. However, in subsequent years, a deemed dividend may arise to the extent a minimum payment is not made (s. 109E ITAA 1936 – see below).

There is also an integrity measure that prevents arrangements involving:

- Private company loans being repaid with borrowings from a third party so that the balance at the relevant time is reduced to $nil, and
- Immediately after the relevant time, borrowing back from the private company and using the funds to repay the third-party loan.

If the Commissioner is satisfied that these arrangements are in place, the repayment made before the relevant time will not be taken into account (s. 109R(2) ITAA 1936).

However, repayments of private company loans would be effective where they are achieved by way of:

- Payment of additional salary to shareholders (subject to s. 109 ITAA 1936).
- Payment of dividends.
- Transfer by the shareholder (or their associates) of assets to the company in satisfaction of the loan (although this may give rise to a CGT issue for the company or stamp duty for the transferee).

If the loan was **made before 4 December 1997**, Division 7A does not apply. If the terms of a pre-4 December 1997 loan are varied on or after 4 December 1997 by either extending the term of the loan or increasing the amount, Division 7A applies to the loan as if it were made on new terms when the variation occurred (s. 109D(5) ITAA 1936).

The ATO is also of the view that where a private company has a present entitlement to an amount from a trust which is not paid to the company, it may be considered to be a loan or financial accommodation from the private company to an associate of the company's shareholders (i.e. the trust) in certain circumstances (refer TR 2010/3). Division 7A will apply to deem a dividend to have been paid in these circumstances. PSLA 2010/4 provides guidance on TR 2010/3 and options on how an unpaid present entitlement can continue to be used by a trust without raising the potential operation of Division 7A.

If a loan is deemed to be a dividend in the year it is made, it cannot be deemed to be a dividend in a subsequent year, even if there is no distributable surplus in the year the loan was made (and thus, the actual amount deemed to be a dividend was $nil).

Exception under s. 109N

Section 109N allows an exception to Division 7A for loans that meet minimum interest rate and maximum term criteria. For loans to fall under s. 109N, they must satisfy the following criteria before the earlier of the lodgement date and the due date for lodgement of the company's income tax return:

- The loan agreement must be in writing. TD 2008/8 outlines the requirements for a loan agreement to be valid. The loan agreement can be a formal agreement or an exchange of letters, emails etc. provided that they show the name of the parties, the loan terms, that the parties have agreed the terms, the date of the agreement etc.
- The rate of interest payable on the loan for the years of income after the year in which the loan was made must equal or exceed the yearly benchmark interest rate published annually by the ATO.
- The term of the loan must not exceed the maximum term of the loan, being 25 years where there is a registered mortgage over real property of not more than 91% of the value of the property. Otherwise, the term is seven years. Section 109N(3A) allows a seven-year loan to be rolled into (i.e. extended into) a 25-year loan.

The benchmark interest rate for the income year ended 30 June 2019 is 5.20% under TD 2018/14.

Amalgamated loans

Loans that have the same maximum term (for the purposes of s. 109N) and are not treated as dividends under s. 109D (in the year of making) are brought together to form a single amalgamated loan at the end of that income year under s. 109E ITAA 1936. A single loan may also constitute an amalgamated loan if one loan only was made by the company to a shareholder (or associate) in an income year.

Under s. 109P ITAA 1936, amalgamated loans made by a private company to a shareholder (or associate) are not taken to be a dividend under Division 7A in the year in which amalgamation occurs.

Required reading

Section 109D and 109N ITAA 1936.

Loans in subsequent years (s. 109E ITAA 1936)

Application

Loans (i.e. amalgamated loans that are not deemed to be dividends in the year they are made) must satisfy the minimum interest rate and maximum term criteria in subsequent income years. In other words, shareholders actually need to make minimum yearly repayments in subsequent years (i.e. not in the year the loan was made).

If the minimum yearly repayment is not made (i.e. there is a shortfall and the loan is not fully repaid) then the **shortfall is treated as a dividend** in that income year to the extent that the company has a distributable surplus.

When determining the minimum yearly repayment:

- ATO ID 2010/82 states that where a repayment is made after year end but before the company's income tax return lodgement date, the repayment is taken into account in working out if the shareholder has made the minimum yearly repayment under s. 109E.
- ATO ID 2013/36 states that if there is a shortfall in the minimum yearly repayment in Year 1 which gives rise to a deemed dividend at the end of Year 1, the capital component of the shortfall does not reduce the closing balance of the loan for the purpose of working out the minimum yearly repayment in Year 2.

Exception (s. 109Q ITAA 1936)

The deemed dividend rules do not apply if a shareholder or an associate pays less than the minimum yearly repayment on an amalgamated loan and can satisfy the Commissioner that the amount paid was less because of circumstances beyond the shareholder's or associate's control and that undue hardship would be suffered if the private company was taken under s. 109E to pay a dividend (refer s. 109Q).

Minimum yearly repayment

Section 109E(6) ITAA 1936 sets out the formula for determining minimum yearly repayments.

$$\text{Amount of the loan not repaid by the end of the previous year of income} \times \text{Current year's benchmark interest rate} \div 1-\left(\frac{1}{1+\text{current year's benchmark interest rate}}\right)^{\text{remaining term}}$$

Where:

- The benchmark interest rate for the income year ended 30 June 2019 is 5.20% under TD 2018/14.
- The remaining term (rounded up to a whole year) is the difference between:
  - the number of years in the longest term of any of the loans that the amalgamated loan takes account of, and
  - the number of years between the end of the private company's year of income in which the loan was made and the end of the private company's year of income before the year of income for which the minimum yearly repayment is being worked out.

Worked example 8.4: Private company loan – minimum yearly repayment
[Available online in myLearning]

Required reading
Section 109E ITAA 1936.

Payments and loans through interposed entities

Anti-avoidance rules apply to arrangements, such as back-to-back loans, where a private company pays or lends an amount to an interposed entity and that entity (or another interposed entity) pays or lends an amount to a shareholder or an associate of the private company or shareholder. These rules are contained in ss 109T and 109U ITAA 1936. The effect of these provisions is to treat the private company (and not the interposed entity) as having paid or lent the amount to the shareholder. This may in turn cause the private company to be deemed to have paid a dividend to the shareholder under Division 7A ITAA 1936, under the rules discussed earlier. For further ATO guidance on the application of s. 109T see TD 2018/13.

For loans that are deemed to arise under the interposed entity rules, s. 109X ITAA 1936 does not preclude the effective operation of s. 109K ITAA 1936. That is, s. 109K still applies, but this provision cannot be used to exclude the operation of Division 7A ITAA 1936 just because the interposed entity is a company.

Another variation is if:

- A private company is a beneficiary of a trust.
- There is an existing unpaid trust distribution to the private company.
- The trustee pays or lends an amount to, or forgives a debt owed by, a shareholder (or associate of the shareholder) of the corporate beneficiary.

In these circumstances, Subdivision EA ITAA 1936 applies (s. 109XA ITAA 1936).

The broad scheme of the provisions is to treat the trust as a private company for the purposes of determining whether a deemed dividend arises in circumstances where the trustee has made a payment or loan, or forgiven a debt, of the kind covered by ss 109XA(1), (2) or (3) ITAA 1936.

This is achieved through the hypothesis contained in s. 109XB ITAA 1936. That section provides that an amount is included (as a dividend) in the assessable income of the shareholder or associate if that amount, referred to as the 'Division 7A amount', would have been so included had:

- the actual transaction (i.e. payment, loan or forgiven debt provided by the trustee) been made by a private company, and
- the shareholder or associate been a shareholder of that company at the time of the actual transaction.

The effect of the hypothetical approach is to allow loans provided by a trustee to a shareholder to be repaid or put on a commercial footing (i.e. have minimum repayments made and written loan agreements put in place), and therefore avoid the operation of the deemed dividend rules.

Note that following the release of TR 2010/3 (see above), the operation of s. 109XB ITAA 1936 is likely to be fairly limited.

Activity 8.2: Private company loan
[Available online in myLearning]

Company losses and bad debts

Overview

There are additional rules that apply when a company incurs a loss or a bad debt under s. 25-35 (see Unit 1). This is largely because a company is a separate taxpayer from its owners and, therefore, the rules are designed to prevent trading (or 'trafficking') in losses or bad debts.

The additional rules that affect the ability of companies to claim tax losses, capital losses and bad debts include:

- Carry forward loss provisions.
- Current year loss provisions.
- Bad debt provisions.
- Unrealised loss provisions
- Loss anti-avoidance arrangements.

Carry forward loss provisions

Under Subdivision 165-A, a company cannot deduct (i.e. utilise) a **carry forward tax loss** in its calculation of taxable income unless it satisfies one of the following:

- The continuity of ownership test (COT) (i.e. the company has the same owners and the same control throughout the period from the start of the loss year to the end of the income year).
- The business continuity test (BCT) (i.e. same business test or similar business test).

Under Subdivision 165-CA, a company cannot deduct (i.e. utilise) a **carry forward net capital loss** if Subdivision 165-A would prevent it if it were a tax loss. The general calculation rules for net capital gains and losses are covered in Unit 4.

See below for further discussion on the operation of Subdivision 165-A.

Current year loss provisions

Subdivision 165-B deals with the calculation of **taxable income and tax losses in a year** when the company has had a change of ownership (or control) in that year, unless it satisfies the business continuity test (i.e. same business test or similar business test).

Subdivision 165-CB deals with the calculation of a **net capital gain or net capital loss in a year** when the company has had a change of ownership (or control) in that year, unless it satisfies the business continuity test (i.e. same business test or similar business test). This subdivision broadly operates in a similar manner to Subdivision 165-B for current year tax losses.

See below for further discussion on the operation of Subdivision 165-B.

Bad debt provisions

Under Subdivision 165-C, a company cannot deduct a bad debt under s. 25-35, unless:

- For debt incurred in an earlier income year, the company had the same owners and the same control throughout the period from the day on which the debt was incurred to the end of the income year in which it writes off the debt as bad.
- For debt incurred in the current year, the company had the same owners and the same control during the income year both before and after the debt was incurred.

Alternatively, if there has been a change in ownership or control, the company must satisfy the business continuity test (i.e. same business test or similar business test) to deduct a bad debt.

Unrealised loss provisions

Subdivision 165-CC contains rules relating to the treatment of unrealised losses in companies. See below for further discussion on the operation of Subdivision 165-CC.

Loss anti-avoidance arrangements

Division 175 provides that, even if a company passes the continuity of ownership and control type tests, losses may still be denied if:

- Income is injected into the company.
- A tax benefit is obtained from available losses or deductions.
- A deduction is injected into the company.
- A tax benefit is obtained because of available income.

See below for further discussion on the operation of these anti-avoidance measures.

Carry forward tax losses

As noted above, under Subdivision 165-A a company cannot deduct (i.e. utilise) a carry forward prior year tax loss against a future year's income unless (s. 165-10) it satisfies one of the following tests:

- The 'continuity of ownership test' in s. 165-12. However, this test may be modified by the rules in:
  - Subdivision 166-A for widely held and eligible Division 166 companies.
  - Subdivision 167-A for companies whose shares do not all carry the same rights to dividends or do not all carry the same rights to capital distributions.
  - Subdivision 167-B for companies whose shares do not all carry the same voting rights, or do not carry all the voting rights in the company.
- The 'business continuity test' in s. 165-13, which comprises the 'same business test' for all losses and the 'similar business test' for losses incurred on or after 1 July 2015.

The tests are applied in this order. The business continuity test (i.e. same business test or similar business test) is only looked at if the continuity of ownership test is failed (i.e. the business continuity test is a 'saving' provision).

Where one of the applicable tests is satisfied, the company can choose whether to claim a tax deduction for the carry forward tax loss in the income year (s. 36-17).

Required reading

Section 36-17.

Continuity of ownership test (COT)

The first test a company must pass in order to carry forward prior year losses is referred to as the 'continuity of ownership test' (COT) (s. 165-12). The COT requires that:

- there is no substantial change in proportionate shareholding within a group of continuing owners
- majority ownership by individuals is maintained throughout the ownership test period time (i.e. the period from the start of the loss year to the end of the income year).

The COT will only be satisfied where, during the whole of the ownership test period, the same **persons** beneficially owned the same shares that, when taken together, carried:

- More than 50% of the **voting power** in the company.
- The rights to more than 50% of the company's **dividends**.
- The rights to more than 50% of any **capital distributions** made by the company.

To pass the COT, the company must demonstrate that the same shareholders who owned **more than** 50% of the voting power, dividend and capital rights in the company at the **start of the loss year** (i.e. the start of the income year in which the loss was incurred) continue to own more than 50% in the company **at all times until the end of the income year** in which the brought forward loss is to be used.

Note: On the death of a shareholder, provided that shares are transferred to someone who receives them as a beneficiary of a deceased estate, the COT would continue to be satisfied (s. 165-250). There is no such concession on a marriage breakdown.

Example – Continuity of ownership test

Charming Pty Ltd (Charming):

- Incurred tax losses of $10,000 and $20,000 in the 2017 and 2018 income years respectively.
- Has $100,000 of taxable income for the 2019 income year.
- Is owned by Jon (34%), Sonika (17%) and Bryn (49%).

To determine whether Charming can deduct the 2017 and 2018 tax losses against the 2019 taxable income, two terms need to be understood:

- 'Loss year' – the income year in which the relevant loss was incurred.
- 'Income year' – the income year in which the loss was purported to be used.

2017 losses

If Charming wishes to use the $10,000 loss from the 2017 year in 2019, it will satisfy the COT if the same shareholders who owned more than 50% of the company at the beginning of the loss year continue to own more than 50% of the company at all times until the end of the income year. This means that Jon, Sonika and Bryn must own more than 50% of the company from 1 July 2016 (the beginning of the loss year) until 30 June 2019 (the end of the income year).

Assume for the moment that Bryn sold all of his shares to Sonika on 30 June 2017. Charming would still satisfy the COT. This is because Jon and Sonika together still own more than 50% of the company.

On the other hand, if it were Jon and Sonika rather than Bryn who sold all of their shares on 30 June 2017, the COT would not be satisfied in relation to the 2017 losses.

2018 losses

The $20,000 loss from the 2018 year must be tested separately from the 2017 losses. Assume that Jon and Sonika sold all of their shares to Lisa on 30 June 2017. Based on this information, we know that Charming will fail the COT in relation to the 2017 losses (as discussed above).

However, the company will satisfy the COT in relation to the 2018 losses. This is because Lisa and Bryn together own more than 50% of the company from 1 July 2017 (beginning of the loss year) until 30 June 2019 (the end of the income year).

Tracing rules

Under Subdivision 165-D, where one company owns shares in another loss, company, ss 165-150, 165-155 and 165-160 provide for tracing of interests back to **persons** who have indirect interests in the company. In other words, when applying the COT, it is always necessary to trace the shareholding back to **natural person shareholders** unless the legislation specifically provides otherwise.

However, it is not possible to trace through a discretionary trust, as the beneficiaries of the trust do not have fixed interests in the income or capital of the loss company or interposed entity. To overcome this problem, there are two special tracing rules:

- **Family trust concession rule**

  This rule applies where relevant interests in a company are held, directly or indirectly, by a family trust. In this situation, the trustee of the family trust will be treated as an individual holding the interests for its own benefit (s. 165-207). Therefore, there is no need to trace through the family trust to identify the individual beneficiaries.

- **Alternative condition rule**

  This rule applies more generally in testing for continuity of majority beneficial ownership of a company. Under Subdivision 165-F, if the company is held by non-fixed trusts such that it cannot pass the COT, the company can still deduct its losses or debts if:

  - Broadly, there has been no change in the person's holding (directly or indirectly) of fixed entitlements to shares of the income or capital of the company, or in the percentage of their shares.
  - Every non-fixed trust (other than a family trust or other excepted trust) that holds fixed entitlements in the company (directly or indirectly) satisfies the relevant tests that apply to non-fixed trusts (the 50% stake test, the control test and the pattern of distributions test).

Percentage of rights

Under Subdivisions 167-A and 167-B, there are special rules that apply for working out a shareholder's percentage of ownership where the shares in a company do not carry all the same rights to voting power, dividends and capital distributions. Without these special rules, a company that has shares with unequal rights to dividends, capital distributions or voting may technically fail the COT even though there is no significant change in underlying beneficial ownership during the ownership test period.

Under these special rules, where the COT is not satisfied because a company has unequal rights to dividends or capital distributions, the company may choose to reconsider the COT in up to three ways, by disregarding:

- debt interests
- debt interests and certain secondary share classes, or
- debt interests and certain secondary share classes, and treat the remaining shares as having certain relative rights (fixed percentage) to receive dividends and capital distributions.

Also under these special rules, if the shares of a company have different voting rights, or do not carry all of the voting rights in the company, a choice can be made to test voting power solely by reference to the maximum number of votes that could be cast on a poll on:

- the election of the company's directors, or
- an amendment to the company's constitution (subject to some restrictions).

A detailed understanding of these special rules is outside the scope of the TAXAU module.

Required reading

Sections 165-10 and 165-12.

Business continuity test (BCT)

Where the COT is not satisfied, the company must rely on the BCT under s. 165-13. This test can be passed by satisfying either the:

- Same business test (i.e. the core test under s. 165-210 applicable to all losses), or
- Similar business test (i.e. the alternative test under s. 165-211 applicable to losses incurred on or after 1 July 2015, subject to specific integrity rules).

The BCT must be applied in the year of loss recoupment and tested against the business carried on immediately before the COT was failed. This test is only considered if the COT is not satisfied (i.e. it is a 'saving provision').

Same business test

Under s. 165-210(1), a company satisfies the same business test if it carries on the same business **throughout a year of recoupment** as it carried on **immediately before** the change in ownership.

The same business test is generally a '**look forward test**'. That is, compare the business in the year of recoupment (say Year 3) to the business immediately before the change of ownership (say Year 1).

However, when the year of recoupment occurs in the same year as the change in ownership, the test is a 'look back' test because it is necessary to have regard to the business from the start of the recoupment year (refer s. 165-13(2)). For example, if a change in ownership occurs on 1 October 2018 and carry forward losses are recouped in the year ended 30 June 2019, it would be necessary to compare the business at 30 September 2018 to the business from 1 July 2018 to 30 June 2019.

ITAA 1997 contains measures to provide a **default test time** at which the same business test can be applied if a company cannot determine precisely when it has failed the COT. In the case of tax losses, the test time is the **latest time** that the company can show it has satisfied the COT. However, if it is not practicable for the company to show that it has maintained the same owners for any period since incurring the loss, the default test time is the start of the loss year, or, if the company came into being during the loss year, it is the end of the loss year.

A company does not satisfy the same business test if it derives assessable income from:

- A business of a kind that it did not carry on before the change in ownership or control.
- A transaction of a kind that it had not entered into in the course of its business operations before the ownership or control change.

Section 165-210(3) provides an anti-avoidance measure so that the same business test will not be satisfied if a company:

- started to carry on a business it had not previously carried on, or
- in the course of its business operations, entered into a transaction of a kind that it had not previously entered into, and
- did so before the change in ownership or control, for the purpose of otherwise satisfying the same business test.

TR 1999/9 sets out the Commissioner's views on the operation of the same business test. In short, organic growth or evolution is permissible, but not sudden or dramatic changes.

In *Lilyvale Hotel Pty Ltd v. FCT*, the court stated that a mere change in the way a business is operated or managed does **not** amount to a different business. Therefore, provided that the output and external characteristics of a business remain the same, changes in the internal processes do not cause the same business test to be failed.

The ATO applies a '*de minimis*' (i.e. small value) test when applying the same business test (refer TR 1999/9). In other words, minor transactions can be ignored.

If a company is not carrying on a business (e.g. if it is a passive investor), it cannot, by definition, pass the same business test because it is not actually carrying on a business in the first place.

Example – Same business test

Donkey Pty Ltd (Donkey) incurred losses of $10,000 and $20,000 in the 2017 and 2018 income years respectively. Its shareholders on 1 July 2016 are:

- Fiona – 40%.
- Shrek – 60%.

Shrek sold all of his shares to Prince Charming on 22 July 2017. Donkey has $100,000 of taxable income for the 2019 income year. Donkey's business remains unchanged since 2013.

COT

Because Shrek sold all of his shares to Prince Charming, Donkey will fail the COT in relation to the 2017 and 2018 losses (i.e. the same beneficial owners did not own the same shares for the period from the start of the loss year to the end of the income year).

Same business test

- To be able to utilise the 2017 and 2018 losses in the 2019 income year, the same business test must be satisfied. To do this, Donkey must show: That it carried on the same business during the whole of the income year (from 1 July 2018 to 30 June 2019).
- That the same business was also carried on immediately prior to it failing the COT (i.e. just before 22 July 2017).

As Donkey's business throughout the income year is the same as it was just before 22 July 2017, the company satisfies the same business test (and the company does not need to consider the similar business test).

Donkey can claim a tax deduction in 2019 for the 2017 and 2018 tax losses, reducing its taxable income to $70,000.

Similar business test

Under the similar business test, companies may be able to deduct tax losses, net capital losses and bad debts where their business, while not the same, uses similar assets and generates income from similar sources. The test operates in a way that is comparable to the same business test but removes the negative limbs which can deny a deduction merely because transactions or activities are new or a different kind to those entered into or carried on before a change in ownership or control.

Under s. 165-211(1), a company satisfies the similar business test if throughout the business continuity test period (i.e. the income year) it carries on a business (i.e. its current business) that is **similar** to the business it carried on immediately before the ownership change (i.e. its former business).

In determining whether the current business is similar to the former business, any relevant factor can be taken into account. But in accordance with s. 165-211(2), regard must be had to the following factors:

- The extent to which the income-generating assets used in the current business were also used in the former business.
- The extent to which activities and operations from which the current business generates assessable income were also activities and operations of the former business.
- The identity of the current business and the former business.
- The extent to which any changes to the former business result from development or commercialisation of assets, products, processes, sources or marketing or organisational methods of the former business.

Whether the similar business test is passed is a question of fact, involving a weighing up of all relevant factors. These factors are intended to allow for changes resulting from attempts to grow or rehabilitate a business.

Consistent with the same business test, s. 165-211(3) provides an anti-avoidance measure so that the similar business test will not be satisfied if a company:

- started to carry on a business it had not previously carried on, or
- in the course of its business operations, entered into a transaction of a kind that it had not previously entered into, and
- did so before the change in ownership or control, for the purpose of otherwise satisfying the similar business test.

LCR 2019/1 sets outs the Commissioner's views on carrying on a similar business. The following are two key points to note:

- It is not sufficient for the current business to be of a similar 'kind' or 'type' to the former business. For example, it is not enough to say that the former business was in the hospitality industry and the current business is in the hospitality industry.
- It will be more difficult to satisfy the similar business test if substantial new business activities and transactions do not evolve from, and complement, the business carried on before the test time.

Required reading

Sections 165-13, 165-210 and 165-211 ITAA 1997.

Control test

Even if a company passes the continuity of ownership test (COT) or the business continuity test (i.e. same business test or similar business test), a deduction will not be allowed if the control test in s. 165-15 applies and is not satisfied.

The control test is an integrity measure that only operates when control of the voting power of a company has been manipulated for the purpose of obtaining a benefit under the rules.

Where the control test applies, it is only passed if the voting power in a company is maintained by the same persons throughout the ownership test period.

If the control test is not passed, a company cannot claim a tax loss unless it satisfies a modified business continuity test. Under the modified business continuity test, the company must carry on the same business (or a similar business where applicable) throughout the income year as it did immediately before the time when the person began, or became able to control the relevant voting power (s. 165-15(3)). This is potentially a different testing time to the normal business continuity test.

For example, if 60% of the voting interests (but not ownership interests) in a company are disposed of on 1 July 2017 for the purpose of obtaining a benefit under the carry forward loss rules (i.e. of not failing COT), the company will fail the control test. To utilise tax losses from prior income years in the year ended 30 June 2019, the company must carry on the same business or similar business where applicable throughout the income year as it did on 30 June 2017 (i.e. immediately before the voting power was manipulated).

Required reading

Section 165-15.

Modified COT – widely held company or an eligible Division 166 company

Division 166 modifies the way in which the rules in Division 165, regarding ownership and control of a company, apply to certain companies. However, these companies may choose not to have Division 166 apply (see s. 166-15).

Division 166 is only available to a company if, in the year in which it wishes to use the carried forward losses, it is:

- a widely held company or an eligible Division 166 company for that whole income year, or
- a widely held company for part of that income year and an eligible Division 166 company for the rest of that income year.

See ss 166-5(1), 166-20(1), 166-40(1), 166-80(1) and 166-220.

Defining a widely held company

A company is a widely held company if it is listed on an approved stock exchange. A company is also widely held if it has more than 50 members, unless:

- At any time in the income year, 20 or fewer people hold or have the right to acquire or become the holder of shares representing 75% or more of the value of shares in the company, other than shares entitled to a fixed rate of dividend only.
- At any time during the income year, 20 or fewer people are capable of exercising 75% or more of the voting power in the company.
- In that year, 20 or fewer people receive 75% or more of any dividend paid by the company, or the company did not pay a dividend in that year, but the Commissioner is of the opinion that, if a dividend had been paid by the company at any time during the income year, 20 or fewer people would have received 75% or more of that dividend.

Defining an eligible Division 166 company

A company is an eligible Division 166 company if more than 50% of the voting power, rights to dividends or rights to capital distributions are held by one or more:

- Widely held companies.
- Superannuation funds.
- Approved deposit funds.
- Special companies.
- Managed investment schemes.
- Entities that are prescribed under the tracing rule that deems entities to be beneficial owners.
- Non-profit companies.
- Charitable institutions, charitable funds or any other kind of charitable bodies.

Applying the concessions applicable to these companies

Widely held and eligible Division 166 companies face less stringent tests under Division 166 than other companies under Division 165. The main concessions that are available include the following:

- Maintenance of the same owners between certain points of time is required, rather than proof of maintenance of the same owners throughout the periods in between. In the case of past year losses, the relevant points of time are:
  - The start of the loss year.
  - The end of each corporate change.
  - The end of the loss year, the end of the claim year and the end of any intervening income years (refer Subdivision 166-A). Recall that the normal rules require that the same shareholders own more than 50% of the company at all times, starting from the beginning of the loss year until the end of the income year. The effect of Division 166 applying is to make it less onerous to demonstrate that the COT is satisfied.

  In the case of current year losses, the company is taken to have satisfied the COT if there were no corporate changes during the income year. If there was a corporate change, the widely held company must show that it had 'substantial same ownership' between the start of the income year and the time immediately after the corporate change occurs (see Subdivision 166-B).

- Direct shareholdings of less than 10% in the company are treated as if they were held by a single notional entity, so that it is unnecessary to trace through to the persons who beneficially own those shareholdings (refer to Subdivision 166-E). There are also concessions available in relation to indirect shareholdings of less than 10%. Without this concession under Division 166, it would ordinarily be necessary to trace through all entities until the ultimate beneficial owner that is a natural person is found. So if all of listed company's shares are held by shareholders who each hold less than 10%, it will be deemed to have a single 100% shareholder.

  Note: The Government has proposed to amend the legislation so that the interposition of a holding company between the tested company and a less than 10% direct stakeholder does not cause a failure of the continuity of ownership test. The proposed amendment is outside the scope of the TAXAU module.
- Direct and indirect shareholdings of between 10% and 50% in the company held by a widely held company are treated as having been held by that widely held company, so that it is not necessary to trace beyond those companies.
- There is also no need to trace through complying superannuation funds (or superannuation funds that are established in a foreign country and regulated under a foreign law), complying approved deposit funds, special companies or managed investment schemes (see Subdivision 166-E).

As the COT is applied each time there is a corporate change, it is critical to define 'corporate change'. The factors used to determine whether corporate change has occurred are listed in s. 166-175.

Activity 8.3: Company losses
[Available online in myLearning]

Current year losses

The current year loss rules in Subdivision 165-B are designed to stop losses incurred by a company in one part of an income year from being offset against income earned by the company during another part of the income year (i.e. the losses are quarantined), unless the shareholders who benefit from the recoupment of the losses are substantially the same as those who bore the burden of those losses.

The current year loss rules are applied if one of the following events is triggered:

- The company does not pass the COT and the business continuity test for the whole income year (s. 165-35).
- A person begins to control, or becomes able to control, the voting power in the company where one purpose of obtaining that control is to get a tax benefit or advantage for any person (s. 165-40).

Basically, where a company makes a loss during one part of the current income year and is profitable for the other part of the current income year, the income year is artificially broken up into two periods: the loss-making period and the profitable period. These periods are notionally treated as two separate income years. Losses from one part can only be offset against income from the profitable period if the COT (or failing that, the BCT) is satisfied, as per the discussion on prior year losses earlier.

Partitioning the income year

If one of those trigger events occurs, the income year is then divided into separate periods (s. 165-45).

The first period starts at the beginning of the income year and ends at the time of the first relevant change of ownership or control.

The next period begins at the end of the first period and continues until the earlier of the end of the income year or the time of any further change of ownership or control. If there is more than one change in ownership or control, successive periods are calculated until the end of the year of income.

If there is more than one change of ownership or control during the year, successive periods can be merged if the company satisfies the business continuity test in relation to them (s. 165-40).

Notional loss or notional taxable income for each period

A notional loss exists for a period if the deductions attributed to the period exceed the assessable income attributed to the period. Conversely, a notional taxable income for a period exists if the assessable income attributed to the period exceeds the deductions attributed to the period.

Section 165-55 explains how deductions are attributed to a particular period. Certain deductions, such as depreciation, are attributed to periods on a time basis. Others, such as bad debts, are 'full year' deductions and are not attributed to any periods. Full year deductions are taken into account in the final calculation of the company's taxable income. All other deductions are attributed to periods as if each period were an income year.

Section 165-60 explains how income is attributed to a period. Broadly, items of assessable income are attributed to periods as if each period were an income year. There are, however, some special rules:

- A company's share of any trust income is attributed to a period if it is 'reasonably attributable' to that period (s. 165-60(2)).
- Certain types of insurance recoveries and recoupments are attributed to periods on a time basis (s. 165-60(3)).
- Deemed dividends are attributed to the period when the amount was paid or credited, whichever occurred first (s. 165-60(5)).

Taxable income and tax loss for the year

To calculate a company's taxable income for the year (s. 165-65):

- Add up the notional taxable incomes for each income period.
- Add any full year income amounts.
- Subtract any full year deductions in the order specified in s. 165-65(4) (notional losses are not taken into account).

To calculate the tax loss for the year (s. 165-70):

- Add up the notional losses for each loss period.
- Add any full year deductions that have not been fully utilised in calculating the taxable income.
- Subtract any net exempt income.

Unrealised losses

Subdivision 165-CC contains rules relating to the treatment of unrealised losses in companies. A company that has failed the COT and the control test may be prevented from claiming losses on assets owned at the time of failure (unrealised losses). If this occurs, the unrealised losses will only be available if the same business test is satisfied.

For example, if a company with an unrealised loss is acquired by a new shareholder and the asset is then sold and the loss is realised, Subdivision 165-CC will deny the loss unless the company satisfies the business continuity test.

Loss anti-avoidance arrangements

Broadly, Division 175 provides that even if the same ownership rules have been satisfied, a claim for tax losses may be disallowed because the benefit of those losses may flow, wholly or in part, to persons who were not shareholders of the company during the year the relevant tax losses were incurred. These rules are outlined broadly in the following table.

Anti-avoidance provisions for losses		
Section	**Description**	**When it applies**
175-10	Income or capital gain injected into a company because of available tax losses	Applies when a company with a tax loss: • derives assessable income because the loss is available, and • continuing shareholders do not appropriately benefit from that income
175-15	Obtaining a tax benefit by a third party because of available tax loss	Applies to a company with a tax loss where: • a person obtains a tax benefit under a scheme because the loss is available, and • the person did not have an appropriate shareholding interest
175-20	Income or capital gain injected because of allowable deductions	Applies when a company with deductions: • derives assessable income because the deductions are available, and • continuing shareholders do not appropriately benefit from that income
175-25	Deduction injected because of available income or capital gain	Applies when a company with assessable income: • incurs deductions, and • continuing shareholders do not appropriately receive the benefit of the deductions
175-30	Obtaining a tax benefit by a third party because of available deduction, income or capital gain	Applies to a company with a loss where: • a person derives a tax benefit under a scheme entered into because the company derived assessable income or incurred a loss or deduction, and • the person did not have an appropriate shareholding interest

In all cases, the Commissioner's discretion must be exercised for the section to apply.

Other key resources

Quick reference guides
8.1: Franking account provisions
8.2: Impact of the imputation system on shareholders
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 9: Partnerships

Contents

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Learning outcomes

At the end of this unit you will be able to:

1. Explain what is a partnership and the general tax principles for partnerships.
2. Explain and calculate the net income or loss of a partnership.
3. Explain and calculate a partner's taxable income.
4. Analyse and calculate the taxation consequences relating to changes in partnership interests.
5. Analyse and apply the partnership CGT rollover relief provisions.

Introduction

In Australia, a partnership structure is commonly used by individuals to operate a small business or a professional practice. However, any entity can be a partner in a partnership (e.g. a company or trust can be a partner).

A partnership can also exist where assets are held jointly. A common example in Australia is where a husband and wife jointly hold a rental property.

Unlike a company or a trust, when determining the taxation consequences of a partnership, you must first identify the level at which each transaction or event is recorded; that is, at the **partnership level** or the **partner level**.

The taxation advantages of a partnership are that partnership net income is split between partners. Furthermore, partnership losses are allocated to partners and can be offset against the partner's other assessable income or carried forward by the partner (if the partner's share of the partnership loss exceeds the partner's other assessable income).

This unit looks at the calculation and allocation of the net income of a partnership and the taxation consequences of changes in the composition of partnerships.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

Partnership tax principles

Defining a partnership

Tax law partnership

For taxation purposes, a 'partnership' is widely defined in s. 995-1(1) ITAA 1997 to mean:

- an association of persons (other than a company or a limited partnership) carrying on business as partners (referred to as a common law partnership)
- an association of persons in receipt of ordinary income or statutory income jointly (referred to as a tax law partnership), or
- a limited partnership.

The taxation definition extends the meaning given by state and partnership law. In the latter system, a partnership is 'the relationship between parties carrying on a business in common with a view to profit'.

The major difference for tax law purposes is that a common law partnership carries on a business, while a tax law partnership may include two people in receipt of income jointly.

Example – Tax law partnership

A tax partnership can exist where:

- Two people own a joint bank account that earns interest.
- Ownership of a rental property is held in joint names. Both parties would be 'in receipt of income jointly' as they both derive rental income.

Whether a partnership is 'carrying on a business' impacts on:

- The types of transactions that may be deductible or assessable and the treatment of assessable income.

Example – Tax law partnership versus common law partnership

Compare a rental property partnership that does not carry on a business and a partnership that carries on a business of renting properties.

In the first case, rents are likely to be assessable on a receipts basis, whereas a due and receivable basis would be more correct in the second case. Outgoings in the first case will be restricted to the first limb of s. 8-1 ITAA 1997, while a wider range of deductions may be available in the second case, as the taxpayer can rely on both limbs of s. 8-1.

Likewise, on sale of a property, the partners who are simply in receipt of income jointly are likely to have to consider the capital gains tax (CGT) implications only, whereas landlords who carry on a business of renting properties would have to consider the application of ss 6-5 and 8-1 ITAA 1997 on any disposal of property.

In addition, blackhole costs would not be deductible to tax law partnerships, but they would be deductible if the landlords were carrying on a business (i.e. a common law partnership).

- The character of the income/loss in the hands of the partner (as flowing from the co-ownership of an asset or from business operations) and consequently the ability of the partners to determine the allocation of the net profit or loss of the partnership. Specifically, where no business is being carried on, profits and losses are shared based on ownership percentages, whereas if a business is being carried on, they are shared based on the partnership agreement.

Example – Allocation of income: *FCT v. McDonald* and TR 93/32

Paragraph 4 of TR 93/32 states:

> Where co-ownership is a partnership for income tax purposes only, the income/loss from the rental property is derived from co-ownership of the property and not from the distribution of partnership profits/losses.

In *FCT v. McDonald*, Mr and Mrs McDonald owned two strata units in joint names. It was agreed between the McDonalds and committed to paper as a record of discussion, that 25% of net profits would be distributed to Mr McDonald and 75% to Mrs McDonald. Further, any net loss would be borne by Mr McDonald.

Unfortunately for the McDonalds, Beaumont J held that because the McDonalds were not partners at common law, deductions and income had to be split equally between Mr and Mrs McDonald in proportion to their ownership interest. If, indeed, the McDonalds were deriving profit from carrying on a business, their income would not flow from co-ownership of a rental property but from business operations. In such a case, their agreement may not have been struck down if it represented a commercial result for risk undertaken and resources committed to the 'business' by each party. The principle in *FCT v. McDonald* was confirmed in *Cripps v. FCT*.

Common law partnership

Whether or not a common law partnership exists is a question of fact. What this means is that all the relevant facts and circumstances of an arrangement must be taken into account and, on balance, a conclusion reached as to the existence or otherwise of a partnership. An essential element in determining the existence of a partnership is the intention of the parties to act as partners. This intention must also be demonstrated by the behaviour and conduct of the parties.

In respect of a common law partnership, the following are relevant factors to consider in determining the existence of a partnership:

- Contractual arrangements – whether or not there is:
  - A formal written partnership agreement. A written (or oral) agreement is, prima facie, evidence of an intention to create a partnership, but it is not conclusive.
  - Sharing of profits and losses.
  - Ownership of assets.
- Partner contributions – whether or not partners have contributed:
  - Capital.
  - Services and labour.
  - Other contributions.
- Operations – whether or not:
  - A partnership bank account exists.
  - Partners participate in the control and management of the business.
  - Business records exist and a trade name of partnership is used.
  - Public recognition of a partnership exists, registrations are in joint or partnership names, and trading is in joint names.
  - Partners have the authority to act on behalf of the partnership.

While none of the above factors are individually determinative, a conclusion on whether a partnership exists may be drawn from an examination of these factors.

TR 94/8 outlines the factors that the Commissioner considers to be relevant in determining whether a partnership exists.

Required reading

Section 995-1(1) ITAA 1997 – definition of 'partnership'.

TR 94/8.

Joint ventures

In some circumstances, participants in a venture will not want to be partners for tax law purposes. A joint venture is an arrangement where one party might contribute capital and another might contribute plant and equipment to, for example, a mining operation (i.e. there is a 'pooling' or bailment arrangement). Each party in this case would continue to own and/or be responsible for the assets contributed. The party contributing plant and equipment may not wish to be in partnership with the other party for commercial reasons (e.g. the joint and several liability of partners) and/or for tax reasons (e.g. the joint venture may wish to retain its depreciation deduction and a transfer of plant and equipment to a partnership may give rise to either capital gains or assessable balancing charges).

A joint venture is an arrangement between at least two parties formed for a particular transaction or transactions, the product (as opposed to the profit) of which will be shared by the parties as mutually agreed. Each party to the joint venture may individually determine how the product is to be disposed of.

If the parties to the joint venture are seen to be carrying on a business as partners, or are in receipt of income (rather than product) jointly, such an arrangement will be a partnership for tax law purposes. This will be despite any contrary intention in the joint venture agreement (i.e. it is necessary to look at the substance rather than the form).

Limited partnerships

Most Australian states allow limited partnerships. From a commercial perspective, limited partnerships offer partners limited liability to the extent of the capital contributed.

From 19 August 1992, Division 5A of Part III (ss 94A–94X) ITAA 1936 has treated limited partnerships (referred to as 'corporate limited partnerships') formed after that date as companies for the purposes of the ITAA 1936.

The key provisions of Division 5A are:

- Distributions (s. 94L ITAA 1936): A dividend is to include a distribution from a limited partnership. However, a distribution out of profits when the limited partnership was not treated as a company will not be regarded as a dividend.
- Non-private company status (s. 94N ITAA 1936): Corporate limited partnerships are generally treated as public companies. That is, the provisions of the law that apply only to private companies do not apply to limited partnerships. The exception is s. 109BB ITAA 1936 and the deemed dividend provisions, which applies to corporate limited partnerships in certain circumstances.
- Share and shareholder (ss 94Q and 94P ITAA 1936): The definitions of 'share' and 'shareholder' include an interest in, and a partner of, a corporate limited partnership respectively.
- Changes in composition of a corporate limited partnership (s. 94S ITAA 1936): For income tax law purposes, a change in the composition of partners in a corporate limited partnership does not create or extinguish the corporate limited partnership.
- Residency (s. 94T ITAA 1936): The determination of the residency of a corporate limited partnership is different from that of a company. A corporate limited partnership is a resident if, and only if, the partnership was formed in Australia or, if not formed in Australia, it carries on business in Australia or its central management and control is located in Australia. See also s. 94U ITAA 1936, which states that a partnership is taken to have been incorporated in the place it was formed under a law in force in that place.
- Company loss rules (s. 94X ITAA 1936): The company loss provisions apply to corporate limited partnerships with certain modifications.

The Australian Taxation Office (ATO) has released a tax determination suggesting that partnerships have to be carrying on business in order to be limited partnerships (see TD 2008/15). This means that tax law partnerships (i.e. where partnerships are in receipt of income jointly) cannot be limited partnerships for tax purposes.

Key features and tax attributes

A broad overview of the key features and tax attributes for both partnerships and partners are set out below.

Tax issue	How the issue relates to partnerships and partners	Refer to
Features and tax attributes		
Taxpayer and tax rate	A partnership is not a separate taxable entity and is not assessed on its income. A partnership does, however, have to lodge a partnership tax return that shows the 'net income' or 'net loss' (i.e. the net income of the partnership or the partnership loss) calculated **as if** the partnership were a taxpayer (s. 91 ITAA 1936) The partners are assessable on their share of the net income of the partnership or are generally entitled to claim a deduction for their share of the net loss of the partnership (s. 92 ITAA 1936). A partner may be an individual, trust, company or another partnership A tax rate is not relevant at the partnership level Partners pay tax at the partner's applicable rate of tax (for example, a partner that is a company pays tax at a flat rate, and a partner that is a resident individual pays tax at resident marginal tax rates)	Unit 1 and later in this unit
Residency	Residence is not relevant at the partnership level, as it is the status of each partner that is relevant. However, a partnership's net income or net loss is calculated as if the partnership is a resident A resident partner is taxable in Australia on their share of the partnership's worldwide net income. However, to minimise the double taxation of foreign income, resident partners may be entitled to exemptions or foreign income tax offsets A non-resident partner is only taxable in Australia on their share of the partnership's Australian sourced net income The normal rules for determining the residency status of an individual or a company continue to apply	Unit 1
Calculations	Certain transactions or events are excluded from partnership calculations for taxation purposes and are, instead, determined at the partner level. For example, capital gains/losses are calculated at the partner level, not at the partnership level (s. 106-5 ITAA 1997) Thus, when determining the taxation consequences for a partnership, you must first identify the level at which each transaction or event is recorded for tax purposes	See later in this unit
Goods and services tax (GST)	A partnership that carries on an enterprise can be registered for GST. Under s. 184-5 GST Act, a supply made by a partner, in their capacity as a partner, is taken to be made by the partnership	Unit 2
Fringe benefits tax (FBT)	A partnership that is an employer can provide a fringe benefits to an employee (or their associate) and may be subject to FBT A partner cannot be an employee of a partnership	Unit 3
Small business entity (SBE)	A partnership that carries on a business may be classified as an SBE and choose to apply the available SBE concessions The SBE CGT concessions apply to a partner in a partnership and not to the partnership itself	Unit 6
Personal services entity (PSE)	A partnership may be classified as a PSE and subject to the personal services income (PSI) rules where it is not a personal services business (PSB)	Unit 7
Net capital gains/(losses)	Net capital gains/(losses) are not applicable at the partnership level. Partners own the interest in each partnership asset. Access to CGT concessions at the partner level depends on the partner's tax profile	Unit 4 and Unit 6

Tax issue	How the issue relates to partnerships and partners	Refer to
Features and tax attributes		
Losses	Losses are not applicable at partnership level as a partnership is able to distribute losses Losses may be claimed at the partner level, subject to the non-commercial loss rules for partners that are an individual taxpayer	Unit 1, Unit 7 and later in this unit
Franking tax offsets	Franking tax offsets are not applicable at the partnership level Franking tax offsets are determined at the partner level based on the partner's tax profile	Unit 8

Partnership net income or loss

Calculation method

A partnership does not pay income tax in its own right. However, it is required to complete an income tax return showing the 'net income' or 'net loss' of the partnership (referred to in s. 90 ITAA 1936 as net income or the partnership loss).

A partnership is treated as a resident for tax purposes and therefore includes income and expenditure from worldwide sources. The net income or loss of a partnership is essentially calculated like the taxable income of a taxpayer, but with modifications.

The following diagram shows the definitions of 'net income' or 'partnership loss' under s. 90 ITAA 1936:

Net income or loss	=	Assessable income	–	Allowable deductions (certain items are not deductible) Exceptions (items taken directly to partners' personal returns): • prior year losses (Division 36 ITAA 1997), and • personal superannuation (s. 290-150 ITAA 1997)

In practice, however, like the taxable income reconciliation for a company, the net income or loss of a partnership is calculated by making the necessary adjustments to accounting profit.

In addition to the exceptions identified above in the definition of net income or loss, **other adjustments** include the following:

- **Capital gains and losses**. It is the partners who make a capital gain or loss when a CGT event occurs in relation to the partnership (s. 106-5 ITAA 1997).

Example – Treatment of assets

The treatment of CGT assets compared to other assets of a partnership is as follows:

- An investment property is subject to CGT. The profit or loss on sale is accounted for at the **partner** level.
- A depreciating asset is excluded from CGT (s. 118-24). The assessable or deductible balancing adjustment on disposal under Division 40 ITAA 1997 is taken into account at the **partnership** level.
- The profit or loss on disposal of trading stock is taken into account at the **partnership** level because it is excluded from CGT under s. 118-25.

Note: For further analysis, refer to 'Acquisition and disposal of partnership assets and interests' later in this unit.

- **Salaries and drawings paid to partners**. These outgoings are not deductible to the partnership.
- **Interest payments on a partner's capital account** (as opposed to partner loan accounts). Payments in respect of capital accounts are not deductible to the partnership (for more information, see 'Partnership borrowings' below).

Salaries

As a partnership is not a separate legal entity, partners are not employees (*Ellis v. Joseph Ellis & Co*) and a partner cannot receive salary or wages (*Scott & Ors v. FCT*). TR 2005/7 confirms the ATO's view that a partner 'salary' is a distribution of partnership profit and not a true salary.

A partner salary is not a deduction under s. 8-1 ITAA 1997 at the partnership level. It is simply a distribution factor, where the allocation of net income or loss is based on each partner's share of the accounting income. This means that the salary should be taken into account in determining the way in which the net income is to be distributed amongst the partners – not the way in which the net income is to be calculated (which gives a very different outcome). This prevents some partners receiving net income and others receiving losses in the same income year.

From a practical perspective, partner salaries are an 'adjustment' in the reconciliation of accounting profit to net income or loss where they are expensed for accounting purposes.

Drawings

Drawings are simply a cash distribution to the partners that are ignored at the partnership level (i.e. they are not deductible to the partnership).

Example – Net income

Assume Paul and Chris are equal partners in the P & C Partnership and each contributed equal amounts of capital. Paul works in the P & C Partnership business, while Chris is a silent partner. They have agreed that Paul should be adequately remunerated for his efforts, which is considered to be $20,000 per annum.

The P & C Partnership carries on a business of buying and selling goods. Excess capital is invested in the share market; however, the P & C Partnership is not in the business of share trading. The accounting profit for the year ended 30 June 2019 is:

Accounting profit for the year ended 30 June 2019	
Item	**$**
Sales	100,000
Profit on disposal of shares (capital gain)	15,000
Cost of goods sold	(50,000)
Business expenses	(10,000)
Salary to Paul	(20,000)
Non-deductible entertainment	(5,000)
Total	30,000

The method for calculating the net income of a partnership starts with the accounting profit and then making the necessary tax adjustments. The adjustments for the year ended 30 June 2019 are determined as follows:

- As the P & C Partnership is a common law partnership and is carrying on a business, it is entitled to claim its deductions under both limbs of s. 8-1 ITAA 1997. However, the accounting profit includes non-deductible entertainment. Thus, an addback adjustment of $5,000 is needed.
- A capital gain or capital loss is ignored in a partnership under s. 106-5 ITAA 1997 – it is calculated at the partner level. The P & C Partnership's accounting profit includes a capital gain of $15,000 in respect of shares. Thus, a subtraction adjustment of $15,000 is needed.

- A partnership is not a separate legal entity; therefore, cash distributions to partners are simply an allocation of a partnership's accounting profit. The P & C Partnership's accounting profit includes a cash distribution in the form of a salary payment of $20,000 to Paul; thus, an addback adjustment of $20,000 is needed.

The net income or loss of the P & C Partnership under s. 90 ITAA 1936 for the year ended 30 June 2019 is calculated as follows:

Net income or loss of the P & C Partnership for the year ended 30 June 2019	
Item	**$**
Accounting profit	30,000
Add back: Non-deductible entertainment	5,000
Add back: Partner salary	20,000
Less: Profit on disposal of shares	(15,000)
Net partnership income	40,000

Partnership borrowings

Interest payments to partners

The treatment of interest payments by a partnership to the partners is summarised in the following table.

Treatment of interest payments		
Interest type	**Taxation treatment**	
	At partnership level	**At partner level**
Interest on partner's capital accounts or credit current accounts	Not deductible (s. 8-1 ITAA 1997)	Allocation of profits (s. 92 ITAA 1936)
Interest payable to a partner for a loan provided by the partner (as a lender) to the partnership (see *Leonard v. FCT*)	Deductible (s. 8-1 ITAA 1997)	Assessable as interest (s. 6-5 ITAA 1997)

Interest payments on refinanced amounts

Interest payable on borrowings by a partnership to fund working capital or to buy income-producing assets is deductible.

Under what is known as the 'refinancing principle', interest payable on borrowings used to fund a repayment of monies originally invested by the partners in the business is deductible. Note, however, that the interest will not be deductible to the extent that the payment to the partners does not replace capital primarily invested by the partner but is for an internally generated revaluation of assets not yet realised (e.g. land or goodwill).

Example – Refinancing principle: *FCT v. Roberts and Smith*

In *FCT v. Roberts and Smith*, the partnership claimed interest deductions in respect of $125,000 borrowed. The issue was whether interest was deductible on partnership borrowings used to pay out partners' capital contributions. The partners used their payouts for private purposes. The Commissioner originally disallowed the interest deductions on the basis that the borrowing replaced capital used for private purposes and thus the $125,000 borrowed was not used to produce assessable income.

The Full Federal Court held that the 'purpose' for which the money was borrowed (i.e. to fund the working capital and ongoing operations of the partnership) was of primary importance, rather than the 'use' to which the funds were put. In other words, if the partnership had initially borrowed the funds needed to run the practice from a bank – instead of having each partner contribute a large amount of capital – then the interest on such borrowings would have been deductible. In this case, the funds were subsequently borrowed from a bank simply to refinance earlier 'borrowings' (from the partners) and, in such a case, interest on these funds used to produce assessable income should also be deductible. This is known as the 'refinancing principle'.

The court said that a deduction for interest on such financing would be limited to the capital of the partnership. This would include capital contributed and profits not drawn on by the partners but left in the business. Hill J said a deduction would, however, not be allowed for borrowings to replace capital generated from a revaluation of assets, such as the recognition of internally generated goodwill.

The views of the ATO on the application of the decision in *FCT v. Roberts and Smith* are found in TR 95/25. The Commissioner accepts the decision in *FCT v. Roberts and Smith* in TR 95/25 and expands the application of that decision beyond common law partnerships to companies (see paras 12–17 of TR 95/25).

Note that the ATO is of the view that partners are not entitled to deductions under s. 8-1 ITAA 1997 for interest on borrowings to pay personal income tax (TD 2000/24).

Required reading

Sections 90 and 91 ITAA 1936.

TR 95/25.

Worked example 9.1: Partnership borrowings

[Available online in myLearning]

Partnership income tax returns

As noted in Unit 1, each year the Commissioner requires taxpayers, including partnerships, to lodge an income tax return which explains how the net income or loss of the partnership has been calculated and how it has been allocated to the partners (see below for details on allocation).

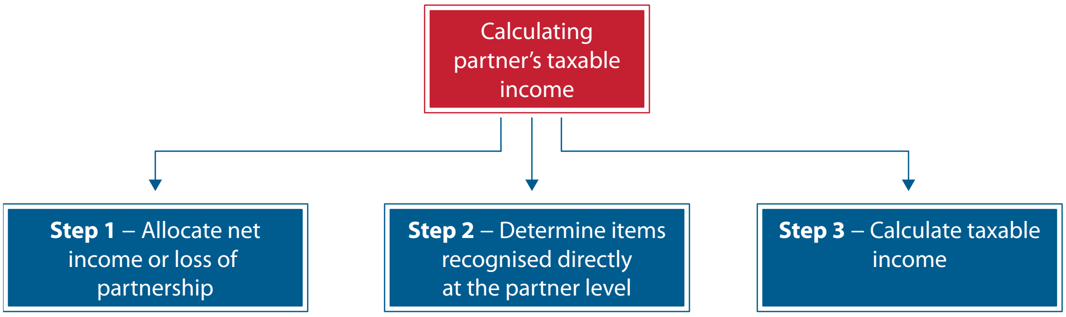
A partnership must lodge its income tax return in the approved format (e.g. partnership tax return 2019) within certain time frames. Where the partnership return is not lodged via a tax agent, the due date for lodgement of the return is by 31 October (e.g. the income tax return for the year ended 30 June 2019 is due by 31 October 2019). Where the partnership return is lodged via a tax agent, the due date for lodgement varies.

Each year the ATO release forms and instructions to assist taxpayers.

Partner taxable income

Calculation method

The following diagram outlines the steps in calculating a partner's taxable income.



Step 1 – Allocate net income or loss of partnership

The allocation of the net income or loss of a partnership (that is carrying on a business) is calculated in accordance with:

- The terms agreed to by the partners – for example, in a formal written or oral partnership agreement.
- The resident versus non-resident status of each partner (for more information, see 'Resident versus non-resident partners' below).

Each partner includes in their assessable income their respective 'individual interest' in the partnership net income or loss (s. 92 ITAA 1936).

The basis of allocating a partner's share of net income or loss will generally be stated in the partnership agreement. It may be based on the following:

- A partner's share of accounting income (the 'income method'). This is generally accepted as the most correct method because it prorates the tax adjustments over all partners.
- A partner's share of equity in the partnership (the 'equity method').
- Some other basis which the partners consider to be appropriate.

The appropriate method is generally determined by the partners (e.g. via the partnership agreement or by some other means (refer TD 2015/19)).

A 'partner salary' included in a partnership agreement is simply a priority entitlement to an allocation of the accounting income of a partnership; that is, before the general distribution of the remainder of the accounting income among the partners.

Each partner is also entitled to the same share of:

- Rebates or credits, including franking tax offsets and foreign income tax offsets.
- Exempt income.
- Non-assessable, non-exempt (NANE) income.

A partnership cannot distribute net income to some partners and losses to other partners in the same year (see TR 2005/7). The equity method of allocating the net income or loss of a partnership is more likely to give this result, which is one of the reasons why it is generally the inferior way of allocation (allocating net (i.e. taxable) income in proportion to the allocation of accounting income prevents this anomaly). For example, there is a fixed draw partner and an equity partner in a partnership. The profit of the partnership is $110 and the net (i.e. taxable) income is $80. The fixed draw partner is entitled to a draw of $100. If net income was allocated based on equity after fixed salaries, the fixed draw partner would include $100 in their assessable income while the equity partner would include a loss of $20. This is not permissible under TR 2005/7. On the other hand, if the net (i.e. taxable) income was allocated based on accounting income, the fixed draw partner would include 100/110 × 80 and the equity partner would include 10/110 × 80. This would prevent the simultaneous distribution of income and losses to different partners.

Example – Net income allocation: Resident partner

The net income of a partnership can be allocated to resident partners under s. 92 ITAA 1936 using the following two methods:

- Method A – Equity method – net partnership income is allocated to each partner equally, after entitlements to partner salaries.
- Method B – Income method – net partnership income is allocated to each partner based on their proportionate share of accounting profits and salary entitlements. Accounting profit is split equally between the partners.

Assume the same facts for the P & C Partnership in the earlier example regarding how to calculate the net income of a partnership for the income year ended 30 June 2019. As the P & C Partnership carries on a business and has arm's-length partners, the partners can agree on the method of allocating the net income or loss of the partnership. An allocation method based on profit would generally be accepted by the ATO. Therefore, both Method A and Method B, below, are acceptable approaches. However, a partner salary cannot create or increase a partnership net loss.

Method A – Equity method

The following is the approach to allocating the net income of the P & C Partnership under Method A:

- Allocate the salary amount to Paul in priority (but not exceeding the net income of the P & C Partnership).
- If the salary amount is less than net income, allocate the balance of net income on a 50:50 basis.
- If the salary amount is greater than net income, disregard the excess salary in the current income year and allocate it in priority against the net income of future years.

Applying this approach, the allocation of the net income of the P & C Partnership for the income year ended 30 June 2019 is as follows:

Calculation of net income allocation under Method A

Description	Paul $	Chris $	Total $
Salary	20,000	–	20,000
Balance[1]	10,000	10,000	20,000
Share of net income (s. 92)	30,000	10,000	40,000

Note

1. (Net income – Partner salaries) × Partner share = ($40,000 – $20,000) × 50% = $10,000.

Paul's share of net income under Method A is $30,000, while Chris' share is $10,000.

Method B – Income method

The following is the approach to allocating the net income of the P & C Partnership under Method B:

- Calculate each partner's proportionate share of accounting profits and salary entitlements as follows:

$$\frac{\text{Individual partner salary} + 50\% \text{ of the accounting profit}}{100\% \text{ of partner salaries} + 100\% \text{ of the accounting profit}} = \text{Proportionate share of accounting profits and salary entitlements}$$

- Calculate each partner's share of net income as follows:

$$\text{Proportionate share of accounting profits and salary entitlements} \times \text{Net income} = \text{Share of net income of the partnership}$$

Applying this approach, the allocation of the net income of the P & C Partnership for the income year ended 30 June 2019 is as follows:

Calculation of net income allocation under Method B

Description	Accounting profit and salary $	Proportionate share	Share of net income (s. 92) $
Paul			
Salary	20,000		
Share of accounting profit[1]	15,000		
	35,000	35 ÷ 50 × $40,000	28,000
Chris			
Salary	0		
Share of accounting profit[1]	15,000		
	15,000	15 ÷ 50 × $40,000	12,000
	50,000		40,000

Note

1. Accounting profit × Partner's share = $30,000 × 50% = $15,000.

Paul's share of net income under Method B is $28,000, and Chris' share is $12,000.

When a partner leaves a partnership and receives a termination payment, this payment would generally go into their assessable income under s. 92 ITAA 1936, rather than under the CGT provisions – see TD 2015/19. This is the case despite the label given to the payment and the timing of the payment (e.g. the payment could be received a year or two later under a commercial settlement to reflect the contention that the exiting partner was underpaid whilst they were a partner).

Resident versus non-resident partners

Partnership distributions are allocated on the basis of source and the residency rules applicable to each partner. Hence, a partner who is not a resident of Australia will have a different amount included in their assessable income than a partner who is a resident for the full year.

A partner who is a resident for the income year will return their share of the entire net income of the partnership (i.e. income from all sources) (s. 92(1)(a) ITAA 1936).

A partner who is a non-resident for the income year will return their share of so much of the net income as is attributable to Australian sources only (s. 92(1)(b) ITAA 1936).

A partner who is a non-resident for part of the financial year will return their share of total partnership net income, other than the amount that is sourced outside Australia and is attributable to the period of non-residency.

Example – Net income allocation: Non-resident partner

Assume Paul and Chris are partners in the P & C Partnership. For the income year ended 30 June 2019:

- The net income of the P& C Partnership from its share trading activities is $91,500. It was derived evenly throughout the year.
- Through a Hong Kong-based agent, 15% of the net income was derived from trading on the Hong Kong Stock Exchange. The remainder was from share trading in Australia undertaken by Paul.
- The P & C Partnership agreement provides that profits/losses are to be shared 60% to Paul and 40% to Chris. Paul was a resident in Australia for the full year, while Chris was a resident for half the year.

Under s. 92 ITAA 1936:

- Paul, who was a resident for the entire income year, will return his individual interest (commonly known as his share) of the entire net income of the partnership (i.e. income from all sources).
- Chris will return:
  - for the period of the income year that he was a resident, his share of the entire income of the partnership (i.e. income from all sources), and
  - for the period of the income year that he was a non-resident, his share of as much of the net income as is attributable to Australian sources only.

Paul's Australian taxable income

Paul's allocation of net income under the partnership agreement is as follows:

Paul's agreed share of partnership profits/losses	×	Net income of the partnership from share trading activities	=	Paul's allocation of net income
60%	×	$91,500	=	$54,900

As Paul is a resident of Australia for taxation purposes, the entire amount allocated is included in his Australian taxable income for the year ended 30 June 2019.

Chris's Australian taxable income

Chris's allocation of net income under the partnership agreement is as follows:

Chris's agreed share of partnership profits/losses	×	Net income of the partnership from share trading activities	=	Chris's allocation of net income
40%	×	$91,500	=	$36,600

As Chris is a non-resident of Australia for taxation purposes for part of the income year ended 30 June 2019, the amount included in his Australian taxable income is calculated as follows.

Resident portion:

Allocation of net income	×	Proportion of year taxpayer is a resident of Australia for taxation purposes	=	Income taxable in Australia
$36,600	×	6 ÷ 12	=	$18,300

Non-resident portion:

Allocation of net income	×	Portion of partnership income that is Australian sourced[1]	×	Portion of year taxpayer is a non-resident of Australia for taxation purposes	=	Income taxable in Australia
$36,600	×	0.85	×	6 ÷ 12	=	$15,555

Total for the year ended 30 June 2019:

Income derived while a resident	+	Income derived while a non-resident	=	Total income taxable in Australia
$18,300	+	$15,555	=	$33,855

Note

1. The source of profits from share trading is generally the place where the purchase and sale take place. Therefore, 15% of the net income is foreign-sourced income and the balance (i.e. 85%) is Australian-sourced income.

Step 2 – Determine amounts recognised at the partner level

Each partner would also reflect the following in their own personal tax calculations:

- Interest income/expense in respect of loans to the partnership (refer to the earlier details on deductible and assessable interest amounts).
- A partner's personal superannuation contributions (see s. 290-150 ITAA 1997).
- Capital gains or losses (see s. 106-5 ITAA 1997).
- Prior year losses carried forward (see Division 36 ITAA 1997).

Step 3 – Calculate each partner's taxable income

A partner's taxable income (in respect of partnership interests) is calculated as follows:

Taxable income (in respect of partnership interests)	=	Allocation of partnership net income or loss (including rebates or credits, if any)	+/−	Assessable and deductible amounts recognised at the partner level

A partner's taxable income would also include other assessable income and deductions unrelated to partnership interests (e.g. investment income).

In calculating the taxable income and tax payable of a partner, the normal taxation laws (as applicable to the type of taxpayer) must also be taken into account. For example, for partners who are individuals, this consideration may include:

- CGT discounts and other concessions.
- Imputation credit refunds.
- Non-commercial loss rules (see Division 35 ITAA 1997).

Required reading

Section 92 ITAA 1936.

Section 106-5 ITAA 1997.

Section 290-150 ITAA 1997.

Acquisition and disposal of assets and interests

Change in partnership composition

When a new partner is admitted to a partnership, the old partnership is dissolved and a new partnership is created, unless there is an express clause (or some other express agreement) in the partnership agreement that the original partnership is to continue. However, such clauses have no effect on trading stock and depreciating assets.

Changes to the composition or existence of a partnership may have taxation consequences:

- At the partnership level – for depreciation, trading stock and work in progress adjustments.
- At the partner level – for capital gains tax.

Partnership level adjustments

Depreciable assets

A balancing adjustment event arises in situations where there is a change in the interests of persons who own a depreciating asset under s. 40-295 ITAA 1997.

This could occur because of either:

- the formation or dissolution of a partnership, or
- a variation in the constitution of a partnership or in the interests of the partners.

Where such a change occurs, s. 40-300 ITAA 1997 treats the **partnership** as having disposed of its interest at market value (s. 40-300(2) item 5), unless a joint election by all partners (old and new) is made under s. 40-340(3) ITAA 1997.

If such an election is made, s. 40-340 ITAA 1997 allows the partnership to defer the tax consequences arising from a balancing adjustment.

Trading stock

Where there is a change in the ownership or interest in trading stock, in circumstances such as formation, variation or dissolution of a partnership, s. 70-100 ITAA 1997 applies, so that there is a notional disposal of trading stock by all of the old owners to the new owners. Such a disposal is treated as being disposed of at market value by the **partnership** (s. 70-100(2) ITAA 1997).

However, the old and new owners can elect that s. 70-90 ITAA 1997 does not apply and a deemed disposal may occur at the value at which the trading stock is recorded (e.g. at cost, and not at market value). Refer to ss 70-100(4), (5) and (6) ITAA 1997. This election can only be made where:

- The trading stock becomes an asset of a business carried on by the new owners.
- The former owners retain an interest in the trading stock of at least 25% of the stock's market value.
- The market value of the trading stock is more than the value of the stock as recorded in the books of the former owners just before the change in ownership.

Where the election is made, its effect is to allow the partnership to defer the income otherwise assessable in respect of the notional disposal.

Work-in-progress

The specific WIP provisions in ss 15-50 and 25-95 ITAA 1997 (see Unit 1) ensure that the sale of WIP does not result in the double taxation of income to the vendor and purchaser.

WIP is the value of services performed by a professional practice where circumstances do not yet allow demand for payment (i.e. unbilled services income). Professional practice income is generally assessable as ordinary income under s. 6-5 ITAA 1997 when it is derived (refer to Unit 1 for discussion of cash versus accruals basis of income recognition).

However, where there is a sale of WIP, a WIP amount that is received (by the old partnership on the sale of the WIP asset to the new partnership) is specifically included in assessable income (of the old partnership) in the income year in which it is received under s. 15-50 ITAA 1997.

Under s. 25-95 ITAA 1997, a deduction for the payment of a WIP amount is included in allowable deductions (of the new partnership) in the income year in which it was paid, to the extent that, as at the end of that income year:

- a recoverable debt has arisen in respect of the completion or partial completion of the work to which the amount related, or
- the taxpayer reasonably expects a recoverable debt to arise in respect of the completion or partial completion of that work within 12 months after the amount was paid.

The legislation does not provide a method for valuing WIP. This is a commercial decision between the parties.

To the extent that a recoverable debt for the completion or partial completion of the WIP to which the payment relates cannot reasonably be expected to arise within 12 months of the date of the payment, that amount will be deductible in the following income year (s. 25-95(2) ITAA 1997).

If none of the WIP amount is deductible in the income year in which the payment is made, the entire amount is deductible in the following income year. This is the case even if no recoverable debt is expected to arise in the future.

Example – WIP deduction relating to a change in partnership interests

A WIP deduction can arise under s. 25-95 ITAA 1997 in relation to a change in partnership interests. Assume the following for the income year ended 30 June 2019:

- The P & C Partnership is an accounting practice that was originally operated by two equal partners, Paul and Chris.
- On 21 July 2018, Paul and Chris accepted an offer from Deb and John to buy the accounting practice. As part of the agreement, Deb and John paid Paul and Chris $22,500 for the WIP of the practice.
- Deb and John now carry on the accounting practice as a partnership in which they are equal partners.
- On 30 June 2019, $12,000 of the WIP at 21 July 2018 had been billed. Of the remaining work related to the payment made to Paul and Chris, $6,000 could reasonably be expected to be completed and billed by 21 July 2019.

For s. 25-95 ITAA 1997 to apply, the definition of WIP under s. 25-95(3) must be satisfied. The key elements of the definition of WIP as it applies to professional partnerships are as follows:

- The payment must be made in respect of work and not goods. Goods would be trading stock of a partnership (not WIP).
- The work must be partially performed by the recipient (i.e. Paul and Chris).
- It is generally envisaged that the entity that pays an amount for WIP (i.e. Deb and John) will attempt to complete the work and bill the entity for which the work is being performed. It is recognised, however, that the work may not be completed, or billed for, in all cases.

Section 25-95 ITAA 1997 applies to Deb and John's situation as follows:

- A deduction will be available in the year the WIP amount is paid (year ended 30 June 2019), in accordance with s. 25-95(1) ITAA 1997, to the extent that, as at the end of that year:
  - a recoverable debt has arisen in respect of the completion or partial completion of the work to which the amount related, or
  - Deb and John reasonably expect a recoverable debt to arise in respect of the completion or partial completion of that work within the 12-month period after the amount was paid.
- A deduction will be available in the following income year (30 June 2020), in accordance with s. 25-95(2) ITAA 1997, for the remainder (if any) of the payment.

The calculation of the portion of the WIP payment by Deb and John that is deductible for the year ended 30 June 2019 is as follows:

Description	**$**
Amount billed by 30 June 2019	12,000
Amount expected to be billed within 12 months, by 21 July 2019	6,000
Total	18,000

The amount deductible to Deb and John for the following income year is the remaining $4,500.

Note: Where partners come and go into a partnership and no amounts are actually paid/received for WIP, there would generally be no implications for WIP. In other words, the WIP would simply 'roll' from the old partnership to the new partnership and would be derived for tax purposes when it is billed. Sections 15-50 and 25-95 ITAA 1997 would not apply in this circumstance because no amount is paid or received for the WIP.

Partner level adjustments

Capital gains tax (CGT) assets

For CGT purposes, the partnership is essentially ignored and a fractional interest approach is taken. Each partner has a fractional interest in each and every CGT asset of the partnership (ss 106-5 and 108-5(2)(c) ITAA 1997).

Each partner will need to calculate their individual capital gain/capital loss on the disposal of their interest in the partnership or the individual asset.

Capital gains are adjusted (i.e. reversed) out of the partnership's net income calculation and are included on a partner-by-partner basis.

Required reading

Section 108-5(2)(c) ITAA 1997.

Sections 15-50 and 25-95 ITAA 1997.

Worked example 9.2: Changes in partnership interests

[Available online in myLearning]

Activity 9.1: Partnership net income

[Available online in myLearning]

Change in partnership structure – CGT rollover

Subdivision 122-B provides CGT rollover relief to partners in a partnership:

- who roll over an asset (or assets) of the business to a **wholly owned company**, or
- where an asset is created by the partners in a wholly owned company.

The partners can transfer to a company either:

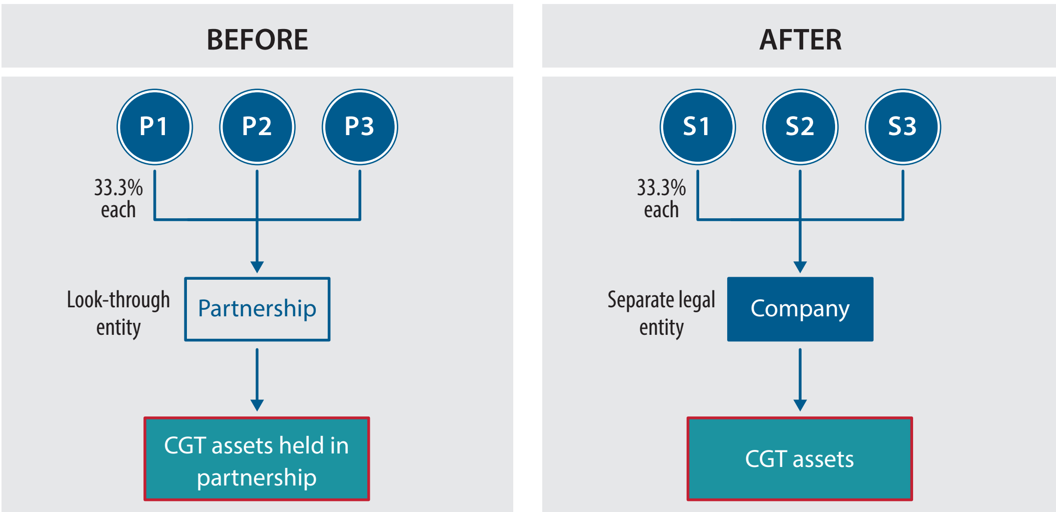
- a specific CGT asset, or
- all of the partnership's business assets.

It is the partners who own a fractional interest in each and every partnership asset – the partnership itself does not own the asset.

The rollover applies to both common law and tax law partnerships.

This means, for example, that the joint owners of a rental property are eligible to roll over assets even though they are not conducting a business and are not partners at general law (TR 93/32 and ATO ID 2004/874). They are partners of a 'tax law' partnership and the jointly owned property is a CGT asset of that partnership. However, if the property was not income-producing, they could not take advantage of this rollover concession because they would not be a tax law partnership.

The disposal or creation of assets by partners to a wholly owned company is illustrated by the following diagram.



It is also relevant to note that the **disposal of some assets may give rise to income gains for the partnership which cannot be rolled over.** For example, if an accounting firm rolls over work in progress to a company in exchange for shares in that company, the partnership would be assessable under s. 15-50 or s. 6-5 on the market value of the shares received (being equal to the market value of the work in progress transferred to the company). In this context, any CGT rollover relief is academic because the income tax provisions apply regardless to tax the gain on sale of the WIP.

Eligibility conditions

Sections 122-125 to 122-145 outline the conditions that must be met for rollover relief to be available where partners dispose of an asset to, or create an asset in, a wholly owned company. These conditions are summarised in the following table.

Conditions for Subdivision 122-B rollover relief	
Condition	**ITAA 1997 section reference**
Either CGT event A1, D1, D2, D3 or F1 has occurred as a result of the partners disposing of their interests in an asset or assets of, or creating an asset in, the company	122-125
All the partners in the partnership must choose to obtain rollover relief	122-125
The following requirements need to be satisfied for rollover relief to apply:	
• The company may issue only non-redeemable shares as consideration for the acquisition, although it may assume liabilities relating to the asset or business	122-130(1) and (2) 122-140 and 122-145
• The market value of the shares each partner receives must be substantially the same as the market value of the partner's interest in the transferred asset(s), and adjusted if the company assumes liabilities relating to the asset or business	122-130(3) and (4) 122-140 and 122-145
• The partners must own all the shares in the company just after the CGT event	122-135(1)
• Each partner must own the shares received 'in the same capacity' as they owned their previous interests (e.g. if the partner's interests were owned in the capacity of a trustee, they must receive the shares in the capacity of a trustee)	122-135(2)
• Rollover is not available for an asset that: – Is a collectable or personal use asset – Is a decoration awarded for valour or brave conduct (except if the decoration was purchased) – Is a 'precluded asset' (defined in s. 122-25(3) to include a depreciating asset and trading stock). Note that these assets can be transferred and qualify for rollover relief only if the entire business is transferred to the company – Becomes trading stock of the company on its disposal	122-135(3)
• The company cannot be exempt from income tax because it is an exempt entity	122-135(5)
• The asset transfer must be either: – from a resident partner to a resident company, or – of an asset that is 'taxable Australian property' (s. 855-15) – the shares in the resident company must also be taxable Australian property	122-135(6)

Consequences for the partners

The following table summarises the consequences for the partners of a Subdivision 122-B rollover.

Consequences for the partners of a Division 122-B rollover		
Conditions	**Consequence**	**ITAA 1997 section reference**
Where the partners choose a rollover to dispose of their interest in a CGT asset to a company	The capital gain or loss in relation to the CGT event is disregarded	122-150
Where a partner's interest in the asset transferred is:		
Pre-CGT	The shares are deemed to be pre-CGT	122-155(2)
Post-CGT	The shares are deemed to have been acquired for a consideration equal to the relevant cost base of the partner's interest in the transferred asset	122-155(1)
Both pre- and post-CGT	The shares will be deemed to be a mixture of both post-CGT and pre-CGT assets determined using an allocation formula	122-160

Consequences for the company

The following table summarises the consequences for the company of a Subdivision 122-B rollover.

Consequences for the company of a Subdivision 122-B rollover		
Where the partner's interests in the asset transferred are:	**Consequences**	**ITAA 1997 section reference**
Pre-CGT	The company is treated as having acquired a pre-CGT asset	122-200(3)
Post-CGT	The company inherits the sum of the cost bases of the partners' interests in the asset	122-200(2)
Partly pre-CGT and partly post-CGT	The company is deemed to acquire two separate assets (i.e. a pre-CGT and a post-CGT asset), with the cost base of the post-CGT asset determined by reference to the sum of the partners' cost bases of their interests in the relevant asset	122-200(4), (5)

Further reading

Division 122.

Worked example 9.3: CGT rollover from a partnership to a company

[Available online in myLearning]

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 10: Trusts

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Explain what is a trust and the general tax principles that apply to trusts.
2. Explain and calculate the net income or loss of a trust estate.
3. Explain how net income of a trust estate is taxed.
4. Explain the main CGT events that relate to trusts.
5. Explain the specific trust anti-avoidance provisions.

Introduction

In Australia, a trust is commonly used to hold investments and assets. However, a business can also be operated by a trust. The structure used affects how the income or loss of the entity is distributed and taxed.

This unit examines the general provisions in Division 6 ITAA 1936 relating to trusts, in particular how the net income or loss of a trust is calculated and how it is taxed. It also provides an overview of some of the more complex trust rules, including those that allow streaming of franked dividends and capital gains to particular beneficiaries, and various anti-avoidance provisions.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

Trust tax principles

Defining a trust

A trust is an equitable obligation binding a person (the trustee) to administer the property (trust property) under the terms of a trust deed for the benefit of the beneficiaries of the trust.

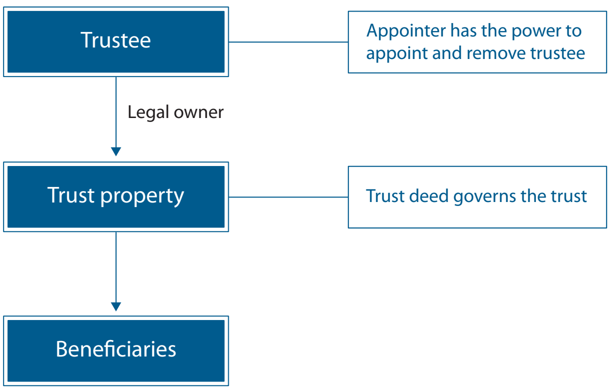
A trust has four essential elements, as follows:

- Trustee.
- Trust property.
- Beneficiary.
- Obligation in respect of the trust property.

A trust essentially comprises a relationship under which a trustee holds property on behalf of a beneficiary and is under an obligation to deal with the trust property under the terms of the trust deed.

A trust obligation may also arise as a result of statute (e.g. family maintenance provisions), as a consequence of a resulting trust, or because of an obligation under a 'constructive trust'. For example, in *Zobory v. FCT*, interest earned on funds misappropriated by the taxpayer from his employer was held not to be assessable income of the taxpayer. Burchett J concluded that the funds were held on constructive trust for the taxpayer's employer and the interest was not income derived by the taxpayer.

A trust can be represented diagrammatically, as follows:



Key terms

Following is a list of key terms commonly used in relation to trusts.

Fundamental terms	
Term	**Explanation**
Appointer	The person nominated in the trust deed as having the power to remove or appoint trustees
Beneficiary	The person who is entitled to, or who may become entitled to, a share of trust income or property
Guardian	The person nominated in the trust deed as having the power to veto the exercise by the trustee of certain powers

Fundamental terms	
Term	**Explanation**
Settlor or creator	The person who creates the trust. This person provides the initial trust property to create the trust. A trust does not exist without trust property
Trust deed	Broadly, the document that contains the rules governing the operations of the trust relationship and the duties and obligations of the trustee and that identifies the beneficiaries and sets out their rights
Trustee	The person or entity (often a company) who controls or administers the trust and trust property in accordance with the trust deed (see s. 6(1) ITAA 1936 for a more comprehensive definition). The trustee is the legal owner of the trust property, which comprises the initial settled sum together with any additions The trustee is: • Personally liable for the debts of the trust • Entitled to be indemnified out of the trust property in respect of liabilities incurred in the proper exercise of the trustee's powers (except where a breach of trust has occurred)
Vest	To vest a trust means to wind it up, or for the trust to cease. The vesting period refers to the life of the trust and is usually either a period no longer than 80 years, or the period ending 21 years from the death of someone living at the time of creation of the trust

Key features and tax attributes

A broad overview of the key features and tax attributes of a trust are set out below.

Tax issue	How the issue relates to trusts	Refer to
Features and tax attributes		
Taxpayer and tax rate	A trust is not a separate legal entity and, therefore, is **not** usually a taxpayer in its own right. The trustee is required to register with the ATO (i.e. obtain a tax file number (TFN) and, if carrying on business, an Australian business number) and lodge an income tax return for the trust showing its net income (i.e. taxable income) and how this amount is allocated (i.e. each beneficiary's share of that net income) Generally, the trust's net income (i.e. taxable income) is taxed in the hands of the beneficiaries (except for non-resident and minor beneficiaries). If the net income is not allocated to a beneficiary, the trustee is taxed The tax rate depends on whether the trustee or beneficiary is being taxed and under which section of the tax law they are being assessed	Unit 1 See later in this unit
Residency	The residency of a trust depends on the residence of the trustee **or** the central management and control of the trust (s. 95(2) and (3) ITAA 1936)	Unit 1
Trust income and losses	Trust income (i.e. accounting income as determined by the trust deed) may be distributed to the beneficiaries. If there is a trust loss then no amount is distributed to the beneficiaries **Note:** There is generally a difference between the amount a beneficiary receives in cash (i.e. the trust income to which they are presently entitled) and the amount a beneficiary must include in their assessable income as a trust distribution (i.e. their share of the trust net income). This difference can have CGT implications for the beneficiary	See later in this unit
Net income and losses	Net income (i.e. taxable income) is calculated as if the trustee is a taxpayer that is a resident (s. 95(1) ITAA 1936) Net trust losses are carried forward by the trust and cannot be allocated to beneficiaries. To utilise a carry forward net trust loss, a trust needs to satisfy additional rules	See later in this unit

Tax issue	How the issue relates to trusts	Refer to
Features and tax attributes		
Goods and services tax (GST)	A trust that carries on an enterprise can be registered for GST	Unit 2
Fringe benefits tax (FBT)	A trust that is an employer can provide a fringe benefits to an employee (or their associate) and may be subject to FBT	Unit 3
Small business entity (SBE)	A trust that carries on a business may be classified as an SBE and choose to apply the available SBE concessions	Unit 6
Personal services entity (PSE)	A trust may be classified as a PSE and subject to the personal services income (PSI) rules where it is not a personal services business (PSB)	Unit 7
Net capital gains/(losses)	A trust must follow the method statement in s. 102-5 to determine the net capital gain included in its net income or the net capital loss carried forward A trust can generally apply both the CGT general 50% discount and the SBE CGT concessions (where relevant) However, where a non-resident trust makes a capital gain: • Only capital gains on taxable Australian property are taken into account when working out the net capital gain or loss for the trust (TD 2017/23) • Amounts attributable to capital gains on non-taxable Australian property will be assessable upon distribution to an Australian resident beneficiary. However, the amounts will not be treated as capital gains of the Australian beneficiary and therefore cannot be reduced by the CGT general 50% discount or by capital losses (TD 2017/24) Special rules apply to allow a trust to allocate net capital gains to particular beneficiaries (i.e. the streaming rules for capital gains) A net capital gain allocated to a beneficiary retains its nature as a capital gain in the hands of the beneficiary. However, to determine a beneficiary's net capital gain the CGT concessions applied by the trust must be reversed. The beneficiary must then determine their entitlement to the CGT general 50% discount and the SBE CGT concessions (where relevant) based on their own tax profile	Unit 4 and Unit 6 See later in this unit
Franked dividends and franking tax offsets	A trust that receives a franked dividend from an Australian company must include the dividend and a franking credit gross-up in its net income Special rules apply to allow a trust to allocate franked dividends and the attaching franking credit to particular beneficiaries (i.e. the streaming rules for franked dividends) Access to a franking tax offset (or refund of any excess) depends on the tax profile of the beneficiary or trustee. A non-resident beneficiary is not entitled to a franking tax offset **Note:** Interest, dividends (unfranked portion), and royalties allocated to a non-resident beneficiary are subject to withholding tax and a deemed to be NANE income of the non-resident beneficiary	Unit 8 and later in this unit Unit 14
Foreign income	A trust includes gross foreign income (i.e. net income grossed-up for foreign taxes withheld) in its net income, unless an exemption applies There are no special rules that allow a trust to allocate foreign income and attaching foreign income tax offsets (FITOs) to particular beneficiaries (i.e. there are no streaming rules for foreign income). Therefore, each beneficiary is allocated a share of the trust's foreign income **Note:** A non-resident's assessable income only includes a share of the net income that is attributable to sources in Australia (s. 97(1) ITAA 1936). Therefore, foreign income allocated to a non-resident is not taxed	Unit 14

Note: The focus of this unit is on resident trusts. Non-resident trusts are outside the scope of the TAXAU module.

Types of trusts

In practice, most trusts are 'express trusts' – that is, trusts created by intention of the settlor. For example, Person A expresses an intention (usually in writing by way of a trust deed) to give Person B $200 to hold on trust for Person C. This type of trust is also known as a 'settled trust', in which A is the 'settlor', B is the 'trustee' and C is the 'beneficiary'. A settlor who appoints themselves as trustee is effectively declaring a trust over the property without transferring legal ownership to another party.

Common types

The common types of express trusts are described in the following table.

Common express trusts	
Type	**Description**
Discretionary trust	A trust whose terms give the trustee a wide discretion to determine which beneficiaries are entitled to distributions of the trust's income and/or capital on a year-by-year basis. The choice of beneficiary and the amount to be distributed is left to the trustee to determine. A potential beneficiary (called a discretionary object) has no beneficial interest in the trust until and unless the trustee makes this determination The discretionary trust offers opportunities for income-splitting due to its flexibility regarding the distribution of income and capital distributions. This makes it popular as a tax planning vehicle in family situations In tax parlance, a discretionary trust is sometimes referred to as a 'family trust'[1] or a 'non-fixed trust'
Fixed trust[2]	A trust under which the beneficiary's entitlements to share in the income or capital of the trust are fixed under the terms of the trust deed
Unit trust	A type of fixed trust under which the unit-holder's capital and income entitlements are determined in proportion to the number of units held in the trust. Unit trusts are commonly used where investors, who are not related to each other, wish to pool their resources to purchase property or other forms of investment. Investors in a unit trust may sell their interest in the unit trust by selling units to new investors
Hybrid trust	A trust that has features of a fixed trust or a unit trust and a discretionary trust

Notes

1. The term 'family trust' is specifically defined in the trust loss provisions and refers to a trust (whether discretionary or fixed) for which a specific 'family trust' election has been made. Therefore, where a trust is referred to as a 'family trust', it is important to determine whether the term is being used descriptively or in this specific legal context.
2. The term 'fixed trust' is specifically defined for the purposes of the trust loss provisions.

Special types

There are also special types of trusts that are subject to specific taxation provisions, including:

- Superannuation funds (see Unit 11).
- Family trusts (see later in this unit).
- Managed investment trusts and attribution investment vehicles (see below).

Managed investment trusts

A managed investment trust (MIT) is a type of unit trust. It is a widely held and commercially operated trust that invests in primarily passive activities, such as shares, property or fixed interest assets. A trust qualifies as a MIT if it meets certain requirements for the particular income year (see Schedule 1 s. 12-400 TAA 1953). MITs (and their members) are generally taxed under the general trust provisions in Division 6 ITAA 1936 (as discussed in this unit). However, MITs are required to withhold an amount of income tax when making certain payments to non-resident members.

The non-resident MIT withholding tax is a final tax (i.e. the income is deemed to be non-assessable non-exempt (NANE) income of the non-resident). The rate of tax to be withheld is:

Non-resident withholding tax		
Payment	**To recipient in an 'information exchange country'**	**Otherwise**
Fund payments (i.e. net income of trust other than the below)	15% (except to the extent it is non-concessional MIT income taxed at 30%, applicable from 1 July 2019)	30%
Dividends, interest and royalties	A separate withholding regime applies (see Unit 14)	
Capital gain or loss on non-TAP	N/A – Non-residents only taxable on taxable Australian property (see Unit 4)	
Foreign sourced income	N/A – Non-residents only taxable on Australian-sourced income (see Unit 1)	

Fund payments are defined in s. 12-405 Schedule 1 TAA 1953 to equal the net income of the trust disregarding certain amounts (see above table). Broadly, they would include distributions of Australian-sourced trading or rental income (if any), and of net capital gains on taxable Australian property (TAP).

From 1 July 2019, funds payments that are categorised as non-concessional MIT income are taxed at a rate equal to the top corporate tax rate even where the recipient is in an 'information exchange country'. Under s. 12-435 non-concessional MIT income includes MIT cross staple structure income, MIT trading trust income, MIT agricultural income, and MIT residential housing income. The purpose of this requirement is to ensure that income attributable to a trading business, that has been converted to passive income, is not concessionally taxed.

A detailed understanding of the MIT regime is outside the scope of the TAXAU module.

Attribution investment vehicles

An attribution investment vehicle (AIV) can be an **attribution managed investment trust** (AMIT) or **an attribution sub-fund of a corporate collective investment vehicle** (CCIV) (see below for proposed new investment structure).

An AMIT is a MIT that has elected to be an AMIT. It is generally taxed under the AMIT regime in Division 276 ITAA 1997. Once a MIT elects in, the general trust provisions in Division 6 ITAA 1936 (as discussed in this unit) do not apply. The AMIT regime:

- Replaces the Division 6 ITAA 1936 concept of 'present entitlement'. Each member of an AMIT is allocated a 'determined member component' of assessable, exempt and NANE income characters. The trustee will attribute those amounts to members on a fair and reasonable basis, consistent with the trust documents, as if the members had derived, received or made the amounts in their own right. Note, if an amount of a discount capital gain is not attributed to members, the trustee of the AMIT is liable to tax on that amount as though it was not a discount capital gain (i.e. the trust is not entitled to the CGT 50% discount).
- Contains methods for reconciling variances in calculating trust components of particular characters (i.e. the 'under/over rules') that allows a trustee to carry forward errors in calculations of taxable income to the year that the errors are discovered (rather than amending the incorrect income tax return).
- Allows for annual upward and downward adjustments to the CGT cost bases of membership interests in an AMIT. CGT event E10 is triggered where the cost base is reduced below $nil.

Note: The Government has released an exposure draft that proposes to introduce a new investment structure, known as a corporate collective investment vehicle (CCIV). A CCIV is a public company that is limited by shares and that is structured as an umbrella fund with one or more sub-funds. The tax treatment of a CCIV is designed to broadly align with that of an AMIT (i.e. on an attribution and character flow-through basis) providing investors with tax outcomes that are equivalent to the those that would apply had they invested directly.

A detailed understanding of the AMIT and CCIV regimes are outside the scope of the TAXAU module.

Trust net income or loss

Overview

Divisions 6 (ss 95 to 102) and 6E (ss 102UW to 102UY) of the ITAA 1936 contain the primary provisions for the taxation of trusts and beneficiaries, reflected in the following two-step process:

Step 1: Determine both the accounting income and the net income (effectively taxable income) of the trust. 'Net income' is defined in s. 95 ITAA 1936 and is discussed below

Step 2: Identify the beneficiaries of the trust. The nature of each beneficiary will determine:
- Who is assessable on the trust's net income
- How much tax is to be paid

This section considers Step 1, in particular net income (i.e. taxable income) under Division 6, income of the trust (i.e. accounting income) and the allocation of net income to beneficiaries under the proportionate approach.

Net income (i.e. taxable income)

Net income, defined in s. 95(1) ITAA 1936, is broadly the excess of assessable income over allowable deductions (i.e. it is in effect a taxable income calculation), calculated on the assumption that the trustee is a resident taxpayer. The calculation is focused on the trustee as, by law, the trustee owns the trust property, earns any income and incurs any liabilities.

If the trust makes a **loss**, that loss is trapped in the trust and **must be carried forward** to be offset against income in a future year – it cannot be distributed to a beneficiary (*Doherty v. FCT*). When the loss is claimed as a deduction in that future year, it should be remembered that it cannot be offset against income due to a beneficiary if the:

- Loss is required to be met out of *corpus* (capital).
- Beneficiary has no interest in the capital of the trust.

Deductions for interest

Careful consideration is needed before claiming a deduction in the net income calculation for interest on funds borrowed by the trustee to pay a monetary distribution to a beneficiary. The refinancing principle expressed in *FCT v. Roberts and Smith* (see Unit 9) is not, in the ATO's view, as applicable to trusts as it is to partnerships and companies. The ATO does not accept that the interest is deductible simply because the borrowing of funds by the trustee allows income-producing assets to remain part of the trust estate. The decision in *Hayden v. FCT* (see example below) supports the ATO's view.

However, in TR 2005/12, the ATO accepts that the interest expenses are deductible if the objective of the trustee in borrowing funds is to refinance a 'returnable amount'.

The ruling provides the following examples of when money or property is a returnable amount:

- an individual has subscribed money for units in a unit trust and has a right of redemption in relation to the units and the money is used by the trustee to purchase income-producing assets;
- a beneficiary has an unpaid present entitlement to some or all of the capital of a trust estate, or some or all of the net income of the trust estate, and the amount to which the beneficiary is entitled has been retained by the trustee and used in the gaining or producing of assessable income of the trust; and
- a beneficiary lends an amount to the trustee who uses the money for income producing purposes (for example, by depositing it at interest in a bank).

In TD 2018/9, the ATO also expresses the view that a beneficiary of a discretionary trust who borrows money, and on-lends all or part of that money to the trustee of the discretionary trust interest-free, is usually not entitled to a deduction for any interest expenditure. It is only where the beneficiary is presently entitled to income of the trust estate at the time the expense is incurred, and the expense has a nexus with the income to which the beneficiary is presently entitled that some part of the interest expense might be deductible.

Example – Funds borrowed to make trust distributions

In *Hayden v. FCT*, a son commenced proceedings in the Supreme Court of Queensland claiming that his deceased father had failed to make adequate provision from his estate for the proper maintenance and support of his son. The court ordered that the estate pay the son $150,000. In order to pay this amount, the executor borrowed $150,000 rather than sell the income-producing assets of the estate. The interest incurred was claimed as a deduction.

The court held that the interest was not deductible. In his decision, Spender J stated:

> Here, the borrowed funds were used to discharge an obligation by the estate [to pay an amount ordered by a court under family maintenance provisions]. I can see no difference in the present case from a case where an individual taxpayer, in order to discharge an obligation such as school fees, borrows funds on which interest is paid rather than sell income-producing assets and from the proceeds discharge the obligation. The paying of school fees requires funds, on which interest might be otherwise earned; that fact does not make interest on funds borrowed for the purpose of paying school fees deductible. The discharge of the obligation is a purpose quite independent of the property.

Net income retains its tax character

Specific provisions allow:

- A franked dividend derived by a trust to retain its tax character as a dividend and the associated franking credits to pass through the trust when a trust distribution is made.
- Capital gains derived by a trust to retain their tax character as capital gains in the hands of beneficiaries.
- Trust distributions of interest, dividends and royalties to a non-resident beneficiary to retain their tax character (s. 128A(3) ITAA 1936). This means that trustees distributing such amounts to non-residents must comply with the withholding tax obligations (see Unit 14).

However, the High Court decision in *FCT v. Bamford* put into doubt the proposition that all types of income and gains derived by a trust generally retain their tax character in the hands of the beneficiary (see *Baker v. Archer Shee* and *Charles v. FCT*). A Treasury policy paper (released in October 2012) contains proposals to provide legislative certainty that all amounts that flow through a trust would retain the character that they had in the hands of the trustee when assessed to the beneficiaries, unless another part of the tax law requires that the amount be treated otherwise. Legislation to give effect to these proposals has yet to be released.

Note: The ATO has expressed draft views on the taxing of non-resident beneficiary capital gains in TD 2019/D6 and TD 2019/D7. The ATO draft views are inconsistent with this policy and are outside the scope of the TAXAU module. However, they should be considered in practice.

Income of the trust (i.e. accounting income)

The **income of the trust** is its distributable income (i.e. a net concept), which is determined by the trustee based on accounting principles and the terms of the trust deed (*FCT v. Totledge Pty Ltd*). It is the **income of the trust** (i.e. accounting income) that may be distributed in cash to the beneficiaries of a trust.

The **income of the trust** (i.e. accounting income) and the trust's **net income** (i.e. taxable income) are sometimes different. However, the trust deed may be drafted in a way that aligns the two. Differences between the **income of the trust** and its **net income** can arise because of tax adjustments (e.g. tax depreciation rates may differ from the rates used for trust accounting purposes, or trust expenses may not be deductible for income tax purposes).

In *FCT v. Bamford*, the High Court held that the **income of the trust** is to be determined in accordance with trust law principles and that the trust deed may influence what is trust income (see also TR 2012/D1 and TR 2012/D1A1). For example, if a trust deed defines trust income to include a net capital gain under ITAA 1997, it would generally include that amount. Depending on the trust deed, there may or may not be a mismatch between the **income of the trust** and its **net income** (i.e. taxable income). In the worst case, a beneficiary entitled to income (i.e. an income beneficiary) may be assessable under s. 97 ITAA 1936 on the accounting-tax difference represented by a capital gain, but may not be entitled to actually receive the capital profit as a trust distribution under the terms of the trust deed. This is why the 'specific entitlement' rules discussed later in this unit under streaming of trust distributions were introduced for capital gains (and franked dividends).

Where the **income of the trust** (i.e. accounting income) exceeds the trust's **net income** (i.e. taxable income) there is a portion of a trust distribution that may be 'non-assessable' to a beneficiary. The non-assessable portion may have CGT consequences for a beneficiary (see later in this unit, under 'CGT events relating to trusts').

Proportionate allocation approach

Generally, the trust's **net income** (i.e. taxable income) is taxed in the hands of the beneficiaries (or the trustee on their behalf) based on their **share** of the **income of the trust estate**. For example, if the beneficiary has a 50% share of the trust's income, they have a 50% share of the trust's net income. This is referred to as the 'proportionate' approach and is the methodology approved by the courts (*FCT v. Bamford*; TD 2012/22).

The operation of the proportionate approach is best illustrated by an example. In both of the example scenarios the income of the trust consists solely of interest and net rental income (i.e. there are no capital gains or franked dividends). The impact of capital gains and franked dividends on the allocation process is considered later in this unit under streaming.

Example – Proportionate approach

Scenario A: The trust's income is the same as its net income

Under the trust deed for the Riverdale Family Trust, 'income' is defined to be the same as the net income calculated for tax purposes. The deed does not contain any provision enabling the trustee to determine a different amount to be the income of the trust.

Prior to 30 June, the trustee calculated the net income for the year as $120,000.

The trustee resolves to distribute $40,000 to each of beneficiaries Ann, Ben and Cy and they were each assessed on that amount. This distribution was **not** done by formula (e.g. ⅓ to each beneficiary). It was a monetary distribution.

Subsequently, the Commissioner determined on audit that the trustee had omitted $9,000 interest income in calculating the net income. The net income and consequently the trust income was therefore $129,000.

The deed contained no provisions dealing with the situation where the trustee failed to appoint some or all of the income of the trust estate by a particular time. As the trustee had distributed only $120,000, there is $9,000 trust income to which no beneficiary was presently entitled.

The corresponding share of net income ($9,000) is therefore assessed to the trustee.

If the distribution had been done by way of formula instead of a monetary distribution, Ann, Ben and Cy would each be assessable on an additional $3,000 each.

Scenario B: Trust income determined and differs from net income

Under the trust deed for the Farmer Trust, 'income' is defined to be the amount determined by the trustee or, if no determination is made, it is the same as the net income calculated for tax purposes.

Prior to 30 June, the trustee determined, pursuant to the trust deed, that the income of the trust for the year was $120,000.

The trustee resolved to distribute $40,000 to each of beneficiaries Ed, Fred and Greg.

The trustee's determination that the income of the trust was $120,000 had the effect of fixing the income of the trust at $120,000.

Although the trustee believed at the time of the determination that the net income would also be $120,000, the net income was actually $129,000 – the trustee had mistakenly believed that $9,000 related to a later income year.

Unlike the result in Scenario A, each beneficiary in this example was presently entitled to one-third of the trust's income and each is assessed on $43,000, being one-third of the net income of the trust. No amount of the trust's net income was assessed to the trustee.

The different result in the two scenarios can be summarised as follows:

(a) Trust income equals net income under the trust deed. Therefore, if the net income changes, the trust income also changes, resulting in a change in the beneficiary's share.

	Trust income = $120,000 + $9,000 = $129,000			**Net income = $120,000 + $9,000 = $129,000**	
	Actual distribution $	**Share**		**Assessed**	
		Calculation	**%**	**Calculation**	**$**
Ann	40,000	40,000 ÷ 129,000	31	31% × $129,000	40,000
Ben	40,000	40,000 ÷ 129,000	31	31% × $129,000	40,000
Cy	40,000	40,000 ÷ 129,000	31	31% × $129,000	40,000
	120,000		93		120,000
Not distributed/ trustee	9,000	9,000 ÷ 129,000	7	7% × $129,000	9,000
Total	129,000		100		129,000

(b) Trust income determined by trustee under the trust deed. Therefore, even if the net income changes there is no change in the trust income and no change in the beneficiary's share.

	Trust income = $120,000			Net income = $120,000 + $9,000 = $129,000	
	Actual distribution $	Share		Assessed	
		Calculation	%	Calculation	$
Ed	40,000	40,000 ÷ 120,000	33.33	33.33% × $129,000	43,000
Fred	40,000	40,000 ÷ 120,000	33.33	33.33% × $129,000	43,000
Greg	40,000	40,000 ÷ 120,000	33.33	33.33% × $129,000	43,000
	120,000		100.00		129,000
Not distributed/ Trustee	–		–		–
Total	120,000		100.00		129,000

Source: TD 2012/22 paras 7–12 and 18–23.

Impact of streaming

It may be possible to stream capital gains and franked dividends to beneficiaries specifically entitled to distributions of such amounts. The distribution of such amounts to beneficiaries is dealt with under specific rules contained in the CGT and dividend provisions. For further details, see 'Streaming of trust distributions' later in this unit.

It is important to note, however, that the net income (i.e. taxable income) calculation at the trust level is **not impacted** by the special rules dealing with the distribution of capital gains and franked dividends: see note in s. 102UX(1) ITAA 1936. This means, for example, that the following items form part of the trust's net income calculation:

- Net capital gains, and the trust is entitled to the 50% CGT discount (ss 102-5(1) and 115-10 ITAA 1997).
- Franked dividends and the gross-up amount for franking credits (s. 44(1) ITAA 1936 and s. 207-20(1) or, if not a corporate trustee, s. 207-35(1) ITAA 1997).

Trust income tax returns

As noted in Unit 1, each year the Commissioner requires taxpayers, including trusts, to lodge an income tax return which explains how the net income of the trust has been calculated.

Each year the ATO releases forms and instructions to assist taxpayers.

Worked example 10.1: Net income and income of a trust
[Available online in myLearning]

Taxation of net income

Relevant taxpayer

Once a trust's net income has been determined, that income may be taxable in the hands of the:

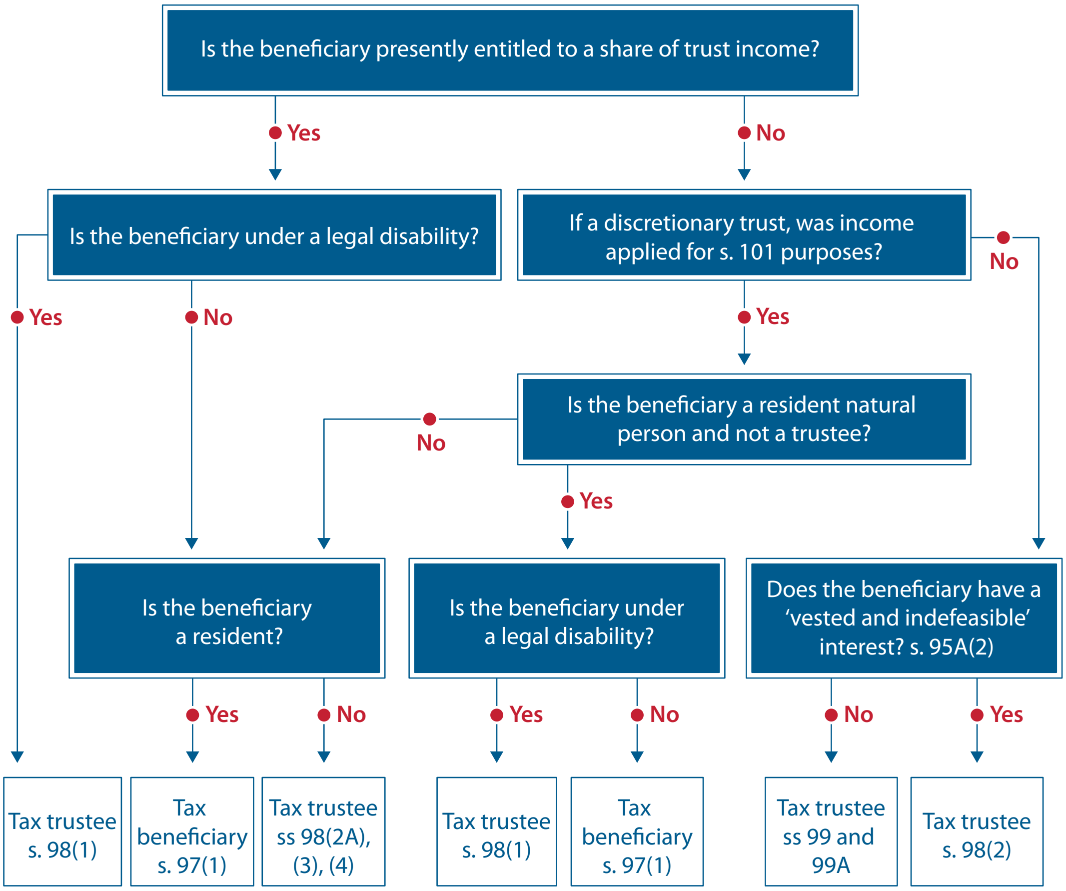
- Trustee.
- Beneficiary.
- Trustee, on behalf of the beneficiary.

Determining the relevant taxpayer depends on whether any beneficiary has a present entitlement to that trust income and/or whether or not the beneficiary is under a legal disability.

Flow chart approach

The following flow chart can be used to determine who is assessed on the net income of a resident trust estate. The flow chart uses the following assumptions:

- No beneficiary is specifically entitled to franked dividends and capital gains (i.e. there is no streaming of distributions).
- The trust only derives Australian-sourced income.



Note: Legislative references relate to ITAA 1936.

Present entitlement

Definition

In practice, present entitlement can only be determined by a careful reading of the trust deed, a clear understanding of how the trust was managed by the trustee and the details of all trustee resolutions and distributions.

The concept of present entitlement was considered in *FCT v. Whiting* and in *Taylor v. FCT*. The expression embraces a vested interest in possession of trust property or income, as opposed to an expected or contingent future interest. The beneficiary must be entitled to immediate payment, whether or not payment is made. The beneficiary's legal capacity to demand payment is irrelevant – that is, a person can still be presently entitled to a trust income even if they are under a legal disability (this is also reflected in the drafting of s. 98(1) ITAA 1936).

In *Harmer & ors v. FCT*, present entitlement was **defined as** a situation where the beneficiary has:

- An interest in trust income that is both **vested** in interest and vested in possession.
- A **legal right** to demand and receive payment, whether or not the:
  - Precise amount can be determined before year end (e.g. accounts may not be completed until some months after year end, yet the trustee resolves to distribute income at 30 June).
  - Trustee has funds available for immediate payment (a beneficiary may still be presently entitled to trust income even though an amount has not been paid; it is only a right to demand that must exist).
  - Beneficiary is under a legal disability and does not have the legal capacity to demand payment (e.g. children under the age of 18, bankrupts and those who are mentally incapable).

The beneficiaries (objects) of a discretionary trust do not have any interest in the property or income of a trust estate. It is for the trustee to determine whether such beneficiaries will benefit at all under the terms of the trust and to what extent they will benefit. Such beneficiaries have no more than a right to have the trust properly administered (*Gartside v. Inland Revenue Commissioners*).

Note: The concept of present entitlement was recently considered in *Lewski v. CoT*. This case considered a situation where there are two resolutions dealing with the same income year. The first resolution deals with the distribution of the income of the trust for the particular income year and the latter varied, in certain circumstances, the distribution made by the first resolution. The court held that both resolutions were valid and thus, when read together that the beneficiary was **not** presently entitled to a share of the net income of the trust. As a consequence of this case, the ATO is currently reconsidering their guidance in TD 2012/22, in particular examples 6 and 7 that deal with ineffective further resolutions.

Timing

Unless the trust deed provides otherwise, present entitlement arises when the trustee makes a resolution to appoint the income to the beneficiaries or discretionary objects of the trust. The trustee must determine present entitlement by the end of the income year (or earlier, if stipulated in the trust deed) (*Colonial First State Investments v. FCT*). Note that if the trustee does not appoint the income of the trust for the year and there is a default clause in the trust deed, the default beneficiary nominated in the default clause of the trust deed will be presently entitled to the income.

Accordingly, if there is a change of beneficiaries in a fixed trust during the income year, it is the beneficiary at the end of the year who is entitled to the income for the whole year, unless the trust deed provides otherwise. For example, listed unit trusts typically have a trust deed that treats beneficiaries (unit-holders) as entitled to quarterly or biannual distributions, regardless of whether they sold their units after receiving the distribution and before year end.

Section 95A(1) ITAA 1936 provides a type of constructive payment rule. It states that where a beneficiary is presently entitled, the beneficiary is taken to continue to be presently entitled, notwithstanding that the income is applied for the benefit of the beneficiary (i.e. actual payment to the beneficiary is not required).

Deeming rules

Present entitlement can arise in other ways. For example:

- In the case of a discretionary trust, a beneficiary in whose favour the trustee's discretion is exercised is deemed, by s. 101 ITAA 1936, to be presently entitled to the amount paid to them or applied for their benefit.
- In the case of a fixed or unit trust, present entitlement typically arises because the terms of the trust deed provide that the beneficiaries (or unit holders) have a vested interest in the income or capital of the trust.
- Aside from s. 101 ITAA 1936, a beneficiary may be deemed to be presently entitled by the operation of s. 95A(2) ITAA 1936 in circumstances where there is not otherwise a present entitlement but there is a vested and indefeasible interest in the trust's income.

Anti-avoidance rules

Two specific anti-avoidance rules apply to address arrangements whereby exempt entities are made presently entitled to shelter the taxable income of a trust:

- The 'pay or notify' rule (s. 100AA ITAA 1936) applies if an exempt beneficiary (e.g. a charity) has not been notified of, or paid their present entitlement to, income of the trust estate within two months of the end of the income year. In this circumstance, and subject to the Commissioner's discretion, the exempt beneficiary is treated as not being presently entitled to that income and the trustee will be assessed under s. 99A ITAA 1936.
- The 'benchmark percentage' rule (s. 100AB ITAA 1936) applies if the entitlement of an exempt entity (e.g. a charity) to the income of the trust estate (ignoring any franked distributions and capital gains that any entity is specifically entitled to), expressed as a percentage, exceeds a benchmark percentage. This rule aims to prevent an exempt entity from receiving a disproportionate share of the trust's net income, relative to the exempt entity's trust entitlements. If the exempt beneficiary's entitlement exceeds the benchmark percentage, the beneficiary is treated as not being presently entitled to the percentage share of the income of the trust estate that exceeds the benchmark percentage.

Under both rules, the trustee is assessed on the share of the trust's taxable income to which the exempt beneficiary has been disentitled. These rules do not apply to tax loss entities.

The Commissioner has a discretion not to apply the anti-avoidance rules if, in the circumstances, it would be unreasonable to do so.

Example – Accounting loss (trust income) and net income

Big Trust is an Australian unit trust. It distributes all of its accounting profits each year to unitholders. In the current income year, the trust made an accounting loss of $5,000 and no corpus/capital distributions were made. The trust has net income (i.e. taxable income) of $20,000 for the current income year.

As the trust made an accounting loss there is no beneficiary who is presently entitled to a share of the trust's income. Therefore, the trustee will be assessed on the $20,000 net income.

Example – Accounting profit (trust income) and net loss

Large Trust is an Australian discretionary trust. In the current income year, the trust made an accounting profit of $100,000 and distributed $10,000 to one of its beneficiaries. The trust made a net loss (i.e. tax loss) of $50,000 because of a deductible prepayment which was capitalised for accounting purposes.

A beneficiary is only assessable on their share of a trust's net income; trust net losses are retained in the trust. Therefore, the beneficiary has no amount to include in their assessable income in the current income year.

No present entitlement

The trustee is assessed on so much, if any, of what may conveniently be referred to as the net income of the trust estate to which no beneficiary is presently entitled (ss 99 and 99A ITAA 1936).

The trustee pays the tax and the income is not taxed again when distributed to a beneficiary, nor does the beneficiary get a credit for the tax paid by the trustee.

General rule

Section 99A ITAA 1936 applies in relation to all trust estates **unless** the:

- Trust estate is of a kind identified in s. 99A(2) as a deceased estate, bankrupt estate, or family maintenance trust.
- The Commissioner forms the opinion that it would be unreasonable for s. 99A ITAA 1936 to apply to the trust estate in relation to the year of income (e.g. trusts for injured persons or those in necessitous circumstances, family breakdown situations, etc).

Where s. 99A ITAA 1936 applies, the trustee is taxed at a flat rate of 45% plus the 2% Medicare levy (i.e. 47%).

Where the Commissioner determines that it would be unreasonable for s. 99A ITAA 1936 to apply, the net income of the trust estate is assessed under s. 99 ITAA 1936, generally at individual rates, rather than at the 47% penalty rate.

Special rule – deceased estate

The most common situation in which s. 99 ITAA 1936 will apply is in the context of the administration of a **deceased estate**.

Beneficiaries usually cannot be presently entitled to income and gains derived by a deceased estate during the administration of the estate and it is the trustee who will be liable for tax during this period (*FCT v. Whiting*). However, where it becomes apparent during the period of administration that part of the net income of the estate will not be required to pay for the deceased's debts, the executor may exercise a discretion to pay some of the income to beneficiaries. The fact that the estate has not been fully administered does not prevent the beneficiaries in this situation from being presently entitled to the income actually paid to, or on behalf of, the beneficiaries (IT 2622).

The ATO's practice in IT 2622 is to adopt an apportionment approach in the income year in which the estate is fully administered:

- Income derived in the period between the beginning of the income year and the day administration was completed – assessed in the hands of the executor under s. 99 ITAA 1936.
- Income derived in the period between the day administration was completed and the end of the income year – assessed to the adult beneficiaries presently entitled to the income under s. 97 ITAA 1936 (the trustee will be liable to pay tax at normal rates if a child is presently entitled under ss 98 and 102AG ITAA 1936).

Legal disability

A person who is under a 'legal disability' is a person who is unable to give the trustee an immediate and valid discharge in respect of a distribution of income from a trust.

In practice, three classes of persons are under a legal disability for trust and tax law purposes:

- A minor who was under the age of 18 on the last day of the income year.
- A bankrupt.
- An insane or mentally incapable person.

Section 98(1) ITAA 1936 provides that where a beneficiary who is under a legal disability is presently entitled to a share of trust income, the trustee is liable to pay tax on that share. A credit for the tax payable by the trustee is allowed to the beneficiary under s. 100(2) ITAA 1936.

Example – Beneficiary under a legal disability

Peter Brown suffered severe head and spinal injuries in a motorcycle accident in 2015 and now resides in the special care unit of a nursing home. He is 25 years old.

The state guardianship tribunal accepted medical evidence that Peter was incapable of managing his own affairs and has appointed a guardian and a financial manager.

The Brown family has established a discretionary trust for Peter. The trust invests in government bonds and the trustees apply the income of the trust estate for Peter's benefit (e.g. by paying for various medical expenses). In 2019, the income of the trust and net income is $30,000.

Section 101 ITAA 1936 deems a beneficiary to be presently entitled to the amount paid to them or applied for their benefit. For the 2019 income year, Peter is deemed presently entitled to $30,000, being the amount of income applied for his benefit.

As Peter is under a legal disability in the relevant year of income, the trustee is liable to be assessed and to pay tax pursuant to s. 98 ITAA 1936. The tax will be calculated at adult resident individual rates and Peter will be credited for the tax paid on his behalf by the trustee when his financial manager lodges his personal tax return (s. 100(2) ITAA 1936).

Taxable income calculation

Resident beneficiary

Where a resident beneficiary is presently entitled and not under a legal disability, the general approach is as follows:

- In accordance with Division 6 ITAA 1936, the resident beneficiary's share of the net income of the trust is included in the assessable income of the resident beneficiary under s. 97 ITAA 1936. However, the amount included in the beneficiary's assessable income under s. 97 ITAA 1936 is modified by Division 6E ITAA 1936 to exclude any net capital gain or franked dividend income.
- Subdivision 115-C ITAA 1997 applies where the net income of the trust includes a net capital gain. In that situation, the beneficiary is deemed to have a share of the capital gain (equal to their proportionate share, ignoring specific streaming) under s. 115-227 ITAA 1997 and to have made the capital gain.

  To determine the amount included in the beneficiary's assessable income, the beneficiary must first gross-up the trust's net capital gain for the CGT concessions applied by the trustee (s. 115-215(3) ITAA 1997). Broadly that is, multiply by two (2) where the trust has applied the CGT 50% general discount or multiply by four (4) where the trustee has applied both the CGT general discount and the 50% small business entity discount. The beneficiary then calculates their own net capital gain under s. 102-5 ITAA 1997 (i.e. by reducing the capital gain by any capital losses and CGT concessions to which they are actually entitled). For further details, see 'Streaming of trust distributions' later in this unit.
- Subdivision 207-B ITAA 1997 applies where the net income of the trust includes a franked dividend. In that situation, the beneficiary is deemed to have a share of the franked dividend and franking credit (equal to their proportionate share, ignoring specific streaming) under s. 207-55(4) and s. 207-57 ITAA 1997.

  The beneficiary calculates their assessable income including their proportionate share of the franked dividend and franking credit gross-up under s. 207-35 ITAA 1997, and their tax payable including the entitlement to a tax offset for franking credits under s. 207-45 ITAA 1997. For further details, see 'Streaming of trust distributions' later in this unit.

Non-resident beneficiary

Where a non-resident beneficiary is presently entitled and not under a legal disability, the general approach for 'amounts sourced in Australia' is as follows:

- The non-resident beneficiary's share of the net income sourced in Australia is subject to income tax in the hands of the trustee (ss 98(2A) and (3) ITAA 1936).
- The share of net income subject to income tax in the hands of the trustee is also included in the assessable income of the non-resident beneficiary, with the income tax payable by the non-resident reduced by the tax already paid by the trustee. Excess tax paid by the trustee can be refunded to the non-resident (ss 98A(1) and (2) ITAA 1936).
- Distributions of Australian-sourced interest, unfranked dividends and royalties retain their character as they flow through a trust and are therefore subject to withholding tax (s. 128A(3) ITAA 1936). The trustee must withhold and remit the withholding tax to the ATO (IT 2680).

  Franked dividends are also subject to withholding tax but the withholding tax rate is reduced to zero (s. 128B(3) (ga) ITAA 1936).

  Dividend, interest and royalty income is deemed to be NANE (i.e. is not subject to further tax in the hands of the trustee or the non-resident). For further details see Unit 14.

The special withholding rules that apply to distributions made to a non-resident beneficiary by a managed investment trust are outside the scope of this unit.

A non-resident beneficiary's share of the net income of the trust that is not sourced in Australia (i.e. foreign-sourced income) is not subject to income tax in the hands of the trustee nor in the hands of the non-resident beneficiary. As explained in Unit 1, a non-resident is only taxable in Australia on their Australian-sourced income.

Trustee

Where a share of the net income of the trust is subject to tax in the hands of the trustee under s. 98(3), s. 98(4) or s. 99A ITAA 1936, the trustee is not entitled to claim the CGT 50% general discount (see s. 115-220 and s. 115-222 ITAA 1997). As this concession has been included in the calculation of the net income of the trust, the trustee must multiply any net capital gain component by two (2) prior to determining the amount of income tax payable.

Tax rates

The tax rates applicable to trusts and beneficiaries vary depending on the circumstances. The following table provides a summary of the rates applicable where an individual beneficiary is a resident.

Tax rates for individual resident beneficiaries	
Circumstances	**Tax rate**
Where beneficiary (18 years and over) is: • presently entitled, and • **not** under a legal disability beneficiary is taxed (s. 97 ITAA 1936)	Tax rates applicable to beneficiary
Where beneficiary (18 years and over) is: • presently entitled, and • under a legal disability other than due to age (e.g. mentally incapable person) trustee is taxed (s. 98 ITAA 1936)	Tax rates applicable to beneficiary
Where beneficiary (under 18 years of age at end of the income year) is: • presently entitled, and • under a legal disability due to age trustee is taxed (s. 98 ITAA 1936)	Children's penalty tax rates (Division 6AA ITAA 1936 and s. 13 ITRA 1986) However, the general tax rate applicable to adult individuals applies where: • testamentary trust distribution (i.e. deceased estate), or • child eligible for some other exception (e.g. extreme disadvantage)
No beneficiary presently entitled – deceased estate under administration (time limits apply) – trustee is taxed (s. 99 ITAA 1936)	Individual rates
No beneficiary presently entitled – trustee taxed (s. 99A ITAA 1936)	A flat rate of 47% applies to the whole amount (s. 12(9) ITRA 1986 and s. 251S ITAA 1936) Note: No CGT discount is available (s. 115-222 ITAA 1997) but franking credits are available (s. 207-35 ITAA 1997)

Note: From 1 July 2019, the Government has proposed to limit the application of general tax rates for minors receiving testamentary trust distributions. The general tax rate will only apply to income generated from assets that are transferred from a deceased estate, or the proceeds of the disposal or investment of those assets.

Streaming of trust distributions

Overview

As an interim response to the High Court decision in *FCT v. Bamford* (pending the outcome of a broader review of the taxation of trusts), the government enacted measures in 2011 to allow a trustee to appoint or 'stream' capital gains and franked dividends (including any attached franking credits) to specific beneficiaries, subject to anti-avoidance rules, where permitted by the trust deed. Other types of income (e.g. interest, rent, etc.) cannot be streamed.

This means that, where permitted by the trust deed, capital gains and franked dividends can be effectively streamed to beneficiaries for tax purposes by the trustee making the beneficiaries 'specifically entitled' to those amounts. In practice, such streaming opportunities are relevant mainly to discretionary trusts.

The tax planning benefits of streaming can be best illustrated by an example.

Example – Streaming capital gains and franked dividends

The Jones Discretionary Trust holds shares listed on the Australian Securities Exchange (ASX) and generates franked dividend income and the occasional capital gain. The trust has made the family trust election (FTE) – discussed later in this unit – and the trust deed empowers the trustee to make beneficiaries specifically entitled to capital gains and franked dividends.

For the 2019 income year, the trustee makes the following resolutions on 30 June 2019:

- Bill Jones is specifically entitled to the net capital gain ($150,000).
- Betty Jones is specifically entitled to the franked dividends ($70,000 with accompanying franking credits of $30,000).

This allocation is advantageous to both beneficiaries because:

- Bill Jones has personal carry forward capital losses that can be utilised against the net capital gain flowing to him through the trust.
- Betty Jones is currently studying full time at a university and is on a low personal tax rate bracket. The franking credits attached to the franked dividends flowing to her through the trust will more than offset the income tax on the dividends and she will receive a refund of the excess franking tax offset when she lodges her income tax return.

Streaming requirements

For streaming to be effective:

- The trust deed must be suitably worded to ensure that it permits the specific entitlement of capital gains and franked distributions.
- The trustee makes the necessary resolutions within the required deadlines to make beneficiaries specifically entitled (see below).
- Discretionary trusts should make a family trust election (FTE) (see the sections on family trusts later in this unit).

Trustee resolutions

To ensure that a beneficiary is presently entitled to trust income for the income year just ended, trustee distribution resolutions relating to beneficiary-specific entitlements (i.e. streamed amounts) must be in place by:

- 30 June – for franked dividends
- 31 August – for capital gains (unless the trust deed requires resolutions to be made by 30 June or unless the capital gains form part of the income of the trust).

To avoid any unintended consequences, best practice is to ensure that all trustee resolutions are in place by 30 June in order to ensure that a present entitlement to trust income has been created.

The resolution does not need to specify an actual dollar amount to be effective, unless the trust deed specifically requires it. A resolution is effective if it prescribes a clear methodology for calculating the entitlement (e.g. 'beneficiary A is entitled to 50% of trust income').

In addition, provided that the distribution meeting is actually held by 30 June, the minutes do not have to be done by then. The minutes are merely evidence of earlier meetings. They therefore can be signed and dated at a later date, provided the meeting was actually held by 30 June.

Distribution components

Irrespective of whether a beneficiary is specifically entitled to a capital gain or franked dividend, provided the trust's net income exceeds $nil and the net income calculation at the trustee level includes a net capital gain or franked dividend, the trust distribution is effectively split into the following three components:

- Division 6 ITAA 1936 component – calculated by applying the assumptions in Division 6E ITAA 1936:
  - This component is the proportionate share of the trust's income, exclusive of capital gains and franked dividends (and franking credits (TR 2012/D1)). The proportion is referred to as the beneficiary's 'adjusted Division 6 percentage'.
  - These adjustments result in what is termed 'Division 6E net income' and 'Division 6E income'.
- Capital gains component – calculated under Subdivision 115-C ITAA 1997 for:
  - Beneficiaries with a specific entitlement (s. 115-227(a)).
  - Other beneficiaries (s. 115-227(b)).
- Franked dividend component – calculated under Subdivision 207-B ITAA 1997 for:
  - Beneficiaries with a specific entitlement (s. 207-55(4)(a)).
  - Other beneficiaries (s. 207-55(4)(b)).

Trust capital gains

Trustee level

The starting point in the calculation of capital gains relating to trusts is at the trustee level, prior to the allocation of the trust net income.

Where a capital gain or capital loss made on a CGT asset held by a trust is taken into account in the trust's net income calculation, the CGT calculation at the trustee level is undertaken in the normal way using the method statement in s. 102-5 ITAA 1997. This means that:

- Any net capital gain forms part of the trust's net income and the trust is eligible for the 50% CGT discount (ss 115-10 and 115-100(a)(ii) ITAA 1997).
- A net capital loss is carried forward by the trust to a future year, subject to the loss carry forward rules (discussed below).

Beneficiary level

Special rules apply to the capital gains component when a net capital gain is distributed and taxed in the hands of the beneficiary (or trustee, if no beneficiary is presently entitled).

Using a presently entitled beneficiary who is not under a legal disability as an example, these special rules are the result of the combined operation of:

- Division 6E ITAA 1936, which applies s. 97(1) ITAA 1936 on the assumption that the trust has no capital gains or franked dividends (ss 102UX(2)–(3) and 102UY ITAA 1936).
- Subdivision 115-C ITAA 1997, which determines how much of the capital gain flowing through the trust is assessable in the hands of the beneficiary. Where Subdivision 115-C ITAA 1997 applies, s. 95AAB(3) ITAA 1936 excludes the capital gain from being assessable again under s. 97 ITAA 1936 (see also s. 95AAC ITAA 1936 for exclusions for s. 98, s. 99 and s. 99A ITAA 1936 amounts).

As noted previously, these provisions also enable a beneficiary to be made specifically entitled to a capital gain flowing through a trust.

Calculation method

To determine the amount a beneficiary includes in their assessable income, the beneficiary must first gross-up their share of the capital gain of the trust for any CGT concessions applied at the trustee level (i.e. calculate their extra capital gain). They then calculate their net capital gain by reducing the extra capital gain by any CGT losses and CGT concessions to which they are entitled.

There are four steps to calculating a beneficiary's extra capital gain under Subdivision 115-C ITAA 1997:

Step 1: Determine the beneficiary's share of the capital gain of the trust (s. 115-227 ITAA 1997). The beneficiary's share of the capital gain is the amount to which:

- the beneficiary is specifically entitled (ss 115-227(a) and 115-228 ITAA 1977)
- no beneficiary is specifically entitled, multiplied by the beneficiary's share of the Division 6E income (s. 115-227(b) ITAA 1997).

Step 2: Divide that amount by the (total) capital gain – this gives the beneficiary's fraction of the capital gain (s. 115-225(1)(b) ITAA 1997).

Step 3: Multiply the resulting fraction by the net income of the trust that relates to the capital gain (the attributable gain) (s. 115-225(1) ITAA 1997).

Step 4: Gross up the result in Step 3 as appropriate for any CGT concessions (e.g. the general CGT discount and the small business 50% reduction) applied by the trustee to that capital gain (s. 115-215(3) ITAA 1997).

Example – Net capital gain made by trust

Assume the following:

- All beneficiaries are presently entitled, resident individuals who are not under a legal disability.
- The trust deed authorises the streaming of capital gains to specifically entitled beneficiaries.

The Little Trust generates $100 of rent and a $600 capital gain on an asset held for at least 12 months.

The trust deed does not define 'income' and therefore capital gains do not form part of the trust's income. As a result, the trust's:

- Income is $100.
- Net income is $400 (i.e. $100 + ($600 × 50%)).

The trustee resolves to:

- Make Catherine specifically entitled to $360 of the capital gain (undiscounted) and nothing else.
- Distribute $100 (i.e. 100%) of the trust's income to Aaron.

Upon distribution, the calculation is now split into two components:

- Division 6 ITAA 1936 component.
- Capital gain component.

Division 6 ITAA 1936 component (calculated by applying the assumptions in Division 6E ITAA 1936)

The Division 6 ITAA 1936 component is calculated by excluding the capital gain; therefore, the trust's:

- Division 6E income is $100.
- Division 6E net income is $100.

Aaron is the only presently entitled beneficiary in respect of the Division 6 component and his assessable income will include all of the Division 6E net income of $100 (s. 97(1) ITAA 1936).

Capital gain component (calculated under Subdivision 115-C ITAA 1997)

The capital gain component is $600 and is dealt with under Subdivision 115-C ITAA 1997.

Calculating the extra capital gain for each beneficiary (using the four-step process):

Step 1: Determine the beneficiary's share of the capital gain.

Catherine's share of the capital gain is $360 because she is specifically entitled to 60% of the $600 capital gain (ss 115-227(a) and 115-228 ITAA 1997).

Aaron is not specifically entitled to the capital gain, but he is presently entitled to 100% of the trust's Division 6E income. His share of the trust's capital gain is 100% of the capital gain to which no beneficiary is specifically entitled: $240 (i.e. 100% × ($600 – $360)) (s. 115-227(b)).

Step 2: Divide by the total capital gain.

Catherine divides her share of the capital gain ($360) by the total capital gain ($600) and therefore has a 0.6 share of the capital gain (s. 115-225(1)(b)).

Aaron divides his share of the capital gain ($240) by the total capital gain ($600) and therefore has a 0.4 share of the capital gain (s. 115-225(1)(b)).

Step 3: Multiply the beneficiary's fraction of the capital gain by the trust's net income relating to the capital gain.

The net income relating to the capital gain calculated under s. 115-225(1)(a) is $300 (i.e. $600 × 50%).

Catherine's attributable gain calculated under s. 115-225(1) is $180 ($300 × 0.6).

Aaron's attributable gain calculated under s. 115-225(1) is $120 ($300 × 0.4).

Step 4: Gross up the amount for CGT discounts applied by the trustee.

Catherine must double her attributable gain from $180 to $360 because the trustee has applied the 50% CGT discount (s. 115-215(3)(b)).

Aaron similarly doubles his attributable gain from $120 to $240.

Catherine and Aaron can now apply any capital losses they have to reduce the capital gain. Because they are both resident individuals, they can then apply the 50% CGT discount to any net capital gain amounts remaining.

Note the harsh outcome for Aaron in this example. He received only $100 as a cash distribution from the trust, but his assessable income from the trust is $340 (i.e. $100 + $240), albeit he can claim the 50% CGT discount on the $240 capital gain component in his own tax return. It is for this reason that Subdivision 115-C ITAA 1997 contains a facility whereby the trustee may choose to pay the tax on the $240 capital gain (see below).

Note: This example was adapted from the Explanatory Memorandum relating to the amendments made in 2011 to Subdivision 115-C.

Summary of consequences

The following table summarises the consequences for assets acquired before and after the introduction of CGT on 19 September 1985.

<table>
<tr><th colspan="3">Treatment of net capital gain made by a trust</th></tr>
<tr><th>Situation</th><th>CGT treatment (trustee level)</th><th>CGT treatment (beneficiary level, assuming trustee is not assessed)</th></tr>
<tr><td>Asset acquired before 21 September 1999</td><td>If asset is held for at least 12 months, the trustee can choose either of the following:
• 50% CGT discount (s. 115-10 ITAA 1997)
• Indexation method (s. 114-5 ITAA 1997) (indexation calculated only up to the September 1999 quarter)
No discount is allowed where the trustee is assessed under s. 99A ITAA 1936 (ss 115-222(3) and (4) ITAA 1997)</td><td rowspan="2">Beneficiaries include an extra capital gain (sometimes called a 'gross-up') in their assessable income to reflect the net gain made at the trustee level, using a four-step process (outlined above)
They then apply any CGT losses and the CGT discount to which they are entitled (ss 102-30 item 2AA and 115-210 to 115-225 ITAA 1997)
Note that a corporate beneficiary is not entitled to a CGT discount</td></tr>
<tr><td>Asset acquired after 21 September 1999</td><td>The 50% CGT discount is applied if asset is held for 12 months (s. 115-10 ITAA 1997)
No discount is allowed where the trustee is assessed under s. 98(3), s. 98(4) or s. 99A ITAA 1936 (s. 115-220 and ss 115-222(3) and (4) ITAA 1997)</td></tr>
</table>

Trustee election

To alleviate the unfairness that can result where a beneficiary is taxed on a trust capital gain to which they are not specifically entitled, s. 115-230 ITAA 1997 authorises the trustee of a resident trust to choose to be assessed on a capital gain, provided the:

- Capital gain was taken into account in working out the net capital gain of the trust.
- Trust property representing all or part of that capital gain has not been paid to or applied for the benefit of a beneficiary by the end of two months after the end of the income year.
- Trustee makes this choice within two months after the last day of the income (or later day as allowed by the Commissioner) (s. 115-230(5) ITAA 1997).

Where the choice is made, the trustee is treated as specifically entitled to the capital gain and is assessed at penalty rates under s. 99A or, at the Commissioner's discretion, s. 99 ITAA 1936.

Trust franked dividends

Franked dividends flowing through a trust are taxed in the hands of the beneficiary (or trustee if no beneficiary is presently entitled), in accordance with the rules in Subdivision 207-B ITAA 1997.

Trustee level

Similar to calculating the CGT, the starting point in calculating a trust's dividends is at the trustee level, prior to the allocation of the trust net income.

Where a franked dividend or franking credit is taken into account in the trust's net income calculation, the net income calculation at the trustee level is undertaken in the normal way. This means that:

- The franked dividend is assessable income of the trust (s. 44(1) ITAA 1936).
- The franking credit gross-up is also included in the trust's net income (ss 207-20 or 207-35 ITAA 1997).

Beneficiary level

Special rules apply to the franked dividend component when the dividend is distributed and taxed in the hands of the beneficiary (or trustee if no beneficiary is presently entitled).

Using a presently entitled beneficiary who is not under a legal disability as an example, these special rules are the result of the combined operation of:

- Division 6E ITAA 1936, which applies s. 97(1) ITAA 1936 on the assumption that the trust had no capital gains or franked dividends (ss 102UX(2)–(3) and 102UY ITAA 1936).
- Subdivision 207-B ITAA 1997, which determines how much of the franked dividend and associated franking credit flowing through the trust is assessable in the hands of the beneficiary (or trustee).

As noted previously, these provisions also enable a beneficiary to be made specifically entitled to a franked dividend flowing through a trust.

Calculation method

There are three steps in calculating a beneficiary's share of a franked dividend flowing through a trust:

Step 1: Determine the beneficiary's share of a franked distribution (s. 207-55 ITAA 1997).

The beneficiary's share of the franked distribution is the amount to which:

- the beneficiary is specifically entitled (s. 207-55(4)(a))
- no beneficiary is specifically entitled, multiplied by the beneficiary's share of the Division 6E income (s. 207-55(4)(b)).

Step 2: Calculate the beneficiary's share of the franked distribution as a percentage of the amount of the franked dividend (s. 207-37(1)(b) ITAA 1997).

Step 3: Multiply that fraction by the amount of the franked dividend included in the net income of the trust to determine the attributable franked dividend and share of franking credit (ss 207-37(1) and 207-57 ITAA 1997)

The steps are best explained through the following example.

Example – Franked dividends paid to a trust

Assume the following:

- All beneficiaries are presently entitled, resident individuals who are not under a legal disability.
- The trust deed enables streaming of franked dividends to specifically entitled beneficiaries and an FTE is in place.

In the 2019 income year, the Fisher Family Trust received $100,000 in rental income and a $70,000 fully franked dividend ($30,000 of franking credits attached). The trust incurred $20,000 in expenses relating to the rental income.

The trust deed does not define income and therefore franking credits do not form part of the trust income. As a result, the trust's:

- income is $150,000 (i.e. $100,000 – $20,000 + $70,000)
- net income is $180,000 (i.e. $100,000 – $20,000 + $70,000 + $30,000).

The trust has two beneficiaries, Ethan and Amelia. The trustee makes the following resolutions:

- Amelia is presently entitled to 60% of the income of the trust excluding dividends ($48,000).
- Ethan is specifically entitled to franked dividends of $70,000, and nothing else.

Upon distribution, the calculation is now split into the Division 6 ITAA 1936 component and the franked dividend component.

Division 6 ITAA 1936 component (calculated by applying the assumptions in Division 6E ITAA 1936)

The Division 6 component is calculated by excluding the franked dividend and attached franking credits; therefore, the trust's:

- Division 6E income is $80,000 ($100,000 – $20,000)
- Division 6E net income is also $80,000.

The only presently entitled beneficiary in respect of the Division 6 component is Amelia. She will include $48,000 (i.e. 60% of $80,000) in her assessable income under s. 97(1) ITAA 1936.

No beneficiary is presently entitled to the remaining $32,000 of the Division 6 component, and this will be assessed to the trustee under s. 99A or (if the Commissioner determines) s. 99 ITAA 1936.

The franked dividend component (calculated under Subdivision 207-B ITAA 1997)

The franked dividend component is $70,000 and is dealt with under Subdivision 207-B ITAA 1997.

Calculating the franked dividend (and attached franking credits) flowing to each beneficiary

1. Determine Ethan's share of the franked distribution:

   Ethan is specifically entitled to franked dividends of $70,000 (s. 207-55(4)(a) ITAA 1997).
2. Calculate Ethan's share as a percentage of the franked dividend:

   Ethan's share as a percentage of the franked dividend is 100% (s. 207-37(1)(b) ITAA 1997).
3. Determine the attributable franked dividend and share of franking credit:

   Multiply the amount of the trust's franked dividend, net of directly relevant expenses, by the percentage worked out in Step 2 (s. 207-37(1) ITAA 1997). As there are no expenses directly related to the franked dividend, the attributable franked distribution amount will be the same as each beneficiary's share of the franked distribution (calculated in Step 2). Ethan's attributable franked dividend is $70,000 × 100% = $70,000.

   Separately, multiply the amount of the franking credit attached to the dividend ($30,000) by the percentage worked out in Step 2 (s. 207-57 ITAA 1997). Ethan's share of the franking credit is $30,000 × 100% = $30,000.

Ethan's assessable income from the trust's franked dividend under Subdivision 207-B ITAA 1997 is $70,000 (attributable franked dividend) plus 30,000 (share of franking credit) (s. 207-35(4)(b) ITAA 1997).

Worked example 10.2: Net income assessed to beneficiaries

[Available online in myLearning]

CGT events relating to trusts

Non-assessable trust distributions – CGT event E4

Distributions from the *corpus* or capital of a trust estate are generally not assessable unless they represent amounts which would have been assessable to a resident taxpayer if they had been derived by a resident taxpayer (s. 99B(2)(a) ITAA 1936).

However, non-assessable distributions from fixed or unit trusts (where the unit or interest was acquired after 19 September 1985) may lead to either a cost base erosion or crystallisation of a capital gain to the beneficiary or unit holder under CGT event E4 (s. 104-70 ITAA 1997).

CGT event E4 erodes the beneficiary's (or unit-holder's) cost base and reduced cost base of the interest or unit by an amount equal to the non-assessable component of a distribution. If the cost base is eroded to $nil, CGT event E4 treats the non-assessable component as a capital gain.

For example, a beneficiary receives a distribution in cash from the ABC unit trust equal to their share of the income of the trust (i.e. the trust's accounting income). Assume that the amount is $100. However, the beneficiary includes in their taxable income their share of the net income of the trust (i.e. the trust's taxable income). Assume that amount is $80. The beneficiary's non-assessable component is therefore $100 – $80 = $20. The cost base of the beneficiary's units in the ABC unit trust will be reduced by $20 (subject to the exceptions discussed below).

Cost base erosion is most commonly encountered by investors in property unit trusts whose distributions include a 'tax deferred' component (e.g. an excess of accounting income over taxable income resulting from differences in the timing of when amounts are expensed for accounting purposes and are deductible for tax purposes).

Fortunately, not all types of non-assessable distributions erode cost base. Section 104-71 ITAA 1997 **disregards** any part of the payment that results from the distribution of:

- CGT 50% general discount.
- Small business 15-year exemption amount in accordance with s. 152-125 ITAA 1997.
- Non-assessable non-exempt (NANE) income (e.g. payments to CGT concession stakeholders of the CGT small business retirement exemption amount under s. 152-310 ITAA 1997).
- Early stage investor exemption amount in accordance with s. 360-50(4) ITAA 1997.

However, cost base **is eroded** where the non-assessable distribution results from the CGT small business 50% reduction amount under s. 152-205 ITAA 1997. See Unit 6 for further details.

The ATO accepts that the cost base reductions **do not** apply to discretionary trusts because a beneficiary is not considered to have the requisite interest in a discretionary trust (TD 2003/28).

Tax practitioners can help their clients plan around CGT event E4 by taking tax timing adjustments into account when making distributions (see example below).

Example – Trading trusts distribution policy

Where a fixed trust carries on a trading business, tax timing adjustments could arise in Year 1, which reverse in Year 2. For example, the provision for annual leave could reduce in Year 1, but increase in Year 2. CGT event E4 will apply on the Year 1 distribution (because accounting profit exceeds net income for tax purposes) and there is no corresponding reversal of CGT event E4 in respect of the distribution in Year 2 (when accounting profit is less than net income).

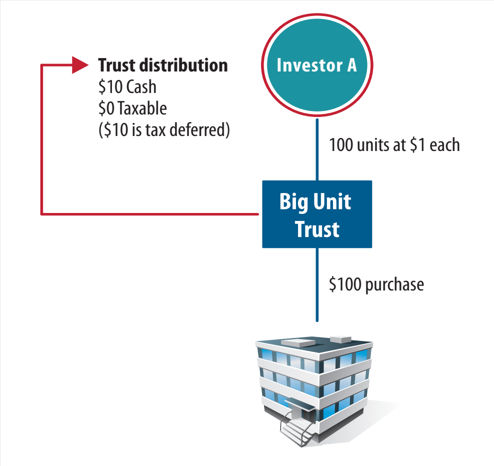
In these circumstances, and provided the trust deed allows it, the trustee may decide to set the Year 1 and Year 2 distributions at an amount equal to the net income for tax purposes (i.e. the trustee could hold back amounts), thus ensuring the beneficiaries do not suffer cost base erosion simply because of tax timing issues.

Anomalous outcomes

The application of CGT event E4 can cause double taxation. The following example is an advanced application of CGT event E4, which may benefit those working in taxation. It is provided only to illustrate the anomalies in the taxation law.

Example – CGT event E4: Double taxation issues

Investor A buys $100 worth of units in Big Unit Trust. The trust buys a building for $100.



The trust's income is $10, but its net income for tax purposes is $0 because of tax accounting differences relating to the Division 43 ITAA 1997 capital works deduction for buildings.

Income and expenses	Accounts $	Tax $
Rent	10	10
Capital works deduction	–	(10)
	10	0

Accordingly, a tax-free distribution (typically called a tax-deferred distribution in the distribution statement) of $10 is made by the trust to Investor A. CGT event E4 reduces Investor A's total cost base by the $10 tax-free amount (i.e. from $100 to $90).

The building is sold for $101. There is a book profit of $1. The trust's capital gain is $11 because the $10 capital works deduction reduces the cost base of the building from $100 to $90 (s. 110-45(4) ITAA 1997).

Because Investor A is presently entitled to the $1 book profit under the trust deed (see *FCT v. Bamford*), Investor A is assessable on the $11 capital gain (the first tax impost). After distributing the $1 book profit to Investor A, the trust is left with cash of $100, being the original subscription monies (i.e. $100 – $100 + $10 – $10 + $101 – $1 = $100).

Investor A winds up the trust and receives $100 back. Because Investor A's cost base of the units is only $90 (due to the cost base erosion under CGT event E4), Investor A has a capital gain of $10 (the second tax impost).

Therefore, tax has been imposed on total gains of $21, even though Investor A has only made an economic profit of $11 (being the $10 rent plus the $1 profit from the sale of the building).

This example shows how poorly constructed legislation can lead to anomalous results.

However, there is a possible solution to this problem. In the year the capital gain is made, the trust could distribute $11 (rather than $1). This would reduce the trust's net assets from $100 to $90. CGT event E4 would not apply to this distribution because the amount assessed to the unit holder would be equal to the accounting distribution. Investor A would not have a capital gain on winding up the trust because the capital proceeds of $90 (being the net assets of the trust) would equal the (reduced) cost base of the units of $90.

Establishment of trusts – CGT events A1, E1 and E2

Inter vivos trusts

An *inter vivos* trust is one created during the life of the creator or settlor. It may also continue to operate after their death. Such a trust is created by the transfer of title (to what is intended to be trust property) to a trustee to be held for the benefit of the beneficiaries of the trust.

The transfer of property to the trustee of an existing trust could attract two CGT events: CGT event A1 (s. 104-10 ITAA 1997) and CGT event E2 (s. 104-60 ITAA 1997). In *Healey v. FCT*, the court held that when a CGT asset is transferred to a trust, it is a CGT event E2 (s. 104-60 ITAA 1997) and not a CGT event A1 that applies. The issue is important because of the timing of the CGT event. CGT event E2 happens at the date of the transfer of an asset, whereas CGT event A1 happens at the date of the contract. The date of the transfer will usually be after the date of the contract (i.e. the date of settlement). This may affect access to concessions, such as the CGT discount provisions and the small business CGT concessions. The principle in *Healey v. FCT* would also appear to apply to any **purchase** of an asset by a trust (but not sales of assets). However, the ATO has stated that arm's-length sales would normally be assessable under CGT event A1 not E2. In other words, *Healey's* principle will be confined to transfers of assets to related trusts, rather than sales to third parties.

Alternatively, if a new trust is created in respect of a particular asset by declaration (i.e. by the owner of the asset declaring that from that time on the asset is held on trust), CGT event E1 will apply (s. 104-55 ITAA 1997). CGT event E1 is also relevant where a new trust is created by settlement. For the ATO's draft views on split trust arrangements see TD 2018/D3.

There are no general CGT rollovers enabling CGT assets owned by individuals to be moved into a trust without attracting CGT consequences. However, a gain or loss on an asset transferred to a special disability trust (SDT) is disregarded (s. 118-85 ITAA 1997). An SDT is a trust established for persons in necessitous circumstances, in accordance with the *Social Security Act 1991* or the *Veterans' Entitlements Act 1986*. Also, a taxpayer that operates a small business may be able to rollover their active business assets to a trust (see Unit 6).

Testamentary trusts

When a person dies, title to the assets owned by that person passes to that person's legal personal representative or executor. The executor is responsible for settling the deceased's debts and distributing the residue of the estate, if any, in accordance with the deceased's will. Division 128 ITAA 1997 explains the CGT implications for the deceased, the executor and the ultimate beneficiaries. The application of the CGT rules to deceased estates is discussed in Unit 4.

It is important to note that trusts are often created by the operation of the deceased's will. These so-called 'testamentary trusts' typically provide for the care and maintenance of the deceased's spouse and children.

In some cases, the will creates a trust under which a 'life tenant' (e.g. the deceased's widow) enjoys all the income of the trust, with the capital (or corpus) of the trust passing to the deceased's children or other beneficiaries once the life tenant dies. A life tenant presently entitled to all of the income of the trust should be assessed under s. 97 ITAA 1936 on the entire net income of the trust (including the capital gains). This is the case even though the life tenant cannot benefit from those capital gains.

However, s. 115-230 ITAA 1997 avoids this unfair outcome by allowing the trustee to choose to be assessed on the share of the trust's net income attributable to capital gains if a beneficiary who would otherwise be assessed under s. 97 ITAA 1936 on that share of the net income does not have a vested and indefeasible interest in the trust property representing that share, nor has had such property paid or applied for their benefit. The trustee must choose to be assessed no later than two months after the last day of the relevant income year or such later day as the Commissioner allows.

Absolute entitlement to trust assets – CGT event E5

Where a beneficiary becomes absolutely entitled to a CGT asset of a trust, CGT event E5 occurs (s. 104-75 ITAA 1997). A beneficiary is absolutely entitled if they have a 'vested and indefeasible' interest in the entire trust asset (i.e. the beneficiary can direct the trustee to transfer the asset to them or to someone else).

When CGT event E5 happens:

- The trustee makes a capital gain if the market value of the asset at the time exceeds its cost base (s. 104-75(3) ITAA 1997). Conversely, a capital loss arises if the market value is less than the asset's reduced cost base.
- The beneficiary makes a capital gain if the market value of the asset at the time exceeds the cost base of the beneficiary's interest in the trust capital to the extent it relates to the asset (s. 104-75(5) ITAA 1997). Conversely, a capital loss arises if the market value is less than the reduced cost base of that interest. Note that CGT event E5 is disregarded where the beneficiary acquired the interest in the trust capital (other than by way of assignment from another entity) for no consideration (s. 104-75(6)(a) ITAA 1997). This means that CGT event E5 would generally not apply to:
  - A mere object (i.e. potential beneficiary) in a discretionary trust.
  - A beneficiary who becomes absolutely entitled to an asset that a deceased person owned at the time of their death (TD 2004/3).

Once absolutely entitled, the beneficiary is taken to own the asset directly. Any actions taken by the trustee in relation to the asset are taken to have been done by the beneficiary directly (s. 106-50 ITAA 1997). This means that if a CGT event happens in relation to the asset, the beneficiary (not the trustee) is responsible for any resulting capital gain or loss, and the gain or loss will go directly to the beneficiary, rather than forming part of the trust's net income.

For further ATO guidance on the consequences of a trust vesting see TR 2018/6.

Example – CGT event E5: Beneficiary becomes absolutely entitled

Paul has established a fixed trust for his sole grandchild, Tabitha, who is currently six years old. The trust has invested in blue chip shares listed on the ASX.

Under the terms of the trust deed, Tabitha will have a vested and indefeasible interest in the trust's assets when she turns 21 years of age. The default beneficiary in the event that Tabitha dies prematurely is the St Vincent de Paul Society.

Until the trust vests, dividend income generated from the trust's share portfolio is applied for Tabitha's benefit (e.g. payment of school fees) and the trustee pays tax on the trust's net income under s. 98(1) until Tabitha turns 18.

On her 21st birthday, Tabitha will become absolutely entitled to the trust's assets and Tabitha (not the trustee) will be the relevant taxpayer if the shares are sold, even if Tabitha never obtains legal title to the shares (s. 106-50 ITAA 1997).

CGT event E5 will trigger a capital gain or loss for the trustee when Tabitha becomes absolutely entitled (ss 104-75(1) and (2) ITAA 1997). There will be no CGT event E5 ramifications for Tabitha regarding her interest in the trust because she acquired her interest for no consideration (ss 104-75(5) and (6)(a) ITAA 1997).

Disposal of CGT asset to a beneficiary – CGT event E6

CGT events also occur where a trustee disposes of CGT assets held by the trust (other than a testamentary trust) to a beneficiary in satisfaction of the beneficiary's:

- right to receive ordinary or statutory income from a trust – CGT event E6, s. 104-80 ITAA 1997
- interest in trust capital – CGT event E7, s. 104-85 ITAA 1997.

For both events, a gain or loss can also arise in respect of the beneficiary's disposal of the right to income or capital in the trust.

Anti-avoidance provisions

Trust losses

A tax loss made by a trust is trapped in the trust – it cannot be distributed to beneficiaries, nor are the beneficiaries treated as having carried on the loss-making activity themselves (*Doherty v. FCT*).

To deduct the tax loss in a future income year (or claim current year tax losses or bad debt deductions), the trust must satisfy various tests in Schedule 2F ITAA 1936 (Schedule 2F) that are tailored to the specific type of trust concerned.

In broad terms, the policy objective in Schedule 2F is to counter trafficking in tax loss trusts, or the transfer of tax benefits by injecting income into tax loss trusts. Note that Schedule 2F does not apply to carry forward or current year CGT losses in a trust: see definition of 'tax loss' in Schedule 2F s. 272-140(1).

Example – Trafficking in trusts with carry forward tax losses

The Bad Luck Trust is a fixed trust (not widely held), which formerly carried on a business that proved to be unprofitable. It ceased business but has $100,000 in carry forward tax losses.

The beneficiaries of the trust agree to an offer from Cash Cow Pty Ltd to transfer their interests in the trust for $10,000.

Once Cash Cow Pty Ltd holds all the interests in the trust, it injects substantial amounts of cash into the trust, which generates assessable interest income. The trust's carry forward losses are claimed against the trust's interest income, thus sheltering the income from tax.

Schedule 2F counters such arrangements by applying the following two tests to this type of trust (also see discussion below):

- A 50% stake test (similar to the continuity of ownership test (COT) applicable to companies).
- An income injection test.

Trust categories

The trust loss measures apply various loss-recoupment tests which differ depending on the type of trust. Therefore, the first step in applying the measures is to categorise the trust.

There are three main categories of trusts under the trust loss measures:

- Excepted trusts.
- Fixed trusts.
- Non-fixed trusts.

Excepted trusts

Excepted trusts are defined in Schedule F s. 272-100 and fall into two sub-categories:

- Trusts that are entirely exempt from the tests, such as:
  - Complying superannuation funds.
  - Deceased estates within the first five years of administration.
- Trusts that have elected to be 'family trusts'.

Fixed trusts

A fixed trust is a trust in which beneficiaries have fixed entitlements to all of the income or capital of the trust (Schedule 2F s. 272-65). The concept of 'fixed entitlement' is dealt with in detail in Subdivision 272-A Schedule 2F. At its broadest, a fixed entitlement to income or capital exists (Schedule 2F s. 272-5(1)):

> [if], under a trust instrument, a beneficiary has a vested and indefeasible interest in a share of income of the trust that the trust derives from time to time, or of the capital of the trust ...

The term 'vested and indefeasible interest' is also used in s. 95A(2) ITAA 1936. Ordinarily, 'vested and indefeasible' requires that the:

- Interest actually exists.
- Amount or value of the interest is ascertainable.
- Interest must not be able to be taken away, even if the beneficiary cannot exact immediate payment or transfer.

The ATO has issued guidance in PCG 2016/16 on when it will treat a trust as being a 'fixed trust' under the trust loss rules. The guidance does not change existing law. However, it introduces an administrative safe harbour for certain kinds of trust. This will reduce the administrative burden of qualifying trusts by allowing them to carry on their tax affairs as if the Commissioner had exercised a discretion in their favour.

Non-fixed trusts

A non-fixed trust is simply a trust that is not a fixed trust (Schedule F s. 272-70). Accordingly, non-fixed trusts would include:

- A discretionary trust.
- A hybrid trust (i.e. a trust with both fixed and non-fixed elements).

Loss recoupment tests

As mentioned above, to deduct a tax loss in a future income year (or claim current year tax losses or bad debt deductions), a trust must satisfy various tests. The table below summarises the main tests that apply to each category of trust. There are also 'abnormal trading' rules for unit trusts (Schedule 2F Subdivision 269-B). These rules are outside the scope of the TAXAU module.

Tests that apply to each type of trust to determine deductibility of a loss or debt					
Trust	**Test**				
	Continuity of more than 50% stake[1]	**Same business test**[2]	**Change in pattern of distributions**[3]	**Change in control**[4]	**Income injected into trust**[5]
Fixed trusts					
Unlisted widely held	Yes	–	–	–	Yes
Listed widely held	Yes	Yes[7]	–	–	Yes
Unlisted very widely held	Yes	–	–	–	Yes
Other fixed trusts	Yes[6]	–	–	–	Yes
Non-fixed trusts					
Non-fixed trust	Yes		Yes[8]	Yes	Yes
Excepted trusts					
Family trust	–	–	–	–	Yes[9]
Excepted trust (other than a family trust)	–	–	–	–	–

Notes

1. Schedule 2F Subdivision 269-C.
2. Schedule 2F Subdivision 269-F.
3. Schedule 2F Subdivision 269-D.
4. Schedule 2F Subdivision 269-E.
5. Schedule 2F Subdivision 270.
6. An alternative test is available in certain cases where non-fixed trusts hold (directly or indirectly) fixed entitlements in the fixed trust.
7. This test is applied where the 50% stake test is failed.
8. This test does not apply for current year loss purposes.
9. The income injection test does not apply where individuals and entities within a family group inject income.

The test period

The tests must generally be satisfied at all times during the test period. The relevant test periods are as follows:

- For a prior year loss (fixed and non-fixed trusts) – the income year in which the loss was incurred, the income year being examined, and all intervening years (if any).
- For a current year loss (fixed and non-fixed trusts) – the income year being examined.
- For debt deductions (fixed and non-fixed trusts) – if the debt is incurred in an income year before the deduction arose, the test period runs from the day the debt is incurred to the end of the income year in which the deduction is available; otherwise, the test period is the income year.

Income injection test

The income injection test applies to most types of trusts. Broadly speaking, it applies where, in connection with a scheme:

- The trust derives assessable income.
- An 'outsider' to the trust provides an economic benefit to: the trustee, a beneficiary of the trust, or an associate of the trustee or beneficiary.
- The trustee, beneficiary or associate provides, directly or indirectly, a benefit to the outsider.
- It is reasonable to conclude the scheme was undertaken because of the deductions available to the loss trust.

Family trusts

A trustee of a trust can choose to make a family trust election (FTE). Making an FTE, can both:

- Enable the trust to enjoy various tax concessions.
- Result in sanctions if future trust distributions are made to beneficiaries who do not form part of the family group (or their entities).

Tax concessions

The table below sets out the scenarios in which the making of an FTE should be considered. It also summarises the benefits of making an FTE and gives a brief explanation of the relevant tax policy and legislative references. The table applies to a discretionary trust, but note that an FTE can be made by other types of trusts.

Scenario	Benefits of making an FTE	Policy, legislation and guidelines
Trust has carry forward tax losses, current year tax losses or bad debt deductions	Trust only needs to satisfy the income injection test in order to claim deductions Income injected by family group members (or their entities) is ignored	Family group (or its entities) reflects continuity of 'economic ownership' of losses • Schedule 2F s. 270-25 ITAA 1936
Trust's income includes franked dividends	Trust satisfies the '45-day holding period rule' (90-day rule for preference shares) and is a 'qualified person' This facilitates the flow-through of franking credits to the trustee and beneficiaries	Family group (or their entities) identifies persons who, in an economic sense, are considered to hold the trust's shares at risk for the purposes of calculating whether the 45-day (or 90-day) holding period is satisfied • Sections 207-145 and 207-150 ITAA 1997 • Definition of 'qualified person' in former Part IIIAA Division 1A ITAA 1936 • TD 2007/11
Trust has a stake in a company that has tax losses or bad debt deductions	Family trust is treated as a 'person' that holds the shares in the company for the purposes of applying the COT. Otherwise, cannot trace ownership through discretionary trust	Family group (or its entities) identifies persons who, in an economic sense, are considered to hold the company's shares. No need to trace ownership through family trust for COT purposes • Section 165-207 ITAA 1997
Trust is a closely held trust	Family trusts are excluded from the trustee beneficiary reporting rules in Division 6D ITAA 1936 However, family trusts are not immune from the need to obtain tax file number (TFN) details from beneficiaries	Family group indicates the potential beneficiaries and obviates the need for reporting • Sections 102UC(1) and (4) ITAA 1936

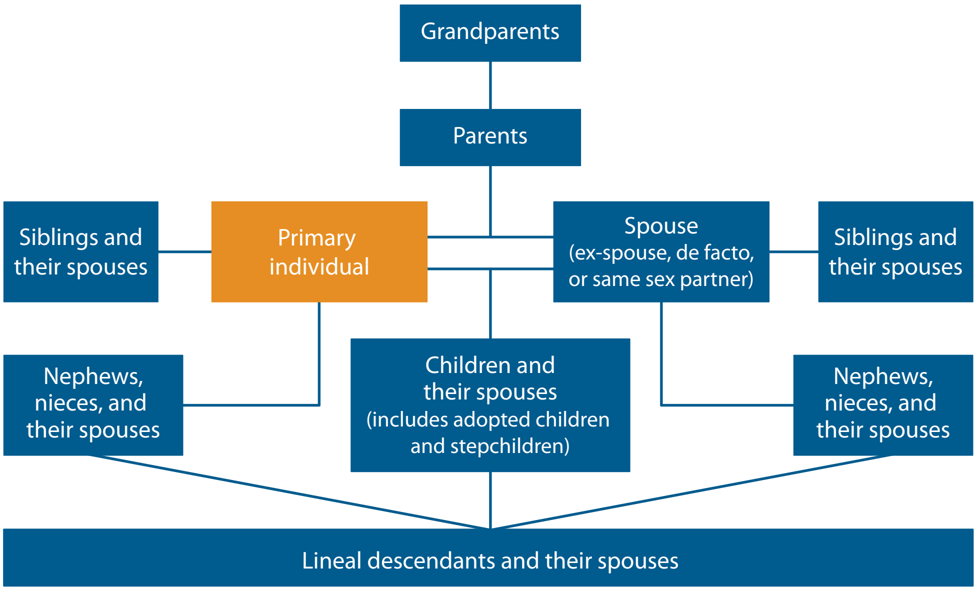
Sanctions

An FTE is effectively an undertaking to the ATO that, henceforth, the family trust will make distributions only to family group members (or their entities). A family trust distribution tax (FTDT) is payable where the income or capital of a family trust is distributed to persons or entities outside this boundary: Schedule 2F Division 271 ITAA 1936 and the *Family Trust Distribution Tax (Primary Liability) Act 1998*. FTDT is imposed on the trustee who made the FTE, at a tax rate of 47%.

Family trust election

A trust becomes a family trust by making an FTE under s. 272-80 of Schedule 2F ITAA 1936, using the relevant ATO notification form.

When making an FTE, the trust must nominate an individual (the primary individual) whose family group is the subject of the election. The definitions of 'family group' and 'family' are set out in ss 272-90 and 272-95 of Schedule 2F ITAA 1936, respectively. The individual members of a family group are illustrated in the diagram below. Note that the family is identified by reference to the primary individual.



The family remains defined even if the test individual dies (Schedule 2F s. 272-95 ITAA 1936).

The family group, together with any interposed entities and professional or legal advisors, is relevant in determining whether the family effectively controls the trust: refer family control test in Schedule 2F s. 272-87 ITAA 1936.

A trust can only have one family trust election in force at a time.

An FTE can be revoked or varied, but only in limited circumstances.

Interposed entities

Companies, trusts and partnerships associated with the family members that provide fixed entitlements to income or capital automatically form part of the family group (Schedule 2F s. 272-90(5) ITAA 1936.

Where no such fixed entitlements exist, these entities form part of the family group only if identified in an interposed entity election made under Schedule 2F s. 272-85 ITAA 1936.

Closely held trusts

Under s. 102UC ITAA 1936, a closely held trust is a trust in which up to 20 individuals have (between them, directly or indirectly) fixed entitlements to 75% or more of the income or capital of the trust, or a discretionary trust, except where that trust is an excluded trust.

An excluded trust includes a complying superannuation fund, a deceased estate (with a five-year limit), an ASX-listed unit trust, and a trust or interposed entity that has made a family trust election.

Where a share of the net income of a closely held trust is included under s. 97 ITAA 1936 in the assessable income of a trustee beneficiary, Division 6D ITAA 1936 may require the trustee of the closely held trust to provide the Commissioner with a trustee beneficiary statement (TB statement) containing the following information:

- If the trustee beneficiary is a resident – the name, TFN and details of any untaxed or tax preferred component of the distribution.
- If the trustee beneficiary is a non-resident – the name, address and details of any untaxed or tax preferred component of the distribution.

The trustee of the closely held trust is liable for 'trust beneficiary non-disclosure tax' at a rate of 47% on the untaxed part of the distribution (ss 102UA – 102UV ITAA 1936) where:

- The trustee fails to provide a correct TB statement (*Taxation (Trustee Beneficiary Non-disclosure Tax) Act (No 1) 2007*).
- That distribution returns to the trust as a circular distribution (*Taxation (Trustee Beneficiary Non-disclosure Tax) Act (No 2) 2007*).

The untaxed part is the share of the net income on which tax has not been paid (i.e. it does not include that part of the net income on which the trustee has already paid tax under s. 98 ITAA 1936).

Note: From 1 July 2019 within the TB statement and circular trust distribution provisions the definition of an excluded trust has been removed and replacement exclusions have been introduced. Under the changes a family trust is excluded from the application of the TB statement provisions. However, it is not excluded from the application of the circular trust distribution provisions. Therefore, trustee beneficiary non-disclosure tax will apply to the untaxed part of a circular distribution to which the trustee of the trust, including a family trust, becomes presently entitled.

Tax file number reporting obligations

Resident closely held trusts may be under an obligation to withhold tax at 47% from distributions of ordinary and statutory income (or present entitlements) where a resident beneficiary fails to quote their TFN (ss 102UU – 102UV ITAA 1936; Schedule 1 ss 12-175 – 12-185 TAA 1953; rr. 38C and 38D Tax Administration Regulations 1976*)*.

Exempt bodies and beneficiaries under a legal disability are excluded from the TFN requirements.

The various categories of trusts excluded from TB statement obligations are also excluded from closely held trust TFN reporting obligations, with the notable exception of a trust that has made a FTE. The trustee of a family trust should therefore obtain TFNs from all potential beneficiaries within the family group.

Tax planning with trusts

The tax planning advantages of trusts have been alluded to throughout this unit.

Depending on the type of trust and the terms of the trust deed and assuming that relevant anti-avoidance rules do not apply, these advantages include:

- Income-splitting between beneficiaries on differing tax rates.
- Ability to stream capital gains and franked dividends.
- Ability to distribute tax deferred amounts that arise because the trust's accounting income exceeds net (i.e. taxable) income.

Trusts cannot stream other types of income to select beneficiaries (e.g. rent, interest, royalties, etc.). If such streaming is desirable, it would be advisable to set up multiple trusts (i.e. each trust deals with a different type of income).

Tax practitioners also maximise these tax advantages by using trusts in tandem with other structures.

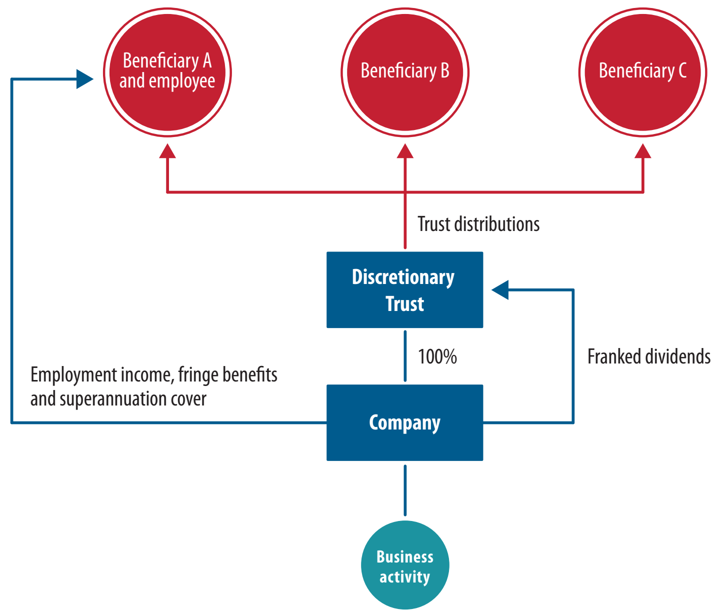
The following are three examples of such structuring:

- Business ownership structure.
- Professional practice structure.
- Stapled stock structure.

Business ownership structure

The use of a trust to hold shares in a business operating via a company provides a mechanism for franked dividends paid by the company to be streamed to specifically entitled beneficiaries, some of whom may also be employed by the company and provided with employment income, fringe benefits and superannuation cover.

The diagram below illustrates this type of business ownership structure.



Note: In practice, this structure may result in the dividends being stripped of their franking credits because a family trust election may not be able to be made (if different families are involved) and therefore the 45-day rule will apply. In addition, if a trust distribution is paid in lieu of salary, the ATO may argue that the alienation is ineffective at law (refer IT 2330 and IT 2403) and tax the employee on the salary. Alternatively, if the trust distribution is validly given to an associate of the employee (or the employee), an FBT liability could arise.

Professional practice structure

A professional practice structure typically uses a service trust to provide staff and equipment to a partnership providing legal, accounting or other types of professional services. The service trust charges the partnership a fee, which includes a profit component (sometimes called a 'mark-up'), which is within parameters set by the Commissioner in TR 2006/2 and associated ATO guidelines.

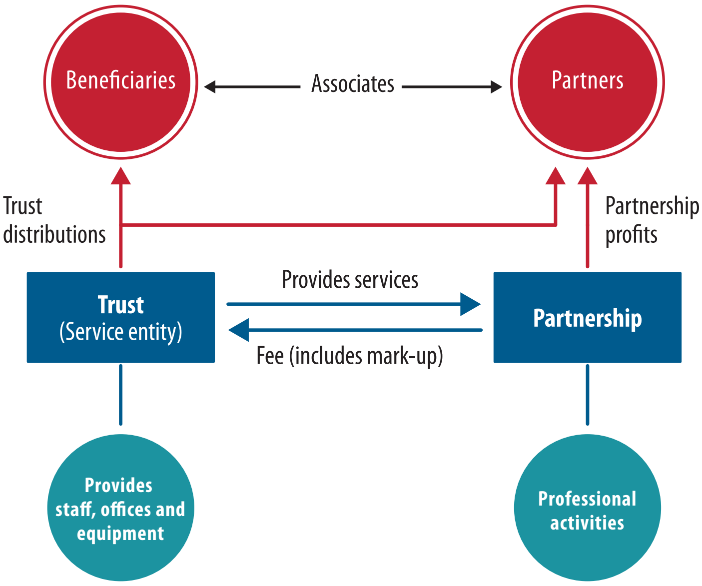
In a professional practice structure:

- A s. 8-1 ITAA 1997 deduction can be claimed for the fee in the calculation of the partnership's net income (refer to Unit 9).
- The trust has net income (e.g. taxable income after payment of staff salaries, equipment lease rentals) to distribute to presently entitled beneficiaries, who are typically associates of the partners, or to the partners themselves.

It was accepted in *FCT v. Phillips* that the service trust structure was motivated by commercial considerations to protect the partners' assets. Such structures are therefore often referred to as 'Phillips service trust' structures.

Note that the service entity can be a company instead of a trust.

A typical professional practice structure is illustrated below.



Stapled structure

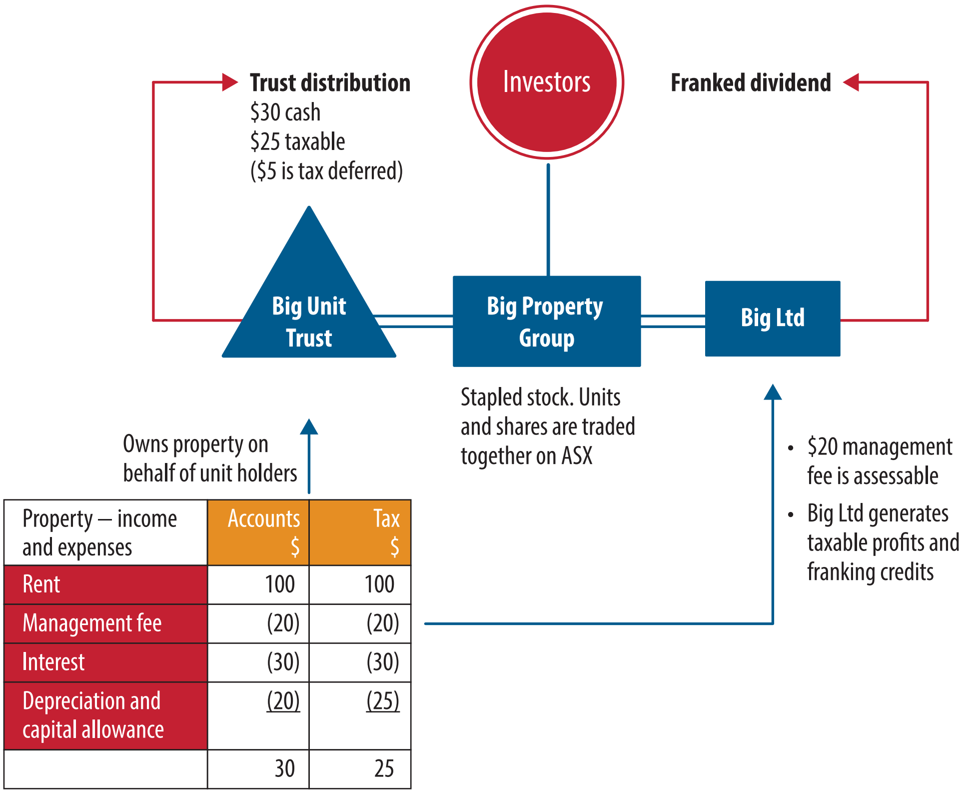
A stapled structure is used to provide investors with the dual benefits that flow from investing in a company and a unit or fixed trust, namely:

- Franked dividends from the company (resulting from taxed profits generated by the provision of management and other services to the trust).
- Tax deferred distributions from the trust that holds the income-producing asset (e.g. the building or toll road that generates accounting income in excess of net income for tax purposes), although this triggers erosion of the CGT cost base under CGT event E4.

Stapled structures are most commonly associated with the property and infrastructure sectors.

The reference to 'stapling' arises because the investor's interest in the trust cannot be traded separately from their share in the company.

The diagram below illustrates a stapled structure.



Property – income and expenses	Accounts $	Tax $
Rent	100	100
Management fee	(20)	(20)
Interest	(30)	(30)
Depreciation and capital allowance	(20)	(25)
	30	25

Trusts treated as companies for tax purposes

The taxation of trusts differs considerably from the taxation of companies. Anti-avoidance legislation treats certain types of trusts as if they were companies for tax purposes. Where these deemed company rules apply the trustee is taxed at the company tax rate, distributions are treated as dividends that can be franked, and trust income and gains do not retain their tax character as they flow through the trust.

Trusts that are treated as companies include public trading trusts (Part III Division 6C ITAA 1936). In broad terms, this treatment applies if the unit trust is widely held, is resident in Australia and carries on a trading business or is controlled by someone who does.

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 11: Superannuation funds

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Explain what is a complying and non-complying superannuation fund.
2. Explain and calculate the tax concessions for superannuation contributions.
3. Explain and calculate the taxable income and tax payable of complying superannuation funds.
4. Identify the tax payable on the payment of superannuation benefits.

Introduction

The aim of superannuation is to encourage individual taxpayers to save for their retirement during their working lives. Employers are required to make superannuation contributions for most employees. Individual taxpayers (including, but not limited to, self-employed taxpayers) may also make personal contributions to their superannuation.

Superannuation funds receive contributions and invest them on behalf of their members. Thus, superannuation funds are a type of trust (see Unit 10). However, the taxation of superannuation funds differs significantly from other types of trusts.

Unlike most other trusts, a superannuation fund is a taxpayer in its own right and many of the general taxation provisions apply to determine its taxable income. However, the general provisions are sometimes modified to fit the unique nature of superannuation funds.

This unit examines the key tax requirements of the three stages of superannuation taxation:

Stage 1 – Contributions (i.e. taxation of contributions by individuals and employers).

Stage 2 – Investment (i.e. taxation of superannuation funds).

Stage 3 – Benefits (i.e. taxation of superannuation benefits paid to individuals on retirement).

Not covered in this unit

This unit focuses on complying superannuation funds. It does not cover:

- Retirement savings accounts (RSAs), which are offered by banks and other financial institutions as a low-cost alternative to superannuation (e.g. for seasonal workers).
- Approved deposit funds (ADFs), which are funds that receive, hold and invest funds that are typically ‘rolled over’ from superannuation funds until such funds are withdrawn or satisfy a release condition.
- Pooled superannuation trusts (PSTs), which are trusts in which regulated superannuation funds, ADFs and other PSTs invest, to gain access to investment expertise or specific asset classes or markets.
- Public sector superannuation schemes and defined benefit funds.
- Non-complying or non-regulated funds that have chosen not to be regulated by the Australian Prudential Regulation Authority (APRA) or the Australian Taxation Office (ATO). For example, a foreign superannuation fund cannot be a complying fund – therefore, such funds are outside the scope of the TAXAU module.

Superannuation funds are highly regulated by the Government. These regulations are outside the scope of the TAXAU module.

Notes:

- The income year end covered in the TAXAU module is 30 June 2019. Therefore, the amendments to the superannuation provisions that have yet to be finalised or are applicable from 1 July 2019 are outside the scope of the module.
- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Superannuation fund tax principles

Defining a superannuation fund

Division 295 deals with the taxation of superannuation funds. It draws a distinction between complying funds and non-complying funds. The definitions are summarised below.

Complying funds versus non-complying funds	
Complying fund	**Non-complying fund**
A large superannuation fund that has received a notice from APRA that the fund is complying (s. 995-1 ITAA 1997 and s. 45 SISA 1993) A self-managed superannuation fund (SMSF) that passes the compliance test (i.e. does not breach the SISA regulatory provisions or the ATO has provided a notice of compliance) (s. 42A SISA 1993) To be an SMSF, the fund must have fewer than five members and all members must be a trustee of the fund	A superannuation fund that is not a complying superannuation fund (s. 995-1)

Note: The Government has proposed to increase the member limit of an SMSF from four to six. However, one of the practical impediments to this proposal is that, under most state tax Acts, the maximum number of individual trustees of a trust is four.

Key features and tax attributes

Some of the key features and tax attributes of a complying superannuation fund are summarised below.

Key features and tax attributes	
	How the issue relates to superannuation funds
Taxpayer	A superannuation fund is a taxpayer
Tax rate	Complying superannuation fund: • Standard rate – 15% • Non-arm's-length income – 45% • No-Tax File Number (TFN) contributions income – 47% Non-complying superannuation fund: • Standard rate – 45%
Tax losses	Losses are allocated to each member's interest
Capital gains tax (CGT)	CGT general discount of one third (⅓) applies to capital gains where the conditions in Division 115 are satisfied Special CGT rules apply (see later in this unit)
Franking tax offsets	A superannuation fund grosses-up its assessable income for franking credits and is entitled to an offset. Excess franking tax offsets are refundable (see Unit 8)

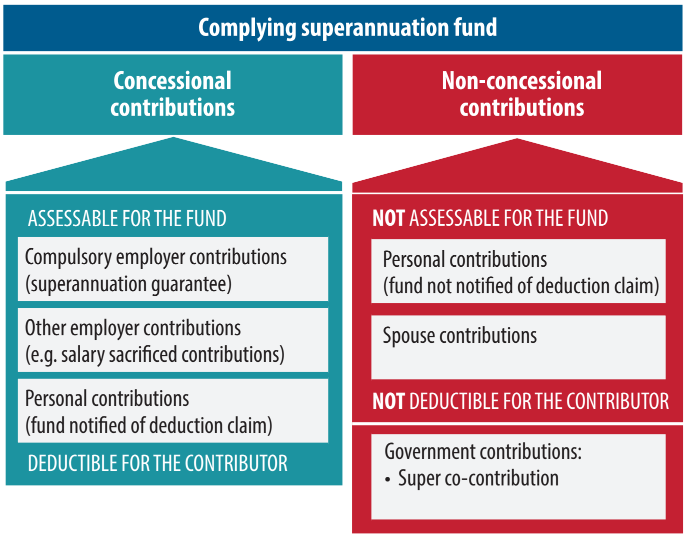
Superannuation contributions

Overview

There are a number of tax concessions available when contributions are made (i.e. by an employer or an individual).

Assessability and deductibility

Contributions to a complying superannuation fund are commonly classified as either concessional or non-concessional contributions; however, there are other types of contributions. The taxation treatment for concessional and non-concessional contributions is illustrated by the diagram below.



Contribution caps

There are caps on the amounts of concessional and non-concessional contributions that can be contributed to a complying superannuation fund. The caps do not impact the deductibility or non-deductibility of the contributions. Contributions that exceed these caps attract an excess contributions tax, which is imposed on the individual for whom the contribution was made.

Downsizer contributions

From 1 July 2018, an individual aged 65 or over may choose to make a downsizer contribution of up to $300,000 from the proceeds of selling a dwelling that was owned for 10 years or more and (in whole or in part) qualifies for the main residence exemption (see Unit 4). The downsizer contribution is not a non-concessional contribution, does not count towards the individual's contribution caps, and is not tax deductible. However, the downsizer contribution will form part of the individual's tax-free component held in the superannuation fund.

For ATO guidance on the downsizer contributions, see LCR 2018/9 and GN 2018/2.

Concessional contributions

Concessional superannuation contributions are generally **assessable income** for the superannuation fund and an **allowable deduction** for the contributor.

Inclusions

Concessional contributions **comprise**:

- Employer contributions (s. 290-60), including:
  - Compulsory employer contributions (under the *Superannuation Guarantee (Administration) Act 1992* (SGAA 1992)).
  - Other employer contributions, which are typically made pursuant to an effective salary sacrifice arrangement (see TR 2001/10 and Unit 3).
- Personal contributions by an individual that are claimed as a tax deduction (s. 290-150).

Contributions can be made in cash or 'in specie' (e.g. in a form other than cash, such as property, shares, etc.). Note, however, that a superannuation fund is prohibited from acquiring an asset from related parties, with limited exceptions.

Deductibility conditions

The **key conditions** that must be satisfied for concessional contributions to be **deductible** in an income year are as follows:

- The contribution must be made to a **complying superannuation fund** (ss 290-75 and 290-155).
- The contribution must be **actually made** (i.e. paid to and received by the superannuation fund) (ss 290-60 and 290-150) and not accrued.

  Note: TR 2010/1 states that if an electronic funds transfer is made to a superannuation fund on 30 June, it will not be deductible until the following month because the funds would not be credited by the superannuation fund until the following day.
- The employee or individual contributor must generally be **less than 75 years old** (ss 290-80 and 290-165).
- For an employer contribution:
  - The employee must satisfy the **employment activity** conditions (s. 290-70).
  - The employer must make compulsory contributions **within the timeframes specified** under the law. If this does not happen, a superannuation guarantee charge (SGC) is levied on the employer under the SGCA 1992. Effectively, the SCG is equal to the contributions the employer should have made plus penalties and interest. The **SGC is not deductible** to the employer (s. 26-95 ITAA 1997).
- For a personal contribution:
  - An individual contributor must **notify the superannuation fund** that a deduction is being claimed and have received an acknowledgment from the superannuation fund (s. 290-170). The deduction is limited to the amount stated in the notice (s. 290-175).
  - An individual, who is under 55 years old, cannot deduct a contribution to the extent it is attributable to a capital gain that is disregarded under the CGT small business retirement concession in s. 152-305 (see Unit 6).
  - An individual cannot create or increase a tax loss by making personal superannuation contributions (s. 26-55) (see Unit 1).

The income tax law places very few restrictions on the amount that can be claimed as a deduction for a superannuation contribution. However, it should be noted that:

- The personal services income (PSI) rules may deny or limit the deduction (see Unit 7).
- An effective limit is placed on both concessional (i.e. deductible) and non-concessional (i.e. non-deductible) superannuation contributions by the operation of caps (see below).

Example – Employer contributions

On 30 June 2019, an Australian employer prepays employee superannuation contributions of $20,000 for the three-month period ended 30 September 2019. Under s. 290-60, the employer can claim an income tax deduction for the full amount of superannuation contributions actually paid, that is $20,000, in the income year ended 30 June 2019. The prepayment rules discussed in Unit 1 do not apply because the deduction for superannuation contributions is made under s. 290-60, and not s. 8-1.

Conversely, on 30 June 2019 an Australian employer raises an accrual of $20,000 for employee superannuation contributions for the three-month period ended 30 June 2019 that is not paid until 28 July 2019. Under s. 290-60, the employer is not entitled to an income tax deduction for the $20,000 accrued superannuation contributions in the income year ended 30 June 2019 because no payment is made to, and received by, the superannuation fund. The employer will be able entitled to an income tax deduction in the subsequent income year when the superannuation contributions are actually paid (i.e. the income year ended 30 June 2020).

Required reading

Sections 290-60, 290-150 and 26-55.

Concessional contributions cap

The concessional contributions cap for the 2018–2019 income year (irrespective of age) is **$25,000** (unchanged for the 2019–2020 income year). The cap is indexed each year in line with average weekly ordinary time earnings (AWOTE) in increments of $2,500 (rounded down).

Under a **'carry-forward option',** from 1 July 2018, individuals with a superannuation balance of less than $500,000 at the end of the previous income year, will be able to carry forward for five years (on a rolling basis) any unused portion of their concessional contributions cap and make additional concessional contributions for any unused amounts.

Consequences of breaching (excess concessional contributions)

While the operation of the contribution cap may effectively limit the amount an individual contributes to superannuation, the cap does not limit the actual deduction for an employer or individual contributor.

A concessional contribution in excess of the cap is taxed in the hands of the individual for whom the contribution is made at the individual's marginal tax rate. The individual is also required to pay an excess concessional contributions (ECC) charge. The ECC charge is applied to the additional income tax liability arising as a result of their having excess concessional contributions. The intent of the charge is to acknowledge that the tax is collected by the ATO later than it otherwise would have been.

The tax on excess contributions that is paid by the individual is in addition to the 15% contributions tax paid by the superannuation fund. However, the individual is entitled to a non-refundable tax offset equal to the 15% contributions tax paid by the superannuation fund. The individual has the choice of paying the excess contributions tax personally or through their superannuation fund.

Any concessional contributions in excess of the cap **will also count towards the individual's non-concessional contributions cap** (see below).

Excess contributions tax can be alleviated in limited circumstances by allowing individuals to ask the Commissioner to determine that the cap was exceeded due to special circumstances. In this case, the excess may be disregarded or reallocated to another income year (s. 292-465).

Non-concessional contributions

Non-concessional superannuation contributions are **not assessable income** for the superannuation fund and are **not an allowable deduction** for the contributor.

For those with the surplus cash, making non-concessional contributions may be attractive because the earnings on the contributions are taxed in the complying superannuation fund at the 15% rate (rather than at the individual taxpayer's marginal tax rate).

Inclusions

Non-concessional contributions **comprise**:

- Personal contributions for which an income tax deduction has not been claimed (e.g. where the superannuation fund has not been notified, contributions on behalf of a spouse, etc).
- Government contributions (e.g. super co-contribution and low income super contribution).

In addition to the above non-concessional contributions, the following are **also included** when applying the non-concessional contributions cap:

- Concessional contributions in **excess** of the concessional contributions cap.
- Contributions to superannuation under the small business entity CGT concessions (see Unit 6) in **excess** of the CGT contributions cap. Contributions up to the CGT contributions cap are excluded.

Non-concessional contributions cap

General rules

The non-concessional contributions cap is:

- For the 2018–2019 income year **generally $100,000** (unchanged for the 2019–2020 income year). The cap is indexed each year in line with the concessional contributions cap.
- **$nil for persons with a total super balance** greater than or equal to the general transfer cap at the end of the previous income year. The general transfer cap for the 2018–2019 income year is **$1.6 million** (unchanged for the 2019–2020 income year).

Under a **'bring-forward option'**, persons aged **under 65** (on one day during the year in which this option is triggered) are able to make non-concessional contributions as follows:

- Where the person's total super balance at the end of the previous income year is $1.4 million to less than $1.5 million: up to twice the cap (i.e. $200,000) and over a period of two years.
- Where the person's total super balance at the end of the previous income year is less than $1.4 million: up to three times the cap (i.e. $300,000) and over a period of three years.

Note: A transitional rule applied to re-assess the bring-forward option cap on 1 July 2017 if a person triggered the bring-forward option in an earlier income year and had not fully utilised their bring-forward option cap before this time. The transitional rules are outside the scope of the TAXAU module.

Special rules

A downsizer contribution (see earlier in this unit) is in addition to the contributions otherwise permitted (i.e. it is not subject to the contribution caps).

Consequences of breaching (excess non-concessional contributions)

A non-concessional contribution in excess of the cap is either:

- Subject to excess non-concessional contributions tax at a rate of 47%. The tax must be paid from the superannuation fund. (See s. 292-80, read in conjunction with the *Superannuation (Excess Non-concessional Contributions Tax) Act 2007.)*
- Withdrawn by the individual along with 85% of the associated earning amount. As a result, the individual will be taxed on these contributions at their marginal tax rate. The individual is entitled to a non-refundable tax offset equal to 15% of the associated earnings amount (i.e. for the tax paid on the associated earnings by the superannuation fund).

CGT contribution cap

The CGT cap for non-concessional contributions links to the small business CGT concessions (see Unit 6). A contribution may be excluded from being a non-concessional contribution to the extent it does not exceed the CGT cap (s. 292-90(2)(c)(iii)). To make this election, the amount contributed must have arisen from a CGT event that meets the requirements of either the:

- CGT mall business 15-year exemption (Subdivision 152-B).
- CGT small business retirement exemption (Subdivision 152-D).

The CGT contributions cap is a lifetime limit. The cap for the 2018–2019 income year is **$1,480,000** (for the 2019–2020 income year it is $1,515,000). The cap is indexed annually in line with AWOTE in increments of $5,000 (rounded down).

The superannuation fund to which the contribution is made must be advised of the CGT cap election before or at the time the contribution is made (s. 292-100(9)).

Note: The general transfer balance cap for the 2018–2019 income year is $1.6 million (unchanged for the 2019–2020 income year). This cap limits the amount that can be moved from an accumulation phase account into a tax-free retirement (i.e. pension) phase account. There is no limit on the amount that can be held in an accumulation phase account. However, taxpayers will need to consider the implications of the transfer balance cap prior to contributing large lump-sums into superannuation.

Higher contributions tax

Under Division 293, where an individual's income for surcharge purposes (disregarding reportable superannuation contributions) plus concessional contributions is more than the high income threshold of $250,000, an additional 15% tax called the 'higher contribution tax' (HCT) applies to the **lesser of**:

- the excess amount over $250,000, and
- the individual's low tax contributions (i.e. concessional contributions of up to the cap amount).

The HCT is imposed on the individual and not the superannuation fund. However, the individual has the choice to pay the HCT liability or have it paid from their balance in the superannuation fund.

The effect of the HCT is that concessional contributions are effectively taxed at a combined total of 30% (i.e. 15% in the superannuation fund and 15% in the individual's hands).

Compulsory employer contributions

Employers are required by SGAA 1992 to contribute **9.5%** of their employees' ordinary time earnings (OTE) to a complying superannuation fund. OTE includes salary, wages, bonuses, commission payments and annual leave payments, but excludes overtime payments: see SGR 2009/2 for a checklist.

The contribution percentage remains at 9.5% until 30 June 2021. It will then increase incrementally by 0.5% each year until it reaches 12% (s. 19(2) SGAA 1992).

There is no upper age limit to which superannuation guarantee payments need to be provided for an employee.

Note: From 1 January 2020 employers are required to contribute 9.5% of their employees' total OTE base to a complying superannuation fund. The OTE base comprises OTE and any amount salary sacrificed to superannuation that would have been OTE but for the salary sacrifice arrangement.

Maximum super contribution base

Employers are not required to pay superannuation contributions on an employee's OTE base that is above the maximum super contribution base in each quarter. The base per quarter for the 2018–2019 income year is normally **$54,030** (for the 2019–2020 income year it is $55,270). This amount is indexed each year.

Employees may choose to salary-package additional pre-tax contributions to bring their total superannuation contributions up to the concessional contributions cap. For the ATO's views on effective salary sacrifice arrangements, see TR 2001/10.

However, for quarters starting on or after 1 July 2018, an individual with more than one employer and who expects their employer compulsory superannuation contributions to exceed the concessional contributions cap, can apply for an 'employer contribution exemption certificate'. Where an employer is issued with a certificate, the maximum contribution base for the quarter is treated as $nil for the purposes of working out the employer's superannuation guarantee shortfall.

Example – Maximum superannuation contribution base and salary packaging

Kate Baker is the chief financial officer (CFO) of Big IT Company (Big IT). Her gross salary is $240,000 per annum (i.e. $60,000 per quarter). To fulfil its superannuation guarantee obligations for Kate during 2018–2019, Big IT calculates its contributions for her as follows:

Quarter	Maximum super contribution base $	Rate %	Contribution $
September 2018	54,030	9.5	5,132.85
December 2018	54,030	9.5	5,132.85
March 2019	54,030	9.5	5,132.85
June 2019	54,030	9.5	5,132.85
		Total	20,531.40

The compulsory employer contributions for Kate are $4,468.60 below the concessional contributions cap of $25,000. Kate might consider negotiating an effective salary sacrifice arrangement with her employer whereby she would forego (i.e. sacrifice) $4,468.60 in salary, which would instead be contributed as a pre-tax concessional contribution to her superannuation fund. Rather than Kate being taxed on the amount as salary at 47%, the amount will be assessable income in the hands of her superannuation fund, which pays tax at only 15%. No FBT is payable on contributions to a complying superannuation fund (refer s. 136(1) FBTAA 1986 in subsection (j) of the definition of 'fringe benefit').

Timing rule

Employer superannuation guarantee contributions must be made by the 28th day after the end of each quarter. Payments that are not made by this date are not counted when determining whether the employer has complied with their superannuation guarantee obligations. As with other tax payments, however, the next business day will suffice if the 28th day falls on a weekend or public holiday (SGD 2003/2). While complying with the 28-day requirement will result in compliance with the superannuation guarantee charge rules, no tax deduction will be available until the amount is received by the superannuation fund (refer TR 2010/1).

Consequences of breaching

If employers do not make superannuation guarantee contributions by the due date, they will be required to make a **shortfall payment** that is equal to the shortfall in the employer's superannuation guarantee payments plus an administration charge and interest, all of which is **not** deductible (s. 26-95).

This superannuation guarantee charge (as it is known) is a penalty. The calculation of the charge is based on 'salary and wages' (as defined in s. 12 SGAA 1992) rather than the generally lower ordinary time earnings (OTE).

The shortfall payment and the interest are distributed by the ATO to the relevant superannuation fund for the benefit of the member for whom it was paid (s. 65 SGAA 1992).

Notes:

- From 1 January 2020 an employer is required to calculate the amount of a superannuation guarantee shortfall on an employee's total 'salary and wage base'. The salary and wage base is comprised of their salary and wages, and any amounts salary-sacrificed into superannuation that would have been salary and wages but for the salary sacrifice arrangement.
- The Government has introduced legislation that proposes a temporary amnesty in relation to historical superannuation guarantee shortfall amounts provided the employer voluntarily discloses the shortfall prior to the commencement of ATO review or audit activity. Under the amnesty the superannuation guarantee, shortfall amounts would be deductible to the employer and no penalties would be applied. The amnesty is outside the scope of the TAXAU module. However, it should be considered in practice.

Reporting

Employers with 20 or more employees must report their compulsory superannuation contributions to the ATO using 'single touch payroll'. Single touch payroll will apply to all employers from 1 July 2019.

Required reading

Section 26-95.

Borrowing to make contributions

An interest deduction is available under s. 8-1 for employers that borrow funds to make deductible superannuation contributions as a cost of employment. However, no interest deduction is available for borrowings that relate to a personal superannuation contribution by a substantially self-employed person (even if a superannuation deduction is claimed) or other individuals (s. 26-80).

Government incentives for low-income earners

Government incentives apply to resident low-income earners, including:

- A co-contribution from the government that is paid directly into the relevant superannuation fund. The co-contribution entitlement is determined by reference to information that is contained in the relevant individual's tax return (i.e. total income and after-tax contributions made) and the co-contribution is paid after the return has been assessed.
- An offset for spouse contributions.

Superannuation co-contribution

The Government will contribute $0.50 for each dollar of personal after-tax contribution to a maximum of $500. To be eligible, the following conditions must be met:

- The individual must have total income of less than $52,697 for the 2018–2019 income year ($53,564 for the 2019–2020 income year). This threshold is indexed each year.
- The concession phases out at a rate of 3.33c per dollar once total income exceeds $37,697 for the 2018–2019 income year ($38,564 for the 2019–2020 income year).
- 10% or more of the individual's total income must be derived from business or employment.
- The individual must be less than 71 years of age at the end of the income year and must lodge an income tax return for the year.
- The individual must have a total superannuation balance of less than the general transfer cap immediately before the start of the income year in which the contributions are being made. The general transfer cap for the 2018–2019 income year is **$1.6 million** (unchanged for the 2019–2020 income year).
- The individual must not have exceeded the non-concessional contributions cap in the relevant income year.

Spouse superannuation contribution tax offset

A tax offset of up to $540 is available for a contribution to a superannuation fund on behalf of a spouse (of any gender). To be eligible the following conditions must be met:

- The spouse must have total income (i.e. assessable income, reportable fringe benefits and reportable employer superannuation contributions) of less than $40,000 (s. 290-230).
- The spouse must not have exceeded their non-concessional contributions cap for the relevant year.
- The spouse must have a superannuation balance of less than the general transfer balance cap immediately before the start of the income year in which the contribution was made. The general transfer cap for the 2018–2019 income year is $1.6 million (unchanged for the 2019–2020 income year).

This tax offset is calculated as 18% of the **lesser** of:

- $3,000, reduced by $1 for every dollar that the sum of the spouse's total income exceeded $37,000.
- The total amount of spouse contributions made for the year.

The maximum offset is therefore 18% × $3,000 = $540.

Superannuation funds

Taxable income and tax payable

Overview

Like any other taxpayer, a complying superannuation fund must calculate its taxable income (i.e. assessable income less allowable deductions). As such, many of the income tax concepts that are covered in the TAXAU module are relevant to superannuation funds.

Special rules in Division 295 impact on the calculation of a fund's assessable income and allowable deductions.

Calculation method

Section 295-10(1) provides a specific six-step method statement to determine the income tax payable by a superannuation fund:

Step	Method statement in s. 295-10(1)
1	Calculate 'no-TFN' contributions income for the fund (taxed at 47%)
2	Calculate the fund's assessable income and allowable deductions, applying the special rules in Division 295
3	Calculate the fund's taxable income (as if its trustee were an Australian resident) The method statement in s. 295-10(1) is straightforward, with a superannuation fund's taxable income being equal to its assessable income less deductions
4	Identify the low tax component and non-arm's-length component of the fund's taxable income
5	Identify and apply the applicable tax rates to the: • low tax component (15%) • non-arm's length component (45%) of the fund's taxable income
6	Subtract tax offsets (if any) from the sum of the fund's Step 1 and Step 5 amounts

'No-TFN' contributions income

Failure by an individual to quote a TFN in a superannuation context results in a range of sanctions. One of these is that the superannuation fund must pay additional income tax on any 'no-TFN' contributions that form part of the fund's assessable income (s. 295-605).

The assessable contributions are taxed an extra 32% in addition to the standard 15% rate that applies to complying superannuation funds to align with the top marginal tax rate of 47% (s. 29 ITRA 1986).

Assessable income

Complying funds are largely assessable on the same amounts and in the same manner as other taxpayers. The major difference is the treatment of contributions.

Contributions

The following table summarises the most common types of contributions that are assessable or not assessable in the hands of a complying fund (Subdivision 295-C).

A fund's assessable and non-assessable contributions	
Assessable	**Non-assessable**
• Employer contributions on behalf of an employee (s. 295-160 item 1) • Personal contributions by an individual who has notified the fund that a deduction will be claimed (s 295-190) • The shortfall component of a superannuation guarantee charge (s. 65 SGAA 1992; s. 295-160 item 3) • Superannuation rollovers – untaxed element (s. 295-190(1) item 2)	• Transfers from a complying superannuation fund • Member contributions for which no deduction is claimed (s. 295-190) • Government co-contributions (s. 295-170)

In a superannuation context, a contribution is anything of value that increases the capital of the superannuation fund, which is provided by a person whose purpose is to benefit one or more particular members of the fund, or all its members in general (TR 2010/1).

Net capital gains and losses

Capital gains tax (CGT) provisions apply to the exclusion of other parts of the income tax law when considering the tax ramifications arising from the disposal of fund assets. Section 295-85(2) makes this clear by providing that the following provisions **do not apply** to CGT events:

- Section 6-5 (ordinary income).
- Section 8-1 (general deductions).
- Sections 15-15 and 25-40 (gain or loss from 'a profit-making undertaking or plan').

This means, for example, that when the stock market falls and a superannuation fund disposes of shares at a loss, that fund cannot argue that it acquired the shares on revenue account or with a profit-making intention. The loss on the shares will be on capital account and can only be used against capital gains.

No pre-CGT assets

All assets held by a complying fund as at 30 June 1988 and assets acquired from that date are within the CGT net (s. 295-90).

The amount deemed to be paid or given by the taxpayer as consideration for a CGT asset acquired before 1 July 1988 is determined under s. 295-85 *Income Tax (Transitional Provisions) Act 1997*.

Determining the capital gain or loss on assets acquired before 1 July 1988	
To determine whether a capital gain arises	Calculate the greater of the: • market value of the CGT asset at 30 June 1988, and • cost base of the CGT asset at 30 June 1988
To determine whether a capital loss arises	Calculate the lesser of the: • market value of the CGT asset at 30 June 1988, and • cost base of the CGT asset at 30 June 1988

Calculation method

Some complying superannuation funds have the choice of using either the indexation method, or discount method when calculating the capital gain on an asset held for at least 12 months.

Date asset acquired (or deemed acquired)	Methods available for calculating a capital gain
Before 21 September 1999	• Indexed cost base method (indexation cannot be calculated beyond the September 1999 quarter) • Discount method (33 ⅓%)
After 11.45am (EST) on 21 September 1999	• Discount method (33 ⅓%) **only**

Financial arrangements

The CGT provisions are also the primary legislative provisions for financial arrangements, which would otherwise fall within the taxation of financial arrangement provisions (TOFA) in Division 230 (s. 295-85(2)(aa)). However, there are exceptions to this rule in s. 295-85(3). Assuming the superannuation fund has assets of $100 million or more (i.e. it is a Division 230 taxpayer), Division 230 will prevail where the gain or loss relates to a:

- Currency exchange rate gain or loss.
- Debenture, bond, bill of exchange, promissory note or other 'debt-like' security (ATO ID 2009/111), a deposit with a bank or other financial institution, or a loan or other type of contract under which an entity is required to pay an amount.

Exempt income

The two major types of exempt income for superannuation funds are:

- Ordinary or statutory income relating to the complying superannuation fund's liability to pay current pensions, using the:
  - segregated current pension assets method (s. 295-385), or
  - proportional method (s. 295-390).
- Non-reversionary bonuses on policies of life assurance (s. 295-335 Item 1).

A CGT gain or loss is disregarded when a CGT event happens to assets that are used to produce exempt income (s. 118-12) and for segregated current pension assets (s. 118-320).

Pooled superannuation trusts (PSTs)

It is possible for a complying superannuation fund to transfer the liability for tax on taxable contributions to entities such as PSTs in which the superannuation fund invests, with the consent of the transferee entity. The mechanism for this transfer is contained in s. 295-260. The amount specified in the agreement is excluded from the fund's assessable income and included in the PST's assessable income.

Gains and losses made by a complying superannuation fund on the disposal of units in PSTs are also disregarded under the CGT regime (s. 118-350).

Franked dividends

Shares in Australian companies that pay franked dividends are an attractive investment proposition for superannuation funds. The fund's assessable income includes the franking credit gross-up and the fund is eligible for the franking tax offset (under s. 207-20 if the shares are held directly; under s. 207-35 if they are held indirectly through a partnership or trust). Any excess franking tax offset is refundable to a complying superannuation fund (s. 67-25(1)).

Example – Franked dividends received by a complying superannuation fund

Ann is an accountant who operates her practice as a sole trader. Due to cash flow problems, Ann was unable to make a substantially self-employed person deductible superannuation contribution to her SMSF during the income year ended 30 June 2019.

Assume that the fund's only assessable income for the 2019 income year is from fully franked dividends (received from companies that each have a tax rate for imputation purposes of 30%) and that there are no deductions.

The fund's tax calculation would be as follows:

Taxable income calculation	**$**
Fully franked dividends (s. 44 ITAA 1936)	70,000
Franking credit gross-up (s. 207-20(1))	30,000
Taxable income	100,000
Tax at 15%	15,000
Franking tax offset (s. 207-20(2))	(30,000)
Refundable tax offset (s. 67-25(1))	15,000

Dividend imputation is one reason for the rapid growth in SMSFs. An SMSF has four members or fewer, all of whom are either trustees or directors of the corporate trustee. The trustees of such funds have more direct control over the fund's investment strategy and can weight investments towards shares that yield franked dividends. The franking tax offset can then be used to 'shelter' tax on the fund's assessable non-dividend income, with any excess refunded.

Allowable deductions

Generally, the allowable deductions of a superannuation fund are determined in accordance with the normal rules that apply to other taxpayers (i.e. s. 8-1 for general deductions, and all specific deduction provisions in the tax law).

TR 93/17 lists the following types of deductible expenditure typically claimed by a superannuation fund:

- Actuarial costs.
- Accountancy fees.
- Tax and audit fees.
- Trustee fees and premiums under an indemnity insurance policy.
- Costs in connection with the calculation and payment of benefits to members (but not the cost of the benefit itself).
- Investment advisor fees and costs in providing pre-retirement services to members (see SMSFR 2008/1 for the ATO's guidelines on the extent to which SMSFs can give financial assistance to members).
- Annual return lodgement fees (e.g. to APRA and the Australian Securities and Investments Commission (ASIC)).
- Subscriptions for membership paid by a fund to relevant bodies (e.g. Association of Superannuation Funds of Australia Limited).
- Other administrative costs incurred in managing the fund.

Note that the superannuation supervisory levy is regarded as a deductible tax-related expense under s. 25-5.

Apportionment

As noted earlier, a fund may derive exempt income from assets that are used to meet the fund's current pension obligations. In such cases, the deduction available for fund expenditure must be apportioned.

TR 93/17 suggests two formulas for calculating apportioned deductions:

- Non-capital expenditure incurred in gaining or producing investment income only (e.g. investment manager fees):

$$\text{Expenditure} \times \frac{\text{Assessable investment income}}{\text{Total investment income}}$$

- General administrative expenses relevant to the operation of the fund as a whole:

$$\text{General administrative expenses} \times \frac{\text{Assessable income (including non-assessable contributions)}}{\text{Total income (assessable and exempt)}}$$

Insurance premiums

Superannuation funds commonly take out insurance policies in respect of their liability to provide benefits to members. Such policies may relate to members generally (i.e. a group policy) or to individual members.

Depending on the type and coverage of the policy, under s. 295-465(1), a complying superannuation fund can deduct part or all of the premiums paid for insurance policies that are wholly or partly for current or contingent liabilities of the fund, in order to provide a:

- Death benefit.
- Benefit payable to an individual with a terminal illness.
- Disability benefit (generally referred to as total or permanent disability or TPD).
- Temporary disability benefit (a two-year restriction applies to this type of benefit, unless approval is given under SISA 1993 or by the Commissioner for a longer period).

TR 2012/6 sets out the ATO's guidelines on the deductibility of premiums paid by a complying superannuation fund for TPD cover.

Special rules apply where a complying fund:

- Self-insures – a deduction is available for the notional cost of cover (an actuary's certificate is required) (s. 295-465(2)–(3)).
- Chooses to claim a deduction that reflects its future liability to pay benefits – the formula for calculating this deduction amount is set out in s. 295-470.

Expenditure that may not be deductible

Some types of expenditure incurred by superannuation funds may be denied a deduction. Tax practitioners should give special consideration to the following types of expenditure before deciding whether a deduction should be claimed.

Expenditure that may not be deductible – special consideration required		
Type of expenditure	**Treatment**	**Legislation and ATO guidelines**
Cost of amending fund's trust deed	Capital in nature and **not** deductible because it affects the structure of the fund However, such expenditure **is** deductible if amendments: • were necessitated by change in tax law or regulations, or • make the administration of the fund more efficient and do not amount to a restructuring of the fund	Section 8-1 TR 93/17
Other legal expenses	May be capital or revenue in nature. Determine the character of the expense and decide if it relates to the fund's: • structure or investments (capital), or • day-to-day running (revenue)	Section 8-1 TR 93/17
Investment advice	Distinguish between: • up-front advice in setting up the funds strategy (capital), and • fees for ongoing advice and advice on changing the mix of existing investments (revenue)	Section 8-1 IT 39 TD 95/60 TD 2004/1
Blackhole expenditure	Superannuation funds generally do not carry on a business (refer *Radnor Pty Ltd v. FCT*). Therefore, they usually cannot claim a s. 40-880 deduction over five years for business-related capital expenditure that is neither deductible (immediately or over time) nor part of the cost base of a CGT asset	Section 40-880

Expenditure which is not deductible

Like other taxpayers, superannuation funds are subject to the general tax provisions which deny deductions for certain types of expenditure. For example, no deduction is available for a fine or penalty paid by a fund (s. 26-5).

Note in particular that a deduction is **not** allowed for superannuation benefits paid by a complying fund (s. 295-495 Item 1). Superannuation benefits are discussed in greater detail below.

Low tax component and non-arm's-length component

The low tax component of the fund's taxable income is that part of its taxable income that remains after deducting the non-arm's-length component from its total taxable income (s. 295-545(3)).

Therefore, identifying the non-arm's length component is the key task when applying Step 4 in the s. 295-10(1) method statement. Non-arm's-length income is income that is:

- derived from a scheme involving parties who were not dealing at arm's-length, and
- more than what might have been expected had those parties been dealing at arm's-length.

Specific types of non-arm's-length income referred to in s. 295-550 include:

- Private company dividends that are not consistent with an arm's-length dealing, having regard to the criteria in s. 295-550(3). See also TR 2006/7 for ATO guidelines that remain relevant even though the ruling relates to the predecessor provision in the ITAA 1936.
- Income derived as a beneficiary of a non-fixed trust – for example, a distribution from a discretionary trust.

Any deductions relating to the non-arm's-length income reduce the amount of this income that is disclosed on the fund's income tax return (i.e. only net non-arm's-length income must be disclosed).

Tax rates

Like other taxpayers, a superannuation fund must apply the applicable tax rate to its taxable income. Unlike a company, a superannuation fund has to apply a different rate to the various components of its taxable income. In practice, this step is effectively done by the ATO, which applies the applicable tax rates to the amounts shown in the relevant labels of a fund's income tax return.

Tax offsets

Franking tax offset

The most commonly encountered tax offset in a superannuation fund tax return is the franking tax offset relating to franked dividends. See Unit 8 for further details.

Low income superannuation tax offset

A low income superannuation tax offset (LISTO) applies where a superannuation fund receives concessional contributions for a member that has adjusted taxable income of less than $37,000. The offset is effectively the difference between the member's personal marginal income tax rate and the 15% tax payable by the superannuation fund (i.e. so that the member pays no more tax on the superannuation contributions made for them, than if they had received the cash themselves).

A detailed understanding of this offset is outside the scope of the TAXAU module.

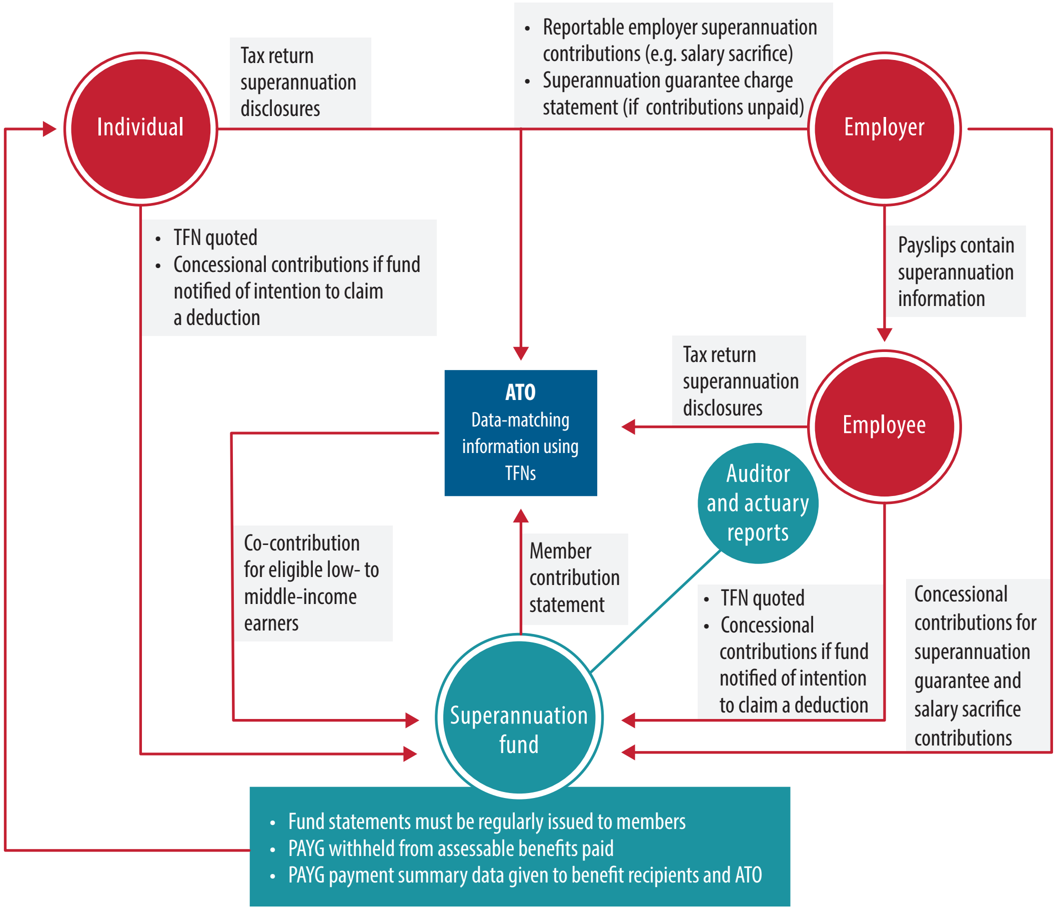
Activity 11.1: Superannuation fund – taxable income
[Available online in myLearning]

Superannuation reporting framework

This unit does not provide a detailed analysis of the extensive information and reporting framework that applies to the superannuation sector.

The ATO and other agencies such as APRA play an integral role in ensuring that superannuation funds satisfy the conditions that are necessary to maintain 'complying' status. The ATO, in particular, is at the centre of a range of reporting and data collection mechanisms that help it determine the correct tax treatment of contributions and benefits.

The diagram below highlights the main features of the superannuation information and reporting framework involving the ATO:



Fund income tax returns

As noted in Unit 1 on Australian tax fundamentals, each year the Commissioner requires taxpayers, including superannuation funds, to lodge an income tax return that explains how the taxable income of the fund has been calculated.

A superannuation fund must lodge its income tax return in the approved format (e.g. fund tax return form) within certain time frames. Where the fund return is not lodged via a tax agent, the due date for lodgement of a small superannuation fund return is by 28 February; and a medium or large superannuation fund return is by 15 February. Where the fund return is lodged via a tax agent, the due date for lodgement varies.

Each year the ATO releases forms and instructions to assist taxpayers.

Superannuation benefits

Payment of superannuation benefits

Division 301 outlines the taxation treatment of superannuation benefits that are paid from complying superannuation funds.

The taxation of superannuation benefits depends primarily on the:

- age of the recipient
- type of benefit.

When the recipient is 60 years of age or over, the payment of superannuation benefits is generally tax-free, provided:

- The benefits have been subject to tax within the fund (i.e. the benefits do not comprise what is known as an 'untaxed element') (s. 280-30(2)).
- The benefits are paid from a retirement phase account.

Note: The superannuation transfer balance cap for the 2018–2019 income year is $1.6 million (unchanged for the 2019–2020 income year). The cap is indexed annually. This cap limits the amount that can be moved from an accumulation phase account into a tax-free retirement (i.e. pension) phase account. There is no limit on the amount that can be held in an accumulation phase account.

Preservation age

Full access to retirement (i.e. pension) phase account benefits requires individual fund members to be permanently retired from the workforce and to have reached their preservation age. Certain restricted income stream benefits may be accessed when an individual reaches preservation age (even if they have not retired from the workforce).

Preservation age has been gradually increased to encourage workers to stay in the workforce until at least the age of 60:

Date of birth	Preservation age
Before 1 July 1960	55
1 July 1960 – 30 June 1961	56
1 July 1961 – 30 June 1962	57
1 July 1962 – 30 June 1963	58
1 July 1963 – 30 June 1964	59
From 1 July 1964	60

Lump sum benefits

The following table summarises the tax treatment of the components of a superannuation lump sum payment from a fund in which the benefits **have been subject to tax** (i.e. are a taxed element).

Tax treatment of superannuation lump sum payments		
Fund member's age	**Lump sum (taxable component)**	**Legislative reference**
Below preservation age	Subject to tax up to a maximum rate of 22%[1, 2]	Section 301-35
Between preservation age and 60 years	• 0% up to the low rate cap [1, 2, 3] • 17% on amounts above low rate cap[1, 2]	Section 301-20 Section 307-345
Aged 60 and over	Tax free [2]	Section 301-10 Section 303-10
Any age – recipient is terminally ill	Tax free	Section 303-10

Notes

1. Rate applicable to a resident individual. Includes Medicare levy of 2% where relevant.
2. If the TFN has not been provided, the fund must withhold 47% from the taxable component.
3. The low rate cap is a lifetime limit and is reduced by any amount previously applied to the low rate threshold. The low rate cap is indexed each year. The low rate cap for the 2018–2019 income year is $205,000 ($210,000 for the 2019–2020 income year).

Income streams

The following table summarises the tax treatment of a superannuation income stream paid from the **taxable component** of a benefit, assuming the income stream complies with the pension rules and minimum standards in the SISR 1994. For example, once you start an income stream, a minimum amount is required to be paid each year. However, there is no maximum amount.

Tax treatment of superannuation income streams		
Fund member's age	**Lump sum (taxable component)**	**Legislative reference**
Below preservation age	Taxed at marginal tax rates,[1] with no tax offset available However, a tax offset of 15% is available if the income stream is a disability superannuation benefit	Section 301-40
Between preservation age and 60 years	Taxed at marginal tax rates[1] Tax offset of 15% available	Section 301-25
Aged 60 and over	Tax free [2]	Section 301-10

Notes

1. Add Medicare levy of 2% where relevant.
2. If the TFN has not been provided, the fund must withhold 47% from the taxable component.

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 12: Consolidated entities

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Explain and apply the eligibility requirements for forming a tax consolidated group.
2. Explain and apply the tax consolidation core rules.
3. Outline the tax sharing arrangements available to tax consolidated groups.
4. Explain and calculate the income tax effect of the tax cost setting rules at consolidation and when an entity leaves a tax consolidated group.
5. Explain and calculate the income tax consequences associated with tax losses within a tax consolidated group.
6. Explain the treatment of franking accounts when tax consolidated groups are formed and exited.

Introduction

The Australian income tax consolidation regime came into effect on 1 July 2002. It applies primarily to wholly owned groups of Australian resident companies that have chosen to consolidate.

In broad terms, the consolidation regime allows members of the same consolidated group to calculate one income tax liability and lodge one income tax return, ignoring the effect of intra-group transactions. The head company is responsible for the income tax related liabilities of the consolidated group from the date of consolidation. However, subsidiary members could be liable to pay some or all of any unpaid income tax liabilities of the consolidated group where the head company defaults in payment.

When a consolidated group is formed, it is necessary to determine a consolidated income tax position for the group. There are complex rules for determining tax asset values, transferring and utilising tax losses and transferring franking credits.

When a subsidiary member leaves a consolidated group, it is necessary to determine the stand-alone income tax position of the exiting entity and thus, the CGT cost base of the shares held by the head company in that entity bearing in mind the shares in the subsidiary are ignored in a tax consolidated group).

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, all legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Consolidated group tax principles

Membership rules

The tax consolidation regime applies where the head company of a consolidatable group makes a choice to form a consolidated group. The choice once made is irrevocable (s. 703-50(2)).

A choice to consolidate must be in writing (e.g. approved in board minutes). In addition, an approved consolidation form must be lodged with the ATO (refer s. 703-50).

A 'one in, all in' principle applies when entering the consolidation regime (s. 703-5(3)). This means that once a head company chooses to consolidate, all eligible subsidiary members automatically become part of the consolidated group. An eligible subsidiary cannot choose not to be part of the consolidated group.

Consolidatable group

A tax consolidatable group must consist of:

- an Australian resident head company (although a head company can also be a corporate unit trust or a public trading trust that is taxed like a company), and
- at least one eligible, wholly owned resident subsidiary, which may be a company, trust or partnership.

In other words, a single entity cannot form a consolidated group. There must be at least two entities: a head company and a subsidiary member (s. 703-10). However, once a consolidated group is formed, it will continue even if the head company has no subsidiaries (i.e. if all subsidiaries are subsequently sold): see note under s. 703-5(3).

Head company

Under s. 703-15(2)(a), the head company must:

- Be an Australian resident (but not a prescribed dual resident) company.
- Not be a subsidiary member of a consolidatable or consolidated group (i.e. the head company must be the 'top' resident company in the domestic group structure).
- Have at least some of its taxable income taxed at the general company tax rate.

Once established, a consolidated group continues to exist until the head company ceases to meet the definition of head company (s. 703-5(2)). This could occur, for example, where a consolidated group is taken over by a stand-alone Australian company.

Subsidiary member

Under s. 703-15(2)(b), a subsidiary member must:

- Be a company, trust or partnership.
- Be **wholly owned** by the head company (except for shares acquired under an employee share scheme where the total of those shares does not exceed 1% of the number of ordinary shares in the company).
- If there are interposed entities, each interposed entity must be a member of the tax consolidated group.
- Be an **Australian resident** (but not a prescribed dual resident), if it is a company.
- Have at least some of its taxable income (if any) taxed at the general company tax rate (if a company).

The following are key points for subsidiary members:

- An entity is a wholly owned subsidiary of the head company if **all of the membership interests** (i.e. shares) in it are beneficially owned by the head company or other wholly owned Australian subsidiaries of the head company (s. 703-30).

  Shares that are classified as debt interests for income tax purposes under the Division 974 debt and equity rules (see Unit 13) do not constitute membership interests (ss 960-130 and 960-135). For example, a preference share that is redeemable for cash with an eight-year life would be a debt interest and would not count as a membership interest.
- For a partnership to satisfy the requirements of a subsidiary member, all partners must be members of the consolidated group. For example, if any of the partners are individuals, the partnership cannot be a member of a consolidated group. However, if all the partners are wholly owned directly or indirectly by the head company, the partnership would be a member of the consolidated group.
- For a unit trust to satisfy the requirements of a subsidiary member, all units must be held by members of the consolidated group.
- With non-fixed trusts (i.e. family or discretionary trusts), all of the trust's objects are taken to be beneficiaries and all the trust's beneficiaries must be members of the consolidated group. If **any** of the trust's beneficiaries are individuals, the trust cannot be wholly owned directly or indirectly by a head company, and therefore cannot be a member of a consolidated group. In practice, it is extremely rare to see a non-fixed trust as a member of a consolidated group.

Note: A consolidated group can exist even where a subsidiary member holds some shares in the head company (refer ATO ID 2008/32).

Multiple entry consolidated group

Consolidation is also permissible between resident subsidiaries of a foreign parent, notwithstanding the absence of a single head company resident in Australia. This is done by way of a multiple entry consolidated (MEC) group (see Division 719).

A MEC group is generally treated in the same way as a consolidated group. MEC groups are outside the scope of the TAXAU module.

Accounting consolidation

Consolidation for financial reporting purposes (also referred to as accounting consolidation) is governed by IAS 10 *Consolidated Financial Statements* (IAS 10). Consolidated financial statements must be prepared by a parent entity if it controls another entity. 'Control' for IAS 10 purposes looks to more than shareholding and can be achieved without 100% share ownership.

For tax consolidation purposes, control is irrelevant and 100% shareholding is required provided that the shares are equity interests (not debt interests) under the debt–equity rules (there is a 1% exception for employee share schemes). Furthermore, certain entities that form part of the accounting consolidated group (e.g. non-resident entities) are excluded from being a member of the tax consolidated group. Therefore, a consolidated group for accounting purposes is very different from a consolidated group for tax purposes.

GST groups

The tax consolidation regime applies to consolidated groups and MEC groups. The GST law allows the formation of GST groups, but the eligibility criteria for forming a GST group is different from those for forming a consolidated group (see Unit 2).

Worked example 12.1: Consolidated group membership

[Available online in myLearning]

Key features and tax attributes

A broad overview of the key features and tax attributes for a consolidated group are set out in the following table.

Tax issue	How the issue relates to a consolidated group	Refer to
Features and tax attributes		
Taxpayer	Under the single entity rule, subsidiary members are ignored for income tax liability purposes	See below under 'Single entity rule'
Residency	The head company and all subsidiary members must be Australian resident entities. A head company is therefore taxable in Australia on its worldwide income unless an exemption for foreign income applies	Unit 1, Unit 14 and above under 'Membership rules'
Goods and services tax (GST)	A head company and/or a subsidiary member can be registered for GST. The single entity rule does not apply for GST purposes	Unit 2
Fringe benefits tax (FBT)	A head company and/or a subsidiary member can provide a benefit to an employee or an associate of an employee. The single entity rule does not apply for FBT purposes	Unit 3
Small business entity (SBE) concessions	Like any other company, a head company may be classified as an SBE and choose to apply the available concessions	Unit 6
Taxable income, assessable income and allowable deductions	Like any other company, a head company calculates its taxable income under the income tax framework. In doing this it applies the general and specific provisions applicable for a company However, when calculating its assessable income and allowable deductions:	Unit 1, Unit 8, Unit 13 and Unit 14
	• the impact of intra-group assets and transactions are eliminated under the single entity rule	See below under 'Single entity rule'
	• the head company is assessable on and entitled to the deductions of a subsidiary member at the time of formation or joining the group under the entry history rule	See later in this unit under 'Entering a consolidated group'
Tax loss and bad debt deductions	Like other companies, to utilise a consolidated group tax loss or bad debt a head company needs to satisfy either the 'continuity of ownership' or the 'same business' tests	Unit 8
	However, additional specific rules exist to limit the transfer and utilisation of carry forward tax losses of members of a tax consolidated group at the time of formation or joining the group	See later in this unit under 'Entering a consolidated group'
Treatment of profits	Like any other company, a head company and subsidiary member company distributes its profits to shareholders through the payment of dividends. However, under the single entity rule, subsidiary member dividend payments are: • eliminated from the head company's calculation of taxable income • have no impact on the franking account and cannot be franked	Unit 8 and below under 'Single entity rule'
Franking account	Like any other company, a head company maintains a franking account. However, a subsidiary member's franking account is inactive while it is a member Credit balances in a subsidiary member's franking account transfer to the head company on formation or joining the group. However, no balance is transferred back on exit	Unit 8 and below under 'Single entity rule' and 'Entering a consolidated group'

Single entity rule

Under the **single entity rule** in s. 701-1 only the head company of a consolidated group is recognised. The subsidiary members are treated as though they are simply parts or divisions (i.e. branches) of the head company, rather than separate entities. Therefore, the assets and liabilities of the subsidiary members are taken to be that of the head company and the membership interests in the subsidiary (i.e. shares) are taken not to exist.

Core application – income tax liability or loss

The single entity rule in s. 701-1 only **applies** for the following 'core purposes':

- For the head company – working out its **income tax liability** or loss for any period during which it is the head company of a consolidated group, or any later income year.
- For a subsidiary member – working out its **income tax liability** or loss for any period during which it is a subsidiary member of a consolidated group, or any later income year.

For all other purposes, subsidiary members are **not** treated as part of the head company (e.g. the tax consolidation regime is not applicable for withholding tax, FBT or GST purposes). However, there are some specific rules within the income tax legislation that extend the scope of the single entity rule (see below).

Example – Single entity rule for commercial debt forgiveness and Division 7A

Core purpose

An example of a core purpose is where a commercial debt owed by a subsidiary member of a consolidated group is forgiven by another member of the same consolidated group. The single entity rule prevents the commercial debt forgiveness rules in Division 245 from applying to the head company because only one entity (i.e. the head company) is recognised. The existence of the subsidiary member and the debt forgiveness transaction are both ignored.

Non-core purpose

An example of a non-core purpose is a transaction that involves an entity outside the consolidated group. For example, if a subsidiary member which is a private company makes a loan to an individual shareholder in the head company, Division 7A ITAA 1936 applies to the subsidiary member (e.g. in determining whether there is a distributable surplus), rather than to the head company (TD 2004/68). Therefore, if the subsidiary has no distributable surplus (e.g. it is in losses), Division 7A will not apply even if the group has a distributable surplus overall.

Extended application – franking, PAYG and value-shifting

There are specific rules in the income tax legislation that extend the scope of the single entity rule. Those that are covered in the TAXAU module are summarised in the following table.

Extension of the single entity rule

Extended rule	Description
Franking accounts and imputation	Subdivisions 709-A to 709-C operate to consolidate the subsidiary member's franking account into the head company's franking account. While the subsidiary members are part of the consolidated group, their own franking accounts are inoperative. Any franking debit or credit that occurs for a subsidiary member is taken to be a franking debit or credit for the head company For example, a subsidiary member distributes its profits to the head company by paying a dividend under the Corporations Act. Under the single entity rule, the dividend cannot be franked and it has no impact on the head company's franking account See Unit 8 for further discussion on franking accounts

Extension of the single entity rule	
Extended rule	**Description**
PAYG instalments	Section 45-710 TAA 1953 contains a single entity rule similar to that in s. 701-1 ITAA 1997. For the purpose of working out the PAYG instalments of the tax consolidated group, subsidiary members are treated as part of the head company See Unit 1 for further discussion on PAYG instalments
Value-shifting provisions	Under s. 715-410, the single entity rule is extended for the purpose of the value-shifting provisions. This essentially means that entities holding debt and equity interests in the consolidated group can treat the consolidated group as one entity for the purpose of applying the value-shifting provisions to those interests. Accordingly, the shareholders can ignore intra-group transactions when considering the value shifting provisions See Unit 15 for further discussion on the value shifting provisions

Consequences

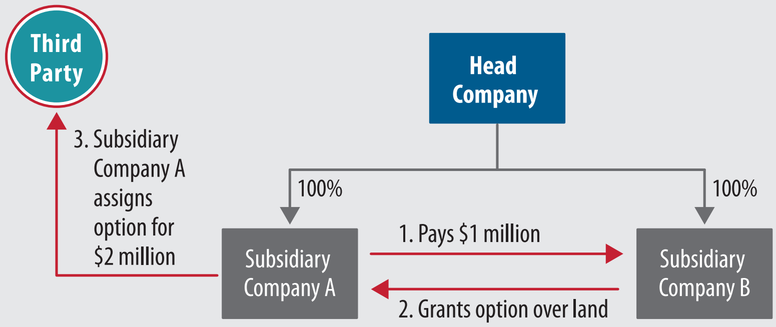
The application of the single entity rule has four broad consequences. These consequences are outlined in detail in TR 2004/11 and are summarised in the table below.

Consequences of the single entity rule	
Impact on	**Consequence**
Assets of subsidiary members	The assets that subsidiary members of the group legally own (except intra-group assets such as shares in other group members) **are taken to be owned by the head company** while the subsidiary remains a member of the tax consolidated group Therefore, a subsidiary member's assets (such as CGT assets, depreciating assets and trading stock) can be moved within a tax consolidated group without triggering any income tax consequences
Intra-group assets and liabilities	Intra-group assets and liabilities are **not** recognised for income tax purposes during the period they are held within the group, regardless of whether the assets or liabilities were created before or during the period of consolidation For example, an option granted by one member to another member of the same tax consolidated group is not recognised. Therefore, they can be moved within a tax consolidated group without triggering any income tax consequences
Intra-group transactions	Dealings that are solely between members of the same tax consolidated group (intra-group dealings) are **not** recognised for income tax purposes. Accordingly, these transactions will not give rise to ordinary income, statutory income or a deduction For example: • A dividend paid by a subsidiary member to the head company, or a dividend paid between two subsidiary members, is not recognised • Trading (i.e. sales and purchases) between members and/or with the head company is not recognised • A debt forgiveness between members and/or with the head company is not recognised (ATO ID 2005/344)
Actions of subsidiary members	The actions and transactions of a subsidiary member are treated as having been undertaken by the head company For example, a sale made by a subsidiary member to an external party is treated as having been made by the head company, rather than by the subsidiary member

Note: A general anti-avoidance notice under Part IVA ITAA 1936 can still be issued to a member of a tax consolidated group as the entry into a tax consolidated group could be a step in a scheme (see Unit 15, TR 2004/11A1 and *Channel Pastoral Holdings Pty Ltd v. FCT*).

Example – Single entity rule for intra-group assets

Intra-group assets are ignored while held within a consolidated group, but are recognised when they are transferred out of the group.



Head Company is the head company of a consolidated group, with Subsidiary Company A and Subsidiary Company B as subsidiary members. The following transactions are entered into:

1. Subsidiary Company A pays $1 million to Subsidiary Company B.
2. In return, Subsidiary Company B grants Subsidiary Company A an option over land it owns.
3. Subsequently, Subsidiary Company A assigns the option to a non-group entity for $2 million. The incidental costs associated with the assignment are $10,000.

Under the single entity rule, transactions 1 and 2 are ignored for income tax purposes because they occur wholly within the consolidated group. However, transaction 3 is treated as if Head Company had assigned the option to the non-group entity. Head Company is considered to have:

- received capital proceeds of $2 million for the assignment of an option
- incurred incidental costs of $10,000 relating to the assignment.

Head Company makes a capital gain of $1,990,000.

Consolidated income tax return

A head company prepares and lodges a single company income tax return for the consolidated group. In practice, many head companies require subsidiary members to prepare their own income tax calculations. The head company simply aggregates this tax data and eliminates the impacts of intra-group transactions (i.e. uses a bottom-up approach to preparing the income tax return for the consolidated group). See Unit 8 for further discussion on company income tax returns.

A part year ('stub') tax calculation and income tax return is required to be prepared by a subsidiary member for the period (if any) during an income year that it is not a member of a consolidated group (i.e. for the period before it becomes a member and/or for the period after it ceases to be a member).

Tax sharing agreement

Despite the single entity rule, the Commissioner is entitled to receive any outstanding income tax debts from subsidiary members (i.e. they are jointly and severally liable with the head company for tax liabilities) (s. 721-15).

This joint and several liability exposure can be mitigated by a valid tax sharing agreement (TSA). A TSA is an agreement that provides for the allocation of liability on default and sets up the amount that each entity is liable to pay the Commissioner directly in the event of default. It is not an agreement that provides for the funding of the head company to make its regular payments, which is typically referred to as the 'tax funding agreement'.

A group that has a valid TSA in place can avoid a situation in which all of the members of the group become jointly and severally liable for each group liability.

Where a group liability is covered by a TSA:

- The head company remains primarily liable for the group liability.
- Where the head company does not pay the group liability by the 'head company's due time' (s. 721-10(1)), each subsidiary member of the group that is party to the TSA becomes liable to pay to the Commonwealth an amount determined in accordance with the TSA (s. 721-20(2)).
- The liability of each TSA contributing member arises just after the head company's due time (s. 721-30(4)).
- The liability does not become due and payable until 14 days after the Commissioner gives the relevant group member written notice, under s. 721-30, of the liability.

Indirect TSA

A TSA under the consolidation regime should not be confused with an indirect tax sharing agreement, which allows members of a GST group or participants in a registered GST joint venture to limit their liability for indirect taxes of the GST group or joint venture (i.e. GST, fuel tax, wine equalisation tax and luxury car tax). For further information on such agreements, see Unit 2.

Entering a consolidated group

Overview

If a consolidatable group decides to consolidate for the first time, or a member joins an existing consolidated group, there are special rules that operate. These rules include the following:

- **Single entity rule** – the consolidated group is treated as a single entity for income tax liability purposes. Or put another way, the assets and liabilities of subsidiary members are treated as if they are held by the head company.
- **Entry history rule** – the tax history of a subsidiary member is taken to be that of the head company (subject to certain modifications).
- **Tax cost setting process** – the tax cost of certain assets of a subsidiary member are 'reset' at the time of consolidation. However, the tax cost of liabilities is not reset.
- **CGT events** – a number of CGT events can occur when a subsidiary member joins a consolidated group.
- **Tax loss transfer and utilisation rules** – tax losses of a subsidiary member are transferred to the head company (subject to certain tests) and may be utilised by the head company (subject to restrictions on the rate of recoupment).
- **Franking credit transfer rules** – franking credits of a subsidiary member are transferred to the head company. Only the head company maintains a franking account, the subsidiary member accounts are inactive while the subsidiary member remains a member.

Entry history rule

For both a formation and joining entity situation, the entry history rule treats everything that happened in relation to an entity before it became a subsidiary member as if it happened in relation to the head company (s. 701-5).

The entry history rule only applies for the head company's core purposes. Accordingly, the rule does not affect the joining entity's responsibility for taxation liabilities relating to pre-consolidation periods. In certain circumstances, the entry history rule is modified by other provisions.

Core application

The following table demonstrates the application of the entry history rule to different types of transactions.

<table>
<tr><th colspan="2">Application of the entry history rule</th></tr>
<tr><th>History inherited</th><th>Description</th></tr>
<tr><td>Income</td><td>In some cases, income is assessable when it is earned, rather than when it is received (Arthur Murray (NSW) Pty Ltd v. FCT). If the derivation period spans an entity joining a tax consolidated group, the entry history rule allows the head company to take into account the amounts that have already been assessed to the subsidiary prior to it joining the tax consolidated group</td></tr>
<tr><td>Deductions</td><td>Under the entry history rule, a head company may become entitled to certain deductions for expenditure incurred by a joining entity before it joined the tax consolidated group. This is generally for items of expenditure that have not been completely deducted by the subsidiary prior to joining. Examples include:
• Unamortised borrowing expenses
• Prepayments under s. 82KZMD ITAA 1936
• Deduction for a debt brought into the tax consolidated group that subsequently goes bad (provided the various tests in Subdivision 709-D are satisfied – see below)
• Gift deductions (where the entitlement to the deduction is spread)
• Cost of connecting water, power and telephone lines
• Certain business-related costs, which are deductible over five years under s. 40-880
• Expenditure allocated to a project pool</td></tr>
<tr><td>Assets and liabilities</td><td>Any history attached to an asset or liability is transferred to the head company when it becomes an asset or liability of the head company. For example, the original acquisition date of the asset is inherited by the head company</td></tr>
<tr><td>Pre-CGT asset (when existing group consolidates)</td><td>Where an existing group with pre-CGT assets chooses to consolidate for the first time, the pre-CGT status of assets brought into the tax consolidated group is inherited by the head company. Note, however, that in a takeover scenario, the change in majority underlying ownership may convert the joining entity's pre-CGT assets into post-CGT assets (Division 149 – see Unit 4)</td></tr>
<tr><td>Purpose</td><td>The purpose of holding an asset can be important when determining whether an asset will realise a capital gain or a revenue gain. Any history attached to an asset demonstrating the purpose of holding the asset will also be transferred to the head company</td></tr>
<tr><td>Elections</td><td>Many elections made by a joining entity prior to joining the consolidated group are taken to be elections made by the head company after the joining time (e.g. an election made by a joining entity to use a low-value pool under s. 40-425)</td></tr>
<tr><td>Private income tax rulings</td><td>Private income tax rulings issued to an entity by the ATO before the entity becomes a member of a consolidated group apply to the head company insofar as the relevant facts have not changed, either by reason of consolidation (e.g. because they relate to intra-group transactions, which are ignored) or otherwise</td></tr>
</table>

Modified application

A number of provisions modify the effects of the entry history rule. Key examples include:

- **CGT assets –** the tax cost setting process, contained in Division 705, resets the cost of an asset that becomes the asset of the head company under the single entity rule. This process overrides the inherited cost (ss 701-55 and 701-56).
- **Depreciating assets –** the tax cost setting process overrides the inherited cost and acquisition date for depreciating assets (s. 701-55(2)).
- **Tax losses –** special rules modify the transfer of losses to the head company and the ability to use such losses (i.e. available fraction rules).
- **Division 230 financial arrangements –** the deemed acquisition of a financial arrangement asset at the joining time under s. 701-55(5A) will, in some cases, affect the history that would normally be inherited by a head company under the entry history rule.

- **Elections –** the law also recognises the need for the head company to make fresh elections in some cases to override the impact of the entry history rule. These mainly fall into two of the following categories:
  - Resettable elections – s. 715-660 lists the elections that the head company can reset, overriding the election made by the joining entity.
  - Inconsistent elections – s. 715-665 lists the elections for which the head company can make a fresh election to overcome an inconsistency between a pre-joining time election made by the joining entity and an election already made by an existing member of the consolidated group.
- **Bad debts** – the head company of the consolidated group is taken to have previously included in its assessable income the debt that was included in the assessable income of the subsidiary member before it joined the consolidated group. When the bad debt write-off occurs post-consolidation, for head company core purposes, the single entity rule means that the write-off is taken for the purposes of s. 25-35 to be a debt write-off by the head company itself.

  However, the claiming of bad debts by a company is subject to the same recoupment tests that apply to company losses (i.e. the continuity of ownership and same business tests). Subdivision 709-D therefore adds additional requirements when applying the recoupment tests to bad debt deductions claimed by the head company of a consolidated group.

  Effectively, Subdivision 709-D looks at each subsidiary member in the group that is owed the debt to determine (based on certain assumptions) whether, disregarding the entry history rule, the subsidiary member would have been able to claim a bad debt deduction. The head company is only able to deduct the debt if the subsidiary member that was owed the debt could have deducted it for the relevant period (assuming the debt was written off as bad by the subsidiary member). The operation of Subdivision 709-D is best illustrated by the following example.

Example – Entry history rule for bad debts

On 1 December 2017, a $20,000 debt was owed to a company, Sub Co. The amount of the debt is brought to account by Sub Co as assessable income in the income year ended 30 June 2018.

On 1 July 2018, a consolidated group is formed, with Head Co as the head company. Sub Co joins the consolidated group at the time the group is formed.

On 31 December 2018, the $20,000 debt owed to Sub Co is written off as bad in Sub Co's books of account. Head Co (as the head company of the consolidated group) seeks to claim a bad debt deduction for this debt in the year ended 30 June 2019.

Head Co (the claimant) can deduct the debt if the conditions in ss 709-205(2) and 709-215 are met; that is, whether:

- Sub Co could, hypothetically, have deducted the bad debt during the period 1 December 2017 to 1 July 2018.
- Head Co could have deducted the bad debt during the period 1 July 2018 to 30 June 2019.

To determine if both these conditions are met, the continuity of ownership test (COT) must be satisfied during the relevant periods. If COT is not satisfied, the bad debt deduction is not available unless an alternative test is satisfied (see Unit 8).

The following worked example demonstrates the application of the entry history rule in a range of commonly encountered situations.

Worked example 12.2: Entry history rule

[Available online in myLearning]

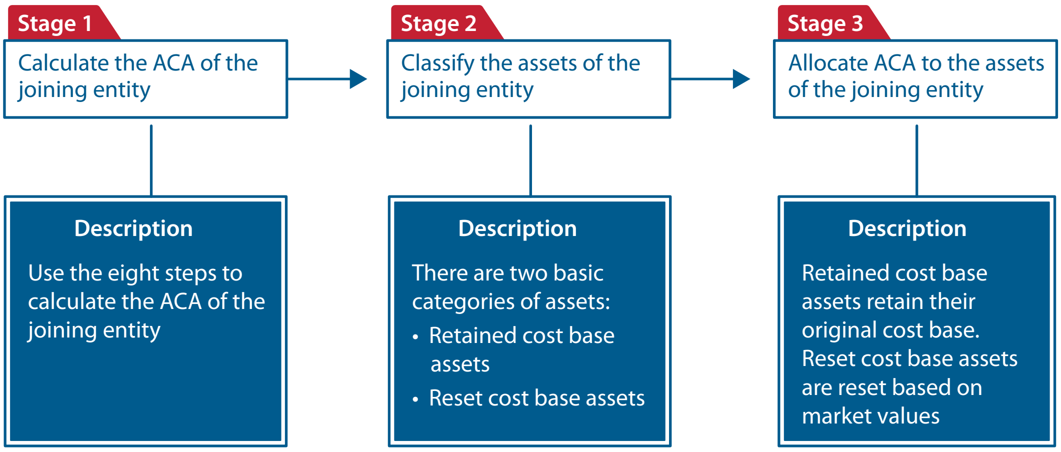
Tax cost setting process

Note: You **do not** need to know how to determine the values for each of the steps in the entry allocatable cost amount (ACA) calculation for the purposes of the TAXAU module. However, you **do** need to know how to calculate a head company's income tax liability, including any impacts resulting from the tax cost setting process. This requires you to understand the calculation of the entry ACA (including where it results in a negative amount); to know how to identify and classify assets for tax consolidation purposes; to understand the allocation of ACA (including where it results in an excess or shortfall amount); to know when particular CGT events apply; and to know how to calculate the relevant capital gain or loss.

Methodology

When a subsidiary member joins a tax consolidated group, its **assets** become those of the head company and their tax cost is 'reset' under Division 705. The subsidiary member's liabilities also become those of the head company but their tax cost is not reset. Only subsidiary members have their assets reset – the assets of the head company are not reset.

The three stages in the tax cost setting process for assets (s. 705-35(1)) are outlined in the following diagram.



Stage 1 – Calculate the ACA of the joining entity

The ACA of a joining entity is worked out under s. 705-60. The eight steps in the ACA process are outlined in the diagram below. When a consolidated group acquires all the membership interests in an entity is a single transaction, **Steps 1, 2, 6, 7 and 8** are applicable. The remaining steps are only applicable to incremental acquisitions.

Broadly, Steps 1 and 2 of the ACA calculation are similar to the basic accounting principle for a balance sheet, that is, if assets less liabilities equals equity, then equity plus liabilities equals assets.

Step 1

Start with the cost of membership interests in the joining entity. This is generally the cost base of the shares in the joining entity (s. 705-65). Note that incidental costs of the kind described in s. 110-35(2) incurred by a head entity before the shares are acquired would form part of Step 1 (TD 2011/8), but not if they are incurred after the shares were acquired (TD 2011/9). Costs incurred after the shares are acquired would generally be deductible over five years as per s. 40-880

Step 2

Add: the value of the joining entities' liabilities (s.705-70).

Prior to 1 July 2016 where the liabilities will result in a future tax deduction to the head company, reduce the amount added by the sum of deductible liabilities multiplied by the corporate tax rate (e.g. deductible liabilities x 30% for non-SBEs) (s.705-75). Certain adjustments are made for unrealised gains and losses (s.705-80).

From 1 July 2016 a consolidated group that acquires a subsidiary with deductible liabilities that give rise to a future deduction are excluded from step 2 (s.705-70(1AB) (e.g. an employee leave provisions and a foreign currency liability that is a net forex loss position) Accounting liabilities that relate to certain insurance liabilities, TOFA liabilities and those relating to retirement village contracts are subject to an exception (s.705-70 (1AC).

From 15 Feb 2018 deferred tax liabilities are disregarded from step 2 (s.705-70 (1B)).

Step 3

Add undistributed, frankable profits that accrued to the tax consolidated group (s.705-90). This is generally the "owned" taxed profits of the joining entity.

From 1 July 2016 where a deductible liability is excluded from step 2 (s.705-70 (1AB), that liability is not taken into account for the purposes of working out the undistributed profits of the joining entity.

Step 3A

Adjust for certain pre-joining time roll-overs from a non-resident company to an Australian-resident company (s. 705-93)

Step 4

Subtract distributions of profits that were made to the consolidated group prior to the joining time, where the distributions related to pre-acquisition profits, or where the distribution recouped a loss of the consolidated group (s. 705-95)

Step 5

Subtract unutilised 'owned' losses of any sort (i.e. tax losses, capital losses, etc.) of the joining entity at the joining time that did not already reduce the owned profits taken into account in Step 3 (s. 705-100)

Step 6

Subtract the sum of the 'acquired' unutilised losses of the joining entity that are transferred to the head company multiplied by the corporate tax rate (e.g. acquired losses × 30% for non-SBEs). These are losses of any sort of the joining entity that are not Step 5 losses (s. 705-110). Losses cancelled under s. 707-145 are excluded from this step

Step 7

Subtract an amount for existing deductions inherited by the head company. For 'acquired' deductions the amount subtracted is the sum of the 'acquired' deductions multiplied by the corporate tax rate (e.g. acquired deductions × 30% for non-SBEs). The amount subtracted for 'owned' deductions is not adjusted (i.e. is the full amount). Step 7 does not cover inherited expenditure that is also an asset that is allocated an ACA (e.g. a prepayment asset), where a future deduction will reduce the cost of an asset (e.g. future depreciation), where the expenditure was already taken into account in reducing Step 3 (i.e. has already been expensed) or for inherited Division 43 deductions (s. 705-115).
The reason is the cost base of the asset will reduce when the head entity claims the inherited deductions

Step 8

If the amount remaining after Step 7 is positive, it is the joined group's ACA. Otherwise, the joined group's ACA is nil (s. 705-60)

Stage 2 – Classify the assets of the joining entity

The second stage in the ACA process is to classify the 'assets for consolidation purposes' held by the joining entity at the joining time as either a 'retained cost base asset' or a 'reset cost base asset'.

Assets for consolidation purposes

Assets for consolidation purposes are defined in s. 701-67 to include the following:

Type	Meaning
CGT asset	CGT asset defined in s.108-5. For example, goodwill, land and buildings, shares etc. (see Unit 4)
Revenue asset	Section 977-50: A CGT asset whose gain/loss on disposal is taken into account in calculating assessable income or tax loss other than as a capital gain or capital loss. Excludes trading stock and depreciating assets Examples: • Profit from short-term investment of surplus working capital (*CoT v. Commercial Banking Co of Sydney*) • Investment business selling long-term held investments (*Australian Catholic Assurance Co. Limited v. FCT, London Australian Investment Co. Limited v. FCT*) • Sale of non-trading stock assets acquired with the intention to make a profit (*FCT v. Myer Emporium*)
Depreciating asset	Section 40-30: Anything that has a limited effective life and declines in value. Excludes land, trading stock and some intangible assets (see Unit 5)
Trading stock	Section 70-10: Anything produced, manufactured or acquired that is held for the purpose of manufacture, sale or exchange (see Unit 1). Includes livestock, raw materials, partially completed goods, finished goods (*FCT v. St Hubert's Island Pty Ltd*)
A thing that is, or is part of, a Division 230 financial arrangement	Financial arrangement defined in s. 230-45, s. 230-50, s. 230-55

The tax cost setting rules will not allocate a tax cost to assets that are not ordinarily recognised for taxation purposes (i.e. are not assets for tax consolidation purposes). For example, certain intangible assets (including customer lists, unregistered designs, trade names and trade secrets) and assets recognised under the Accounting Standards (including deferred tax assets).

Retained cost base assets

As defined in s. 705-25(5), a retained cost base asset is:

- Australian currency or a right to a specified amount of Australian currency (e.g. an A$ debt owed to the joining entity or an A$ bank deposit), other than a right that is a marketable security under s. 70B ITAA 1936.
- A unit in certain types of cash management trusts.
- A prepayment.
- A 'right to future income', other than a 'work in progress (WIP) amount asset'. This type of asset is outside the scope of the TAXAU module.

The tax cost of a retained cost base asset is generally set at an amount that is equal to the joining entity's tax cost of the asset (e.g. prepayments at their unamortised tax balance). However, bank accounts, loans, etc. have a tax cost equal to their face values (s. 705-25(2) and (5)(b)).

Reset cost base assets

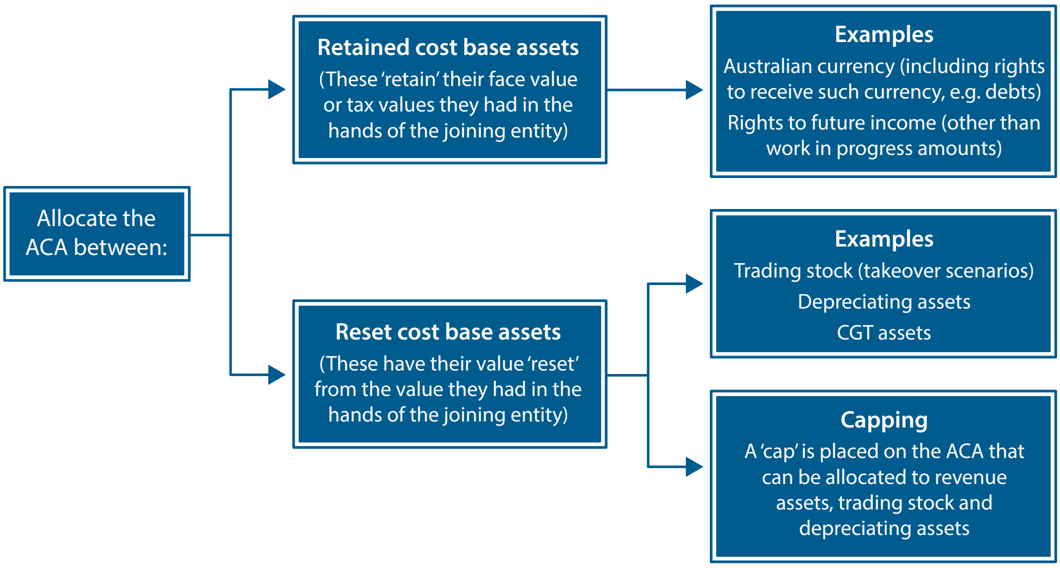
A reset cost base asset is any asset of the joining entity that is not a retained cost base asset (s. 705-35(1)). Examples include: trading stock (where the joining entity is not a continuing majority-owned entity), WIP amount assets, revenue assets, depreciating assets and CGT assets.

Stage 3 – Allocate the ACA to the assets of the joining entity

Once the ACA has been calculated and assets have been categorised, the tax cost setting amount (TCSA) for each asset is determined by allocating the ACA to each asset as follows:

- First, to retained cost base assets (s. 705-35(1)(b)).
- The remainder, to reset cost base assets in proportion to their market values (subject to adjustments) (s. 705-35(1)(c)).

The overall approach to allocating the ACA is illustrated in the diagram below:



The following example demonstrates the ACA process.

Example – Tax cost setting process on entry

On 1 July 2018, Aussie Sports, which is the head company of the Aussie Sports consolidated group, acquired 100% of the shares in Hockey Sticks – referred to as the 'joining entity' – in a single transaction.

At the time of acquisition, the balance sheet of Hockey Sticks was as follows:

Hockey Sticks' balance sheet at acquisition			
Assets[1]	**$**	**Liabilities**	**$**
Cash	20,000	Loans	50,000
Plant (written-down value)	100,000	Current tax liability	100,000
Trading stock	35,000	**Equity**	
Buildings (at cost)[2]	300,000	Share capital	100,000
Deferred tax asset: borrowing costs[3]	15,000	Retained earnings	220,000
Total	470,000	Total	470,000

Notes

1. Except as stated, all assets are at market value.
2. Market value of buildings: $800,000.
3. Represents the tax effect of the undeducted portion of borrowing costs of $50,000 (s. 25-25), previously expensed for accounting purposes.

At the time of acquisition, Aussie Sports paid $1.75 million to acquire the shares in Hockey Sticks. As the value of net assets is $320,000 and the unrecognised value of the building is $500,000, the goodwill on acquisition is $930,000 (i.e. $1.75 million – $320,000 – $500,000).

The following steps are required to calculate the tax cost setting (TCSA) for each asset.

Step 1 – Calculate the ACA of Hockey Sticks

Step	Description	Explanation of steps under s. 705-60	$
1	*Add*: Cost of membership interest in Hockey Sticks	Amount paid by Aussie Sports (s. 705-65)	1,750,000
2	*Add*: Liabilities of Hockey Sticks	Includes loans and current tax liability. There are no liabilities that will give rise to a future deduction and therefore no exclusion is required (s. 705-70 (1AB)	150,000
6	*Deduct*: Acquired unutilised losses of Hockey Sticks	Hockey Sticks has no unutilised losses (s. 705-110) $0 × 30%	0
7	*Deduct*: Inherited deductions	30% of acquired deductions (excluding unclaimed capital allowances and capital works deductions) and 100% of owned deductions (s. 705-115). Hockey Sticks has $50,000 in undeducted borrowing costs under s. 25-25. $50,000 × 30%	(15,000)
8	Total: ACA		1,885,000

Step 2 – Classify the assets of Hockey Sticks

Asset	Category	Explanation/reference
Cash	Retained	Retained cost base (TR 2005/10)
Plant (written-down value)	Reset/depreciating asset	Depreciating assets (s. 705-40)
Trading stock	Reset/trading stock	Trading stock (s. 705-40)
Buildings	Reset/non-revenue	Not likely to be depreciating assets for Hockey Sticks (s. 705-40 is not applicable)
Goodwill	Reset/non-revenue	Per TR 2004/13 Not a depreciating asset (ss 705-25 and 705-40 are not applicable)
Deferred tax asset: borrowing costs	–	Not a recognised asset (s. 701-67)

Step 3 – Allocate the ACA to each asset of Hockey Sticks

Asset	Market value $	Proportion %	ACA allocated $	Reduction
Retained cost base				
Cash			20,000	
Reset cost base – held on revenue account and depreciating				
Plant (written-down value)	100,000	5.36	100,000	n/a
Trading stock	35,000	1.88	35,000	n/a
Reset cost base – not held on revenue account				
Buildings	800,000	42.89	800,000	–
Goodwill	930,000	49.87	930,000	–
Total	1,865,000	100.00	1,885,000	

Capping rules

The initial amount allocated to a reset cost base asset may need to be recalculated if the ‘capping’ rules (s. 705-40) apply to restrict the amount that can be allocated.

To the extent that the amount of ACA allocated to a particular asset is reduced by the capping rules, the reduction amount is reallocated to other reset cost base assets in proportion to their market values, provided those assets do not breach s. 705-40 (if applicable).

Capping the amount of ACA that can be allocated

Type of asset	General impact of capping	Terminating value (s. 705-30)
Trading stock	Section 705-40 reduces the tax cost setting amount to the greater of: • the asset’s market value, or • joining entity’s ‘terminating value’ for the asset	If stock was on hand at the start of the income year, its value at that time as determined under Subdivision 70-C Otherwise, the amount incurred by the joining entity to acquire the stock
Depreciating asset		The asset’s ‘adjustable value’ under s. 40-85 (sometimes called the tax written-down value)
Revenue asset (see above meaning of assets)		The amount that would be the asset’s cost base just before the joining time

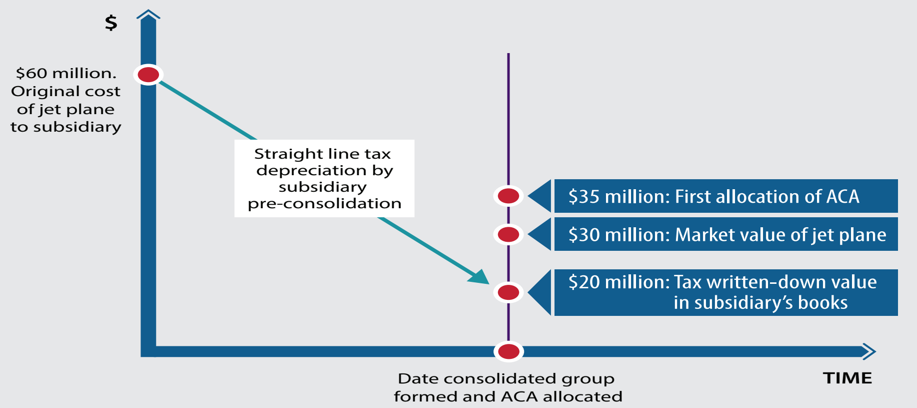
Example – ACA allocation capping rule

Aussie Airlines Ltd (Aussie Airlines) is the parent company of an Australian airline business, operated through various wholly owned subsidiaries that own jet planes. Because of Aussie Airlines’ excellent reputation for maintenance, the market value of the group’s jet planes is very high.

Aussie Airlines chooses to consolidate for tax purposes and undertakes the ACA calculation and allocation process.

For one of the jet planes, the outcome of the first allocation of ACA to the asset results in a reset tax cost at $35 million. This exceeds both the:

- Terminating value (i.e. the adjustable value, sometimes called the tax written-down value) of the plane in the subsidiary’s books ($20 million).
- Market value of the plane ($30 million).



The tax cost of this jet plane will be capped at $30 million, with the excess $5 million being reallocated to other reset cost base assets (s. 705-40). Post-consolidation, Aussie Airlines will depreciate this jet plane by reference to the reset cost of $30 million.

Residual tax cost setting rule

The tax cost of trading stock, revenue assets and depreciating assets can be reset in a way that can have beneficial tax outcomes, subject to the capping rule.

To prevent deductions for the tax cost of other assets being brought forward in an unanticipated way (e.g. by breaking down goodwill into a range of intangible assets, some of which attract deductions), the legislation contains a **residual tax cost setting rule** applicable where an entity joins a consolidated group.

This residual tax cost setting rule states that the head company is deemed to have acquired all of the assets of the joining entity as part of acquiring the business of the joining entity as a going concern (ss 701-56(1), (1A), (1B) and (2)).

This overrides both the single entity rule and the entry history rule by treating the joining as a **business acquisition** (i.e. the revenue or capital character of the joining entity's assets is determined based on the **character of the assets in the hands of the head company**, rather than the joining entity).

Example – Tax character of assets

Wealth Pty Ltd (Wealth) is the head company of a consolidated group which operates in the financial planning industry. Wealth proposes to acquire 100% of Rich Pty Ltd (Rich). The takeover is motivated by a desire to gain access to Rich's database of high-wealth clients, its successful marketing strategy and other accounting intangibles.

By deeming the acquisition to be that of a business which is a going concern, the acquisition by Wealth is likely to be on capital account for tax purposes.

When undertaking the ACA tax cost allocation process, non-CGT assets such as client databases (see s. 701-67) are treated as part of the goodwill acquired and on capital account.

Exception

There are two important exceptions to the business acquisition approach.

- WIP amount assets brought into a consolidated group by a joining entity are treated as if the head company had paid a WIP (s. 701-55(5C)). This treatment links with the s. 25-95 deduction for WIP amounts, meaning that the head company can claim a deduction for the tax cost setting amount allocated to WIP amount assets.
- The tax cost setting amount allocated to consumable stores is treated as an outgoing incurred by the head company at the joining time, thus enabling the head company to claim a s. 8-1 deduction for the amount so allocated (s. 701-55(5D)).

Tax cost

The TCSA allocated to each asset under the tax cost setting process is the 'tax cost' of the asset for the head company. The head company uses this tax cost to determine its income tax liability. For example:

- For trading stock – the assessable or deductible amount for movements in closing values (see Unit 1).
- For CGT assets (e.g. land, buildings and investments) – the net capital gain or loss on disposal under the CGT provisions (see Unit 4).
- For depreciating assets (e.g. plant and equipment) – the decline in value deduction and balancing adjustment on disposal under the capital allowance provisions (see Unit 5).

CGT events

When an entity joins a tax consolidated group, certain CGT events may occur. As some of these events may result in a capital gain or a capital loss to the head company, it is important to consider these events at the joining time. These events are summarised in the following table.

CGT events on entry		
CGT event	**Description**	**Note**
CGT event L1	Where the cost base of the shares of the joining entity was increased due to the application of Division 149 before the joining time (i.e. where pre-CGT assets are deemed post-CGT assets with a market value uplift), the increase in the cost base due to Division 149 (and therefore the increase to Step 1 in the ACA process) cannot be allocated as an ACA to revenue assets. Instead, the amount of ACA is reclassified as a capital loss, claimed in equal proportions over five years (ss 705-57 and 104-500)	Outside scope of TAXAU module
CGT event L2	Adjustments made at Step 3A of the ACA calculation can result in an ACA being negative. The negative amount is treated as a capital gain under CGT event L2 (s. 104-505)	
CGT event L3	Retained cost base assets retain their cost base under the allocation process. If the total ACA is less than the tax cost setting amount of all the retained cost base assets, the excess is treated as a capital gain. For example, if the ACA is $100 and the retained cost base balance is $200, this will result in an ACA allocated to the asset of $200 and a capital gain of $100 (s. 104-510) Note that CGT event L3 gains reduce the tax cost setting amount of assets consisting of a right to Australian currency (i.e. s. 705-25(5)(b) assets) if the asset's market value is less than its tax cost setting amount but not below zero (s. 705-27). This has the effect of reducing the CGT event L3 capital gain. This may apply if a company is acquired with a large doubtful debt balance	
CGT event L4	If there are only retained cost base assets and no reset cost base assets to allocate to, the remaining unallocated ACA is treated as a capital loss (s. 104-515). Refer to TD 2005/54, which contains a *de minimis* rule when determining whether there are reset cost base assets	
CGT event L6	Where an error occurs under the ACA process, the error is treated as a capital gain or loss (s. 104-525). This provision and Subdivision 705-E were included to reduce compliance costs associated with recalculating the ACA when an error is identified. The CGT event occurs when the Commissioner becomes aware of the error, rather than when the ACA calculation is done. This may reduce interest penalties. The Commissioner's guidelines on errors in tax cost setting amounts are contained in TR 2007/7	Outside scope of TAXAU module
CGT event L8	There is a cap placed on the ACA allocated to revenue assets (i.e. the higher of the market value or terminating value under s. 705-40). If the excess ACA cannot be allocated to any other assets, this excess amount is treated as a capital loss (s. 104-535). Refer to TD 2005/54, which contains a *de minimis* rule when determining whether there are reset cost base assets	

Activity 12.1: CGT event L3 on acquisition of wholly owned subsidiary

[Available online in myLearning]

Tax loss transfer and utilisation rules

Overview

All the entities that join a consolidated group are treated, for income tax purposes, as a single entity. As such, a mechanism must exist to deal with losses incurred prior to the entities joining the consolidated group.

Where a consolidated group forms for the first time, the loss transfer tests are applied to both the:

- Head company (to determine whether the head company's own pre-consolidation losses can be transferred to itself in its new capacity as the head company of a tax consolidated group).
- Subsidiary members (see s. 707-120(1)).

Note: Losses can be cancelled if their retention would otherwise have an adverse impact on the ACA calculation.

Methodology

The following stages apply when dealing with transferred losses:

Dealing with transferred losses	
Stage 1:	Can losses be transferred to the head company (Subdivision 707-A)
Stage 2:	Can transferred losses be used by the head company (Subdivision 707-B)
Stage 3:	Calculate the amount that can be used by the head company (Subdivision 707-C)

Stage 1 – Can losses be transferred? (Subdivision 707-A)

Note: The modifications to COT and SBT are outside the scope of the TAXAU module.

Unutilised losses (i.e. tax losses or CGT losses) can be transferred to the head company if the joining entity passes either a modified COT or, if the modified COT is failed, a modified SBT (for an analysis of the normal COT and SBT rules, see Unit 8).

These modified tests establish whether the joining entity could hypothetically have used the losses during a deemed period, known as the trial year, assuming that it did not join the consolidated group and had enough income or capital gain to use the losses (s. 707-120(1)).

If the tests are satisfied, the loss can be transferred and the head entity is **taken to have made the loss in the year of transfer** (s. 707-140). If the modified loss tests are not satisfied, the losses cannot be used by any entity (s. 707-150).

Stage 2 – Can transferred losses be used? (Subdivision 707-B)

Note: The modifications to COT are outside the scope of the TAXAU module.

When the head company wants to use a transferred loss, it must pass either the COT or, failing that, the SBT (as discussed in Unit 8).

However, if the transferred loss is a COT transfer (i.e. original loss maker passed the modified COT under Stage 1 above), the COT is also modified at this stage (s. 707-210(1)).

If the transferred loss is not a COT transfer, the COT applies normally to the head entity without s. 707-210 operating.

If the head entity fails the COT, it would need to pass the normal SBT to use the transferred loss.

Stage 3 – Calculate the amount that can be used (Subdivision 707-C)

Once it is ascertained that a transferred loss is able to be used, the next step is to calculate the amount of the loss that can actually be used. In working out this amount, it is necessary to understand the following terms:

- **Bundle of losses.** The term 'bundle of losses' refers to the losses that are transferred by the joining entity. Each bundle represents the loss transferred from one joining entity.
- **Sort of loss.** The term 'sort of loss' refers to the type of loss that is transferred within a bundle (e.g. tax loss and a net capital loss). You should note that each bundle of losses can contain more than one sort of loss.
- **Available fraction.** The 'available fraction' is calculated for each bundle of losses. The available fraction limits the amount of losses in a particular bundle that can be utilised (s. 707-310). Conceptually, the limit represents the proportion of income that the subsidiary contributed to the consolidated group. It essentially uses the market values (as modified) of the subsidiary and the consolidated group as the proxy to determine the subsidiary's contribution.

Available fraction

Note: Calculation of the available fraction for a bundle of losses is outside the scope of the TAXAU module.

The available fraction is calculated using the following formula in s. 707-320(1):

$$\frac{\text{Modified market value of the real loss-maker at the initial transfer time}}{\text{Transferee's adjusted market value at the initial transfer time}}$$

Where:

- 'Modified market value' is the market value of the entity **after taking away** the market value attributed to any losses (but only to the extent that losses are actually reflected in the market value of the entity), the value of the franking account (where it is actually reflected in the market value of the entity), any injections of capital within the prior four years under certain conditions, and any value attributable to a membership interest held in other members of the group (s. 707-325).
- 'Transferee's adjusted market value' is the market value of the group (including the loss-making entity) after taking away the market value attributed to any losses and franking account surplus of the group (s. 707-320(1)). The denominator is worked out immediately after the acquisition (s. 707-320(1)).

The available fraction is rounded to three decimal places. However, where the rounding would result in an available fraction of zero, it is rounded to the next non-zero decimal place (e.g. for 0.000065, the available fraction is 0.00007 (s. 707-320)).

The available fraction for a bundle of losses must be re-calculated if events specified in s. 707-320(2) occur and the transferred losses have yet to be fully utilised. For example, a consolidated group acquires another loss entity, or the group's market value is increased as a result of a capital injection or a non-arm's-length transaction.

Loss limit

The amount of a loss bundle that the head company can use in a particular income year is calculated using the following formula:

$$\text{Total group income of a particular kind} \times \text{Available fraction} = \text{Amount of loss bundle that can be used}$$

However, the head company must use consolidated group losses arising in the income year before transferred losses of the same sort.

Example – Transferred loss utilisation

Head Co is the head company of a consolidated group. Head Co has the following two bundles of transferred losses:

- Bundle 1: $4,500 net capital loss, with an available fraction of 0.940.
- Bundle 2: $20,000 tax loss, with an available fraction of 0.060.

During the income year ended 30 June 2019, Head Co's taxable income (before the utilisation of transferred losses) comprises:

- Net capital gain of $4,500.
- Ordinary income of $17,000.

Assume Head Co has satisfied the COT and can use the transferred losses.

Head Co's net capital gain can be reduced by transferred losses as follows:

- Bundle 1: Net capital gain $4,500 × available fraction 0.94 = $4,230.
- Bundle 2: Net capital gain $4,500 × available fraction 0.060 = $270.

Head Co's ordinary income can be reduced by transferred losses as follows:

- Bundle 1: Not applicable. A net capital loss can only be used to reduce a net capital gain.
- Bundle 2: Ordinary income $17,000 × available fraction 0.060 = $1,020.

Head Co's taxable income (after the utilisation of transferred losses) is:

(Ordinary income $17,000 – transferred losses $1,020) + (net capital gain $4,500 – transferred losses $4,500)

= $15,980

The balance of Head Co's bundles of transferred losses are:

- Bundle 1: $4,500 – $4,230 = $270.
- Bundle 2: $20,000 – $270 – $1,020 = $18,710.

Franking credit transfer rules

Overview

When a subsidiary member joins a tax consolidated group and its franking account is in:

- Surplus – the balance is transferred to the head company, setting the subsidiary member's franking account balance to zero.
- Deficit – the subsidiary becomes liable for franking deficit tax, with a corresponding credit in the franking account setting its franking account balance to zero.

The amount of the franking credits which are transferred to the head company are not limited by the subsidiary's profits. While part of a consolidated group, the subsidiary's franking account continues to exist, but is inoperative.

The head company operates a single franking account for the consolidated group. Activities that would otherwise have caused a franking credit or debit to arise in the franking account of a subsidiary member will instead give rise to a franking credit or debit in the franking account of the head company.

Generally, a subsidiary member cannot frank distributions to entities outside the group. Only the head company can do this. However, a subsidiary member can make frankable distributions in relation to shares in employee share acquisition schemes and non-share equity interests. Such distributions are treated as having been made by the head company, which gives rise to a franking debit in the head company's franking account.

There is an anti-avoidance provision (s. 177EB ITAA 1936) that applies where, very broadly, companies are acquired for the purpose of transferring their franking credits into a tax consolidated group.

Note: When a subsidiary member leaves a tax consolidated group, all franking credits remain in the head company (see below under 'Exclusions' to the 'Exit history rule').

Exiting a consolidated group

Overview

A subsidiary member automatically leaves a tax consolidated group when it is no longer eligible to be a member. For example, when it is no longer wholly owned directly or indirectly by the head company (i.e. there is a disposal of membership interests outside the tax consolidated group).

When an entity ceases to be a subsidiary member, the following special rules operate:

- **Exit history rule –** history is transferred to the leaving subsidiary in respect of certain items.
- **Tax cost setting process –** the cost base of the shares in the subsidiary are reset on exit.
- **CGT events –** CGT event L5 happens when a subsidiary exits the tax consolidated group and its liabilities exceed the tax cost of its assets.

Exit history rule

Under s. 701-40, the exit history rule operates so that everything that happened in relation to an 'eligible asset etc.' while it was that of the head company is taken to have happened in relation to it as if it had been an 'eligible asset etc.' of the leaving entity.

'Eligible asset etc.'

Section 701-40 defines 'eligible asset etc.' to include any:

- asset
- liability
- business.

Similar to the entry history rule, the exit history rule only operates for the core purposes of the entity.

Example – Exit history rule

Borrowing costs

If borrowing costs relate to a liability of the leaving entity, the leaving entity can inherit the undeducted s. 25-25 borrowing cost deductions of the head company.

Depreciating assets

If a leaving entity takes away assets, such as depreciating assets or CGT assets, the history of the asset is inherited by the subsidiary. This includes, among other things, the acquisition date and the terminating value of the asset.

Exclusions

It is important to note that the exit history rule applies only to 'eligible assets etc.'. In comparison, the entry history rule applies to everything. Accordingly, where an item is not an eligible asset, the leaving entity cannot inherit that item's history. This ensures that **losses, franking credits and foreign income tax offsets** remain with the head company when a subsidiary entity leaves the tax consolidated group.

Tax cost setting process

Note: You **do not** need to know how to determine the values for each of the steps in the exit ACA calculation for the purposes of the TAXAU module. However, you **do** need to know how to calculate a head company's income tax liability, including any impacts resulting from the tax cost setting process. This requires you to understand the calculation of the exit ACA (including where it results in a negative amount), to know when CGT event L5 applies, and to know how to calculate the relevant capital gain or loss.

Methodology

When a head company disposes of membership interests (i.e. shares) in a subsidiary member, that entity leaves the tax consolidated group and the head company needs to calculate the capital gain or loss it makes on the disposal. As explained in Unit 4, a capital gain is equal to the difference between the cost base and the capital proceeds.

The cost base of the membership interests (i.e. shares) must be determined (or 'set') under Division 711. Assuming a scenario in which there is only one leaving entity, s. 711-15 applies a two-stage process as follows:

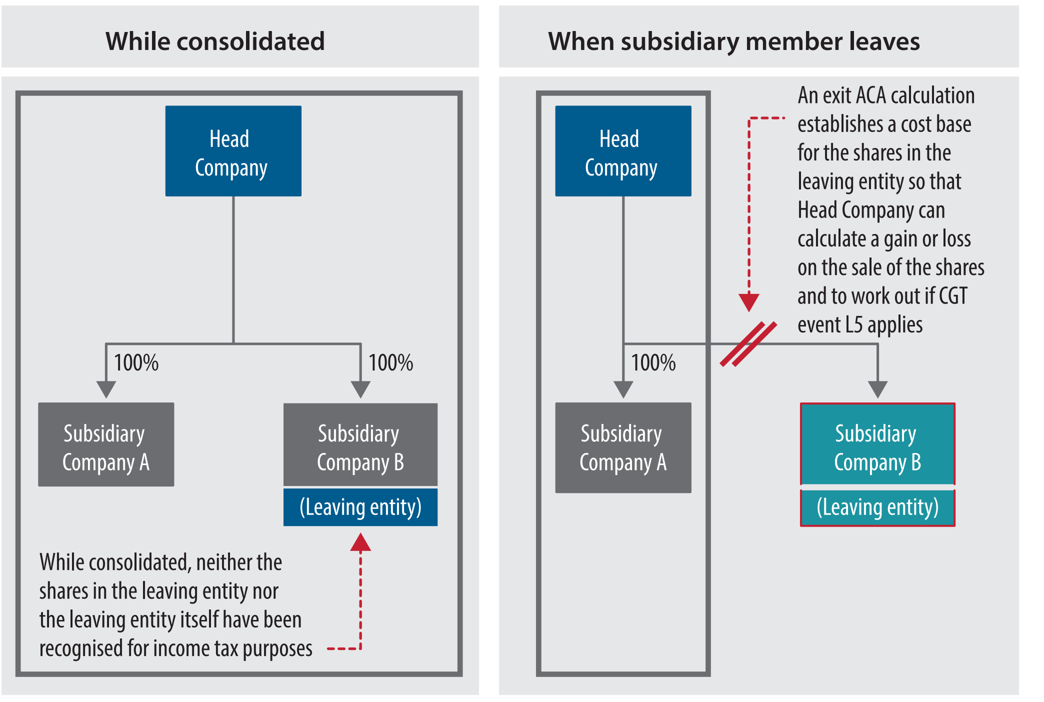
Stage 1: Calculate the exit ACA of the leaving entity.

Stage 2: Allocate the exit ACA of the leaving entity to the membership interests held by the head company.

The original amount paid to acquire the membership interests (i.e. shares) is not relevant. Shares in a subsidiary do not exist under the single entity rule. While the subsidiary was a member of the tax consolidated group, the head company was taken to own the assets and liabilities of the subsidiary.

If there is more than one class of membership interests, the exit ACA is allocated to each class according to their market values.

Cost base of membership interests



Stage 1 – Calculate the exit ACA of the leaving entity

Division 711 aligns the cost of the membership interests with the net tax cost of assets in the leaving entity so that it does not matter whether the head company disposes of the assets or the shares in the leaving entity for tax purposes.

The exit ACA of a leaving entity is determined under a five-step process summarised in the table in s. 711-20. These five steps are outlined below.

Step 1

Start with the terminating values of assets that the leaving entity takes with it when it ceases to be a subsidiary member (s. 711-25). The term 'terminating value' is defined in s. 705-30 as the cost base of assets at the leaving time. For depreciating assets, this would be the cost of the asset for tax purposes less amounts claimed as decline in value deductions up until the leaving time. Note that incidental costs of the kind described in s. 110-35(2) incurred by a head entity **after** the shares are sold would be taken into account in the calculation of the gain or loss on the shares (TD 2011/10), but if they are incurred **before** the shares are sold (TD 2010/1), then these costs would generally be deductible over five years as per s. 40-880

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Step 2

Add to the result of Step 1 inherited deductions of the leaving entity multiplied by the corporate tax rate (e.g. inherited deductions × 30% for non-SBEs). Step 2 does not include undeducted Division 43 amounts and deductions reflected in the terminating value of the assets taken by the leaving entity (s. 711-35)

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Step 3

Add to the result of Step 2 the market value of liabilities owed by members of the old group to the leaving entity at the leaving time (s. 711-40). Essentially this allows the leaving entity to recognise the cost of intra-group debts receivable from other members of the tax consolidated group at the leaving time

↓

Step 4

Subtract any liabilities of the leaving entity just before it leaves the group (s. 711-45(1)). The liability amount is changed in the following circumstances:

(a) Where a liability gives rise to future tax deductions – reduce the liability by the tax value of the future deductions (s. 711-45(3)) (e.g. deductible liabilities × 30% for non-SBEs)

(b) If the liability is an intra-group liability owed to a member of the old group, the market value of the liability is included (s. 711-45(4))

(c) Where a liability is recognised now for accounting purposes but later for tax purposes – the liability is the amount of the payment necessary to discharge the liability without the head company being assessed or deducting anything for tax purposes (s. 711-45(5)). Where both ss 711-45(3) and 711-45(5) apply, the latter section prevails (see TD 2005/53 paras 7–10); that is, these sections cannot both operate for the same item. For example, an employee provision is recognised for accounting purposes when accrued, but is deductible for tax purposes when paid (see s. 26-10). Both ss 711-45(3) and 711-45(5) are satisfied. Therefore, s. 711-45(5) will prevail. Section 711-45(5) asks how much is required to discharge the liability without the head company being assessed or deducting anything for tax purposes. The answer is $nil, because if the head entity pays off the provision, it would be deductible to the head entity (as a general business expense). So the s. 711-45(5) amount is $nil. Therefore, the Step 4 amount for the employee provision is $nil

(d) The market value of employee share scheme shares is included (s. 711-45(6))

(e) The market value of items that are equity under the Accounting Standards and 'debt interests' under Division 974 is also included (s. 711-45(7))

(f) If the s. 711-45(5) liability was included in an entry ACA calculation (whether or not the leaving entity), the liability is adjusted to the value used in the entry ACA calculation (s. 711-45(8) and (10))

Note: (a), (c) and (f) do not apply to a joining entity that becomes a member of a consolidated group on or after 1 July 2016. This is because deductible liabilities (other than excluded liabilities for certain insurance companies, TOFA liabilities and relating to retirement village contracts) are not added to Step 2 in an entry ACA calculation (see Step 2 of ACA calculation on entry).

From 15 February 2018, deferred tax liabilities (DTLs) are disregarded from step 4 (s. 711-45(1B), except for DTLs that relate to assets held by life insurance companies. This is consistent with Step 2 of the ACA calculation on entry.

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Step 5

If the amount remaining after Step 4 is positive, it is the old group's ACA for the leaving entity. Otherwise the old group's ACA is $nil. CGT event L5 (see below) would need to be considered if the ACA is negative

Stage 2 – Allocate the exit ACA of the leaving entity to the membership interests held by the head entity

Once the exit ACA has been calculated, the amount is then allocated to each membership interest by dividing the ACA by the total number of membership interests on issue. Where more than one class of shares is on issue, the ACA is first allocated based on the market values of each class of share (s. 711-15).

Capital gain or loss on disposal

Once the cost base of each membership interest has been determined under the tax cost setting process, the head company needs to calculate the capital gain or loss on disposal under CGT event A1 (see Unit 4).

$$\boxed{\text{Capital proceeds}} - \left(\boxed{\text{Number of membership interests disposed of}} \times \boxed{\text{Amount allocated to each membership interest}} \right) = \boxed{\text{Capital gain}}$$

The following example demonstrates the exit ACA process and the calculation of the capital gain on disposal.

Example – Tax cost setting process on exit

Aussie Sports is the head company of a consolidated group. On 1 July 2018, Aussie Sports disposes of 100% of the membership interests in Netball in a single transaction for $1.75 million. There are 100,000 shares on issue in Netball at the leaving time. There is only one class of shares.

At the time of disposal, the balance sheet of Netball is as follows:

Netball's balance sheet at disposal			
Assets[1]	**$**	**Liabilities**	**$**
Cash	20,000	Loans	50,000
Plant (written-down value)	100,000	Current tax liability	100,000
Trading stock	35,000	**Equity**	
Buildings (at cost)	300,000	Share capital	100,000
Deferred tax asset: borrowing costs[2]	15,000	Retained earnings	220,000
Total	470,000	Total	470,000

Notes

1. Assume values in balance sheet are equal to the terminating value of each asset for income tax purposes.
2. Netball has an undeducted s. 25-25 borrowing cost of $50,000 related to loans that Netball will take with it when leaving (i.e. an inherited deduction).

The following steps are required to calculate the tax cost of each membership interest (s. 711-20).

Step 1 – Calculate the exit ACA of Netball

Step	Description	Explanation of steps under s. 711-20	$
(i)	*Add*: Termination value of Netball's assets	Assets taken by Netball (s. 711-25) All the assets except the deferred tax assets are assets for tax consolidation purposes (s. 701-67) $470,000 – DTAs $15,000	455,000
(ii)	*Add*: Deductions inherited by Netball (other than those reflected in the terminating value of assets in Step 1)	Value of deductions not reflected in the terminating value of assets (s. 711-35) $50,000 × tax rate 30%	15,000

Step	Description	Explanation of steps under s. 711-20	$
(iii)	*Add*: Market value of intra-group liabilities owed to Netball	Netball has no unrecognised intra-group liabilities (s. 711-40)	0
(iv)	*Subtract*: Liabilities that Netball takes with it when it leaves	Reduced by future tax deductions or adjusted for unrealised gains/losses (s. 711-45) Neither the loan or current tax liability give rise to a future tax deduction ($50,000 Loan × 100%) + ($100,000 CTL × 100%)	(150,000)
	Total: Exit ACA		320,000

Step 2 – Allocate to membership interests

As there are 100,000 membership interests in Netball on issue, this results in a cost base of $3.20 per share.

Step 3 – Capital gain calculation

Capital gain = Capital proceeds $1.75 million – Cost base 100,000 shares × $3.20 = $1.43 million

CGT events

When an entity leaves a tax consolidated group, CGT event L5 can apply to result in a capital gain to the head company (s. 104-520). CGT event L5 happens if the amount after Step 4 of calculating the exit ACA process is negative. The negative amount is treated as a capital gain. The purpose of CGT event L5 is best explained through the following example.

Example – CGT event L5

Assume that a subsidiary member has one asset (with a cost base of $100,000 and a market value of $1 million) and one (non-deductible) liability ($500,000) and it is sold for its net value of $500,000.

A disposal of the **asset** by the subsidiary member would result in a capital gain under CGT event A1 of $900,000 (calculated as the proceeds ($1 million) **less** the cost base of the asset ($100,000)).

A disposal of the **shares** in the subsidiary member would result in a capital gain under CGT event A1 of only $500,000 (the net value of the company), as the ACA process on exit would result in a cost base of membership interests being $nil (as the amount under the five-step process cannot be reduced below $nil).

However, CGT event L5 would result in an additional capital gain of $400,000, being equal to the negative amount after Step 4. The total capital gain would therefore also equal $900,000 (being $500,000 under CGT event A1 and $400,000 under CGT event L5). Accordingly, CGT event L5 ensures that a share sale results in a similar outcome to an asset sale.

Note: In TD 2006/38, the ATO accepts that Division 711 does not apply upon an entity ceasing to be a subsidiary member of the acquired tax consolidated group when one tax consolidated group is acquired by another. Therefore, CGT event L5 also cannot apply.

Activity 12.2: CGT event L5 on sale of wholly owned subsidiary

[Available online in myLearning]

Exit time

For consolidation purposes, a sale takes place when a group member (i.e. a subsidiary or head company) stops being the beneficial owner of the shares (ss 703-15(2)(b) and 703-30(1)) – that is, when the subsidiary member ceases being entitled to be registered as the holder of the shares (refer s. 703-33(2)).

Pre-CGT membership interests

The tax consolidations regime deals with pre-CGT membership interests by (per s. 705-125):

- Working out the pre-CGT proportion of the total membership interest of the joining entity by market value at joining time (i.e. pre-CGT proportion).
- When the joining entity later leaves the group, applying that pre-CGT proportion to the membership interests of the leaving entity (s. 711-65).

However, the pre-CGT proportion is $nil if any assets held by the leaving entity at the time it joined the old group stopped being a pre-CGT asset under Division 149 (s. 711-70).

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 13: Financial transactions

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Identify the taxation of financial arrangements (TOFA) provisions.
2. Explain the tax consequences of financing asset acquisitions by lease or as a hire purchase agreement.
3. Determine the appropriate Australian dollar tax base for transactions in foreign currency applying the foreign currency translation rules.
4. Explain and calculate foreign exchange gains and losses.
5. Analyse and apply the tax debt-equity rules.

Introduction

Taxation issues are invariably an important consideration in business financing transactions. Tax practitioners are frequently called on to advise on the after-tax return (or cost) of such transactions and the tax recognition time for assessable income or deductions.

Financial transactions are dealt with in a piecemeal fashion in the legislation. Although Division 230 ITAA 1997 appears to provide a comprehensive code for the taxation of financial arrangements (commonly referred to as the TOFA rules), the division does **not** apply to:

- all taxpayer categories (e.g. individuals and small to medium businesses and funds are typically excluded), or
- all types of financing transactions (e.g. leases, hire purchase agreements and short-term financing arrangements are excluded).

This unit, therefore, covers the separate rules for:

- TOFA (however, you do not need to know Division 230 in detail).
- Financing asset acquisitions – including lease arrangements, hire purchase arrangements, chattel mortgages and luxury car leases.
- Conversion of foreign currency into Australian dollars.
- Realisation of foreign exchange gain and losses.
- Classification of financial transactions as either debt or equity.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997).

Taxation of financial arrangements (TOFA)

Overview

The TOFA rules in Division 230 do not apply to all taxpayer categories, or to all types of financing transactions. In this unit, taxpayers and transactions falling within Division 230 are referred to as 'Division 230 taxpayers' and 'Division 230 financial arrangements' respectively.

Despite the gaps in the coverage of Division 230, the TOFA rules nonetheless provide a unique opportunity for Division 230 taxpayers with audited general purpose financial reports to choose to align the income tax treatment of Division 230 financial arrangements with their treatment under relevant Accounting Standards.

The TOFA rules apply to Division 230 financial arrangements entered into on or after 1 July 2010 (or income years starting after 1 July 2009 by election). Arrangements entered into before the start dates are dealt with under the pre-existing tax law, although taxpayers could choose to bring their existing arrangements into the Division 230 framework.

Division 230 is complex, with many concepts in taxing gains and losses from financial arrangements. For the TAXAU module, you do not have to know the division in detail. You only need to have an awareness of the main points.

Application

Financial arrangements

Division 230 applies to 'financial arrangements' entered into by entities. 'Financial arrangement' is defined in ss 230-45 to 230-55 and refers to arrangements made up of rights to receive (or obligations to provide) financial benefits that are monetary in nature (i.e. a cash-settleable right or obligation). This concept of financial arrangement is very similar to the concept of financial asset and financial liability in IAS 32 *Financial Instruments: Presentation* (IAS 32).

The definition is deliberately broad. It is designed to cover the many different types of financial arrangements already in existence and those that will be developed by financial institutions and markets in the future. TOFA is a little like FBT because it acts as a 'dragnet' – most things are caught and you need to find exemptions and/or exclusions to get you out.

However, a cash-settleable right or obligation is not a financial arrangement if, under the same arrangement, the entity also has a 'not insignificant' right or obligation that is either:

- to provide or receive something that is not a financial benefit, or
- not cash-settleable.

Example – A cash-settleable financial arrangement

Steam Co enters into an arrangement with Big Co to acquire a train for $1 million. Steam Co's obligation to pay for the train is a cash-settleable obligation to provide a financial benefit and its right to receive the train from Big Co is not cash-settleable.

Scenario 1: The train is delivered and payment is made at the same time.

Under this scenario, there is no financial arrangement. There is, until the time of settlement, a not-insignificant non-cash-settleable right (i.e. the delivery of the train) and after settlement, there are no subsisting rights or obligations under the arrangement.

Scenario 2: The terms of the agreement are such that the train will be delivered to Steam Co immediately, but payment will be deferred for 18 months.

Under this scenario, there is a financial arrangement immediately after delivery of the train as, at this time, the only subsisting rights and obligations under the arrangement are cash-settleable.

In other words, TOFA is looking at the post asset delivery liability.

Adapted from: Explanatory Memorandum to *Tax Laws Amendment (Taxation of Financial Arrangements) Act 2009*.

Turnover thresholds

Division 230 applies to the following entities (s. 230-455):

- An authorised deposit-taking institution (e.g. a bank), a securitisation vehicle or a financial sector entity with an aggregated turnover of $20 million or more.
- A superannuation entity, a managed investment scheme or a similar scheme under a foreign law if the value of the entity's assets is $100 million or more.
- Any other entity (except for individuals) that satisfies any of the following thresholds:
  - An aggregated (associate inclusive) turnover of $100 million or more.
  - Assets of $300 million or more.
  - Financial assets of $100 million or more.

This means that Division 230 is generally not applicable to individuals, small to medium enterprises and self-managed superannuation funds unless they invest in qualifying securities (see below). However, care is needed where an Australian subsidiary has a small turnover, but it is part of a larger worldwide group with a large turnover. This is because the non-resident group companies, being associates, are taken into account in working out the threshold.

Qualifying securities

Regardless of the above thresholds, Division 230 also applies to the qualifying securities of an entity (including individuals). Broadly, a qualifying security is one that has a deferred income element (i.e. it is issued under terms likely to exceed 12 months, where the investor's return on the investment, other than periodic interest, will be greater than 1.5% per annum) (see s. 159GP(1) ITAA 1936). For example, if interest on a debenture is only payable at the end of four years, TOFA will apply to 'tax' the gain on an accruals basis. TOFA will also apply to a security which is issued at a discount.

Opting into Division 230

Taxpayers outside the scope of Division 230 may make an irrevocable election to 'opt-in' to Division 230 (refer ss 230-455(6) and (8)). This election applies to all of the taxpayer's financial arrangements that the taxpayer starts to have in the income year in which the election is made (see s. 230-455(7)).

Exclusions

As noted, Division 230 does not apply to every type of financial arrangement. The table below summarises the main exclusions and identifies the relevant tax law that should be applied.

Division 230 financial arrangements: exclusions and relevant income tax law	
Excluded financial arrangements irrespective of who undertakes them	**Relevant income tax law**
Sale or acquisition of goods or services where the arrangement is settled within 12 months (s. 230-450)	General concepts of derived and incurred, bad debt provisions (see Unit 1) and cost (see Units 4 and 5)
Luxury car leases (s. 230-460(2)(a))	Division 242 (see later in this unit)
Hire purchase arrangements (s. 230-460(2)(b))	Division 240 (see later in this unit)
Assets leased to or used by a tax-preferred entity (e.g. a tax-exempt body, government agency or non-resident) (s. 230-460(2)(c))	Division 250 (outside the scope of the TAXAU module)
Leases of land and goods (s. 230-460(2)(d))	General concepts of derived and incurred, Division 40 (leased depreciating asset) and Australian Taxation Office (ATO) guidelines on leasing arrangements
Certain interests in partnership and trusts (s. 230-460(3))	Division 5 and Division 6 ITAA 1936, and relevant capital gains tax (CGT) provisions
Superannuation and pension benefits (s. 230-460(11))	Part 3-30 'Superannuation' (see Unit 11)
Earn-out arrangements based solely on economic performance of a business following the sale of the business, or a company or trust which operates the business (s. 230-460(13))	CGT rules (adjustment to cost base or capital proceeds) if transaction on capital account. General concepts of derived and incurred if on revenue account (see Units 1 and 4)
Farm management deposits (s. 230-460(15))	Division 393

Note: Section 230-505 can apply to the sale or acquisition of an asset where part of the consideration is deferred for greater than 12 months (i.e. as the arrangement is **not** settled within 12 months it is not excluded by s. 230-450). Where applicable, the section changes the ordinary operation of certain regimes, such as the capital allowances rules and CGT rules, to ensure the asset is taken to have been acquired for or disposed of for its market value. Therefore, the difference between market value and the actual amount under the arrangement, that would generally be included in the cost or sale proceeds of the asset, is converted into a TOFA gain or loss (i.e. a revenue amount).

Consequences

Gains from a Division 230 financial arrangement are assessable. Losses are deductible only if a taxpayer makes them in gaining or producing assessable income or in carrying on a business that produces assessable income (s. 230-15).

Gains and losses from financial arrangements are **not** assessable or deductible if:

- They relate to exempt income or non-assessable, non-exempt (NANE) income (s. 230-30) (e.g. a foreign currency borrowing to buy shares in a controlled foreign company which will pay NANE dividends under s. 768-5 – see Unit 14).
- The arrangement is held for private or domestic purposes (s. 230-35).

CGT does not apply to gains and losses made on Division 230 financial arrangements (s. 118-27).

Recognition methods

The default tax recognition methods for Division 230 financial arrangements are the accruals method and the realisation method (if the accruals method does not apply).

Alternatively, a Division 230 taxpayer could choose to apply a number of elective tax-timing methods, subject to satisfying specific eligibility requirements.

Accruals method

The accruals method allocates a gain or loss from a financial arrangement to income years according to an implicit rate of return (the compounding accruals method or a similar method, such as the effective interest method).

The assessable gain or deductible loss will take into account all the financial benefits received or given under the arrangement. For example, borrowing costs relating to a Division 230 financial arrangement will be treated as part of the overall loss from the transaction and will be deductible over the term of the loan, rather than being separately claimed as a deduction under s. 25-25 (see Unit 1). So if a loan goes for eight years, the borrowing costs would be deductible over eight years as part of the overall loss, rather than over five years under s. 25-25.

The accruals method applies to a financial arrangement when there is:

- An **overall** gain or loss from the arrangement that is **sufficiently certain** at the time when an entity starts to have the arrangement.
- A **particular** gain or loss from the arrangement that is **sufficiently certain**, either at the time when an entity starts to have the arrangement or that becomes sufficiently certain during the life of the arrangement.

A determination of whether a gain or loss is sufficiently certain will usually be made at the commencement of the financial arrangement and will take into account the terms and conditions of the arrangement, the accepted pricing and valuation techniques, and the economic substance of the arrangement. Under s. 230-115, a financial benefit is treated as 'sufficiently certain' only if both of the following apply:

- It is reasonably expected that the entity will receive or provide the financial benefit, assuming it will continue to hold the financial arrangement for the rest of its life.
- At least some of the amount or value of the benefit is, at that time, fixed or determinable with reasonable accuracy.

Example – Accruals method and sufficiently certain gain or loss

Big Superannuation Fund (Big) acquires a three-year, zero-coupon bond for $100 on 1 July 2018, with a face value of $133.10. As there is a sufficiently certain overall gain of $33.10, the accruals method will apply to the zero-coupon bond.

Big's gain of $33.10 is spread across the three years. Applying the internal rate of return of 10% to the cost of the financial arrangement on a compounding basis, Big makes an assessable gain of $10, $11 and $12.10 respectively during the three-year term.

	Income year ended		
Acquisition cost: $100	30 June 2019	30 June 2020	30 June 2021
Value through term	$110	$121	–
Face value at end	–	–	$133.10
Tax treatment under the accruals method	$10 gain	$11 gain	$12.10 gain[1]

Note

1. A 'balancing adjustment' (sometimes called a 'true-up') applies at the end of the financial arrangement to recognise any gain or loss not brought to account during the period the financial arrangement was held (Subdivision 230-G).

Realisation method

If the gain or loss is not sufficiently certain, the realisation method allocates the gain or loss on the Division 230 financial arrangement to the income year in which it is realised.

Example – Realisation method

Big Bank Ltd (Big) invests in a futures contract which will result in a gain only if the S&P/ASX 200 Index on the Australian Securities Exchange exceeds 5,000 three months from now. Big has not chosen to use any of the elective tax-timing methods (see below).

The gain or loss on this type of speculative investment is not sufficiently certain, so Big will only bring the gain or loss to account for income tax purposes when the futures contract is closed out.

Elective methods

If eligible, a Division 230 taxpayer can choose one or more of the elective tax-timing methods. These methods are designed to reduce compliance costs by allowing entities to rely on their financial reports to work out the gain or loss made from their Division 230 financial arrangements in each income year.

The main eligibility criterion is that the Division 230 taxpayer prepares audited financial reports in accordance with relevant Accounting Standards.

The four elective tax-timing methods are:

- Foreign exchange retranslation.
- Fair value.
- Reliance on financial reports.
- Hedging financial arrangements.

These elective tax-timing methods are outside the scope of the TAXAU module.

Financing asset acquisitions

Overview

A business can finance asset acquisitions in many ways. The methods covered in this unit include:

- Lease arrangements.
- Hire purchase arrangements.
- Chattel mortgage.
- Luxury car leases.

Lease arrangements

Lease financing is a common way for business owners to obtain the equipment they need to operate their business without incurring large upfront costs in purchasing the assets.

Except where luxury car leases are involved (see below), there is no definition of the term 'lease' in Australian income tax law.

In general terms, a 'lease' is an agreement between two individuals or entities where one party is granted a legal right to use or occupy the property of the other party for a specified period in return for payment.

The ATO also has guidelines on what it regards as a genuine lease arrangement. In broad terms, the ATO requires that (see IT 28 and IT 2051):

- There must be no agreement, express or implied, under which the property in the asset can pass from the lessor to the lessee (i.e. it is not a disguised sale and purchase agreement).
- For leases of depreciating assets, minimum residual values should exist (i.e. a very low or nominal residual value in a lease, e.g. $1, suggests to the ATO that the transaction is a disguised sale and purchase agreement on credit terms).

Lease payments

The general tax treatment of leases, if both parties are carrying on business and the leased asset is used solely to produce income, is as follows:

- Lessee – the lessee generally receives a tax deduction under s. 8-1 for lease payments incurred during the year.
- Lessor – the lessor is assessed on lease payments derived during the year and claims a Division 40 decline in value deduction for the asset under the lease (subject to the motor vehicle cost limit where applicable), with a balancing adjustment on disposal (this is sometimes referred to as the 'asset method').

  The lessor is entitled to the Division 40 deduction because it will be the holder of the asset under s. 40-40.

The accounting treatment of a **lessee for a finance lease and for an operating lease** (under the new Accounting Standard for leases, IFRS 16) is to:

- Capitalise an asset and liability on its balance sheet.
- Write down the value of the asset (e.g. as depreciation or reduction in the value of its right of use) and expense a component of the lease payment only (e.g. as interest or a reduction in its obligation to make lease payments).

Note: The new Accounting Standard for leases (IFRS 16) applies from 1 January 2019, or earlier if the entity also adopts the new revenue Standard (IFRS 15).

Since the accounting treatment is reflected in accounting profit of the lessee, which is the usual starting point for calculating the taxable income of business entities, tax return preparers typically add back the accounting expenses (e.g. depreciation and interest for a finance lease) and deduct the lease payments when calculating taxable income of a lessee.

Example – Lease arrangements

LeaseCo, an Australian resident company, has entered into a lease arrangement for a new machine costing $10,000. Under the terms of the lease agreement, LeaseCo is required to make payments of $1,200 per year.

For the year ended 30 June 2019, LeaseCo has recognised the following for accounting purposes:

Balance sheet		**Profit and loss**	
Asset – Machine	$10,000	*Less:*	
Less: Accumulated depreciation	($900)	Depreciation expense	900
	$9,100	Interest expense	200
Liability – Loan	$10,000	Accounting profit/(loss)	($1,100)
Add: Notional interest	$200		
Less: Repayments	($1,200)		
	$9,000		

LeaseCo is entitled to claim the $1,200 of lease payments as a tax deduction. Therefore, when preparing its taxable income calculation (i.e. reconciliation of accounting income to taxable income), LeaseCo makes the following adjustments:

Reconciliation of accounting income to taxable income	
Accounting profit/(loss)	($1,100)
Add back: Non-deductible amounts	
Accounting depreciation	$900
Accounting notional interest	$200
Less: Deductible amounts	
Lease payments	($1,200)
Taxable income/(loss)	($1,200)

The accounting treatment of a **lessor for an operating lease** (under IFRS 16, the new Accounting Standard for leases) is unchanged. The lessor:

- Capitalises the asset on its balance sheet and depreciates its value over time (i.e. includes a depreciation expense in its accounting profit).
- Recognises lease payments received as income in its accounting profit.

The same treatment applies to finance leases.

As the tax and accounting treatments are similar, an adjustment is only needed for the difference between the tax decline in value and the accounting depreciation (if any).

Lease shortfall payments

The ATO accepts that an income tax deduction is allowed if a taxpayer makes a lease shortfall payment on a previously leased asset which had been used for income-producing purposes (IT 2287).

A lease shortfall payment arises if the lease agreement requires the lessee to indemnify the lessor against any loss incurred after termination of the lease and the sale of the leased asset. In practice, such payments are encountered if the lessor (i.e. the finance company) or the taxpayer cannot sell the previously leased asset on the open market for an amount at least equal to the lease residual value.

Lease incentives

Non-cash lease incentives (e.g. a rent-free period and fit-out contributions) are an example of a non-cash business benefit that are treated as if they are convertible to cash under s. 21A ITAA 1936. The taxation consequences are covered in detail in Unit 1. In general terms:

- A rent-free period for a business taxpayer would not give rise to assessable income, due to the application of the 'otherwise deductible rule' in s. 21A ITAA 1936.
- A fit-out contribution which is transferred from the lessor such that it is owned by the lessee will give rise to assessable income upfront under s. 21A ITAA 1936, with a decline in value deduction being allowable over time.

Lease termination payments

Section 25-110 allows taxpayers to deduct capital expenditure to terminate a lease or licence over five years (unapportioned, i.e. 20% in the first year) if the expenditure is incurred in the course of carrying on a business (or ceasing to carry on a business). The taxation treatment of making a lease termination payment is covered in Unit 5.

Lease documentation expenses

Section 25-20 allows taxpayers to deduct expenditure incurred for preparing, registering or stamping a lease of property (or an assignment or surrender of a lease of property) to the extent the taxpayer uses the property for the purpose of producing assessable income. For example, assume John pays $5,000 to prepare and register a lease document in respect of a warehouse used in his manufacturing business. A deduction of $5,000 is available in the year the expenditure is incurred (i.e. no apportionment is required). However, if John used 15% of the warehouse for private purposes, the deduction would be 85% × $5,000 = $4,250.

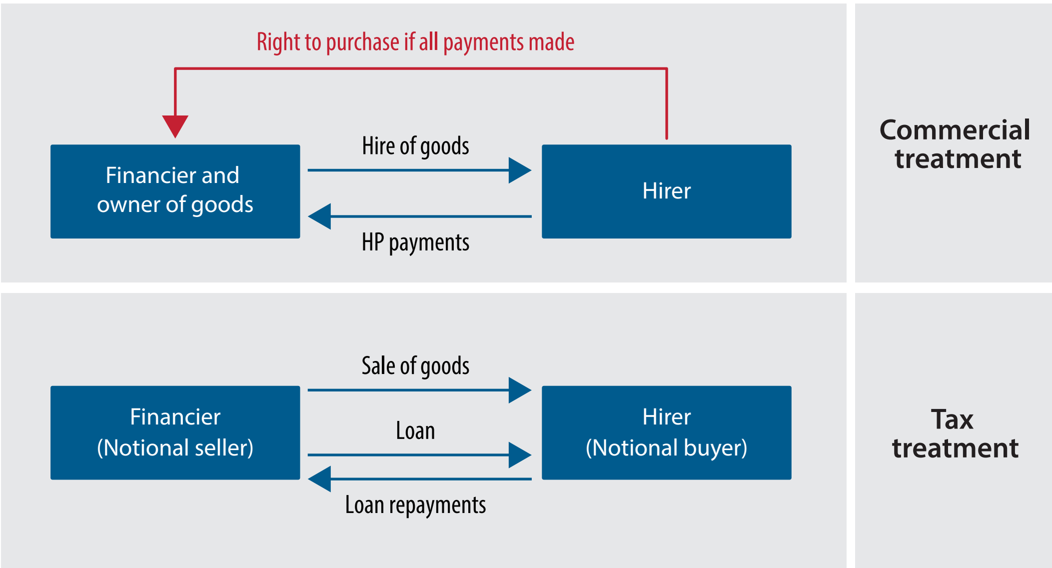
Hire purchase arrangements

Division 240 applies to hire purchase agreements. Under s. 995-1(1), an agreement is a hire purchase agreement if it is:

- a contract for the hire of goods where:
  - the hirer (notional buyer) has the right, obligation or contingent obligation to buy the goods, and
  - the charge that is or may be made for the hire, together with any other amount payable under the contract (including an amount to buy the goods or to exercise an option to do so), exceeds the price of the goods, and
  - title in the goods does not pass to the hirer (notional buyer) until the option is exercised, or
- an agreement for the purchase of goods by instalments where title in the goods does not pass until the final instalment is paid.

Division 240 deems a hire purchase transaction to be a loan (to the person or entity hiring the asset) to purchase the asset. This deeming applies for all purposes of the income tax law, except the withholding tax provisions.

The following diagram highlights how the tax treatment differs from the treatment of hire purchase agreements under commercial law.



Note: You need to be careful when identifying the terminology used for the notional buyer and notional seller. The definition section of the taxation legislation (and the explanations in this unit) refers to the notional buyer as the 'hirer'. However, in practice the notional buyer may be called the 'hiree' and the notional seller might be called the 'hirer'.

Hire purchase payments

The tax implications for the hirer (notional buyer) are as follows:

- The periodic payments are treated as a repayment of loan principal plus interest. Therefore, only the interest component is deductible (as opposed to the whole payment).
- The notional buyer is treated as the holder of the depreciating asset (s. 40-40) from the start of the hire purchase arrangement. Therefore, the decline in value (i.e. depreciation) of the asset is deductible.

The tax implications for the hire purchase company (notional seller) are as follows:

- On entering into the arrangement, there is a notional disposal of the asset.
  - If held as trading stock, the notional selling price is included in assessable income. The trading stock is no longer 'on hand' for tax purposes (see Unit 1).
  - If held as a depreciating asset, the notional selling price is included in the balancing adjustment calculation as the terminating value (see Unit 5).
- The notional selling price is also treated as an interest-bearing loan. The interest component of the periodic repayments received is included in assessable income (as opposed to the whole amount).
- The notional seller is not the holder of the depreciating asset (s. 40-40) and is not entitled to any decline in value (i.e. depreciation) deductions.

The accounting treatment of a hire purchase arrangement is commonly the same as the above tax treatment – that is, the hirer (notional buyer):

- Capitalises the asset and hire purchase liability on its balance sheet.
- Depreciates the asset and expenses the interest component of the hire purchase payment only.

Due to the similarity in tax and accounting treatment, tax return preparers will typically only make adjustments when calculating taxable income (i.e. when preparing a reconciliation of accounting income to taxable income) for any difference between accounting and tax depreciation (e.g. because of different depreciation periods for accounting and tax, or because of the car depreciation cost limit).

Loan amount and price

The rules for determining the loan amount and the sale or acquisition price of the asset where Division 240 applies are complex. However, the loan amount or the sale or acquisition price of the asset is, broadly, the agreed cost of the asset or the arm's-length value of the property. A detailed understanding of these rules is outside the scope of the TAXAU module.

Chattel mortgage

Business owners also sometimes use what is called a 'chattel mortgage' to acquire equipment.

A chattel mortgage is a loan agreement similar to a standard consumer loan (i.e. the business owner is not hiring or leasing the equipment – it owns the equipment from the outset). The business owner borrows funds to purchase the equipment and provides security for the loan by way of a mortgage over the equipment. Under a chattel mortgage, the business owner takes title in the chattel from the time of purchase.

Leases and hire purchase arrangements are sometimes confused with chattel mortgage arrangements.

The tax and accounting benefits of chattel mortgages include the following:

- Assuming the purchaser accounts for GST on a non-cash basis and the chattel purchased is a creditable acquisition, the purchaser is entitled to the entire input tax credit in the tax period in which the invoice is received or any payment is made, whichever is the earlier.
- The interest component of the repayments is fully tax deductible.
- Tax depreciation on the equipment is claimed by the owner, not the financier.

Luxury car leases

Leases of luxury cars are also treated as a deemed sale and loan transaction under Division 242, with the lessee entitled to claim deductions (apportioned for private use of the car) for:

- The interest component of the lease payment.
- Division 40 decline in value (i.e. depreciation) deductions subject to the car depreciation limit (see below).

The policy rationale for Division 242 is to ensure that a lease of a luxury car cannot be used to provide greater tax benefits than those that would be available if the lessee had purchased the car and was themselves subject to the car depreciation cost limit.

To determine whether the car lease relates to a 'luxury' car, refer to the annual taxation determination published by the Commissioner which states the car depreciation cost limit (indexed) for the relevant income year. The car limit for the income year ended 30 June 2019 is $57,581 (TD 2018/6).

Activity 13.1: Leases and hire purchases
[Available online in myLearning]

Foreign currency translation rules

Overview

Australia's small but economically advanced domestic market means that it is quite common for taxpayers to provide services or trade overseas. These transactions will often be denominated in a foreign currency.

The general rule in the income tax law is that amounts relevant to the calculation of an Australian tax liability must be translated into Australian currency (s. 960-50).

Some taxpayers may be eligible to use a functional currency other than the Australian dollar to work out their taxable income, which is then translated into an Australian dollar amount (Subdivision 960-D), but these rules are outside the scope of the TAXAU module.

Application

The currency translation requirements extend far beyond **assessable and deductible items**. Section 960-50 **includes** examples of amounts that require translation, including ordinary income, expenses, obligations, liabilities, receipts, payments, consideration and values.

The list includes amounts that are on revenue or capital account (s. 960-50(3)).

Translation rate

Section 960-50(6) contains specific currency translation rules clarifying the **time** at which a translation or event needs to be translated into Australian currency for income tax purposes.

Currency translation rules (s. 960-50(6))		
Item	**Situation**	**Exchange rate**
2	Cost of a depreciating asset	Earlier of time obligation satisfied or asset first held
3	Trading stock valued at cost	At the time item 'on hand'
4	Trading stock valued at market selling value or replacement value	At end of the income year
5	CGT transaction or event	At the time of the transaction or event
6	Ordinary income	Earlier of time received or derived
7	Statutory income	Earlier of time received or included in assessable income
8	Deduction (except under Division 40)	Earlier of time paid or became deductible
10	Withholding amount	At the time required to be withheld
11	Receipt or payment where none of the above apply	At the time of the receipt or payment

The table needs to be read in conjunction with the regulations in Subdivision 960-C ITAR 1997, which authorises the use of other currency translation rules found in Schedule 2 ITAR 1997.

These other currency translation rules include:

- Exchange rates used in financial reports (relevant only to taxpayers that prepare audited financial reports).
- A daily exchange rate applied to all transactions occurring in the particular currency on that day provided this approach is appropriate having regard to the entity's business or activities.
- An average exchange rate for a period (i.e. weekly, monthly, quarterly) not exceeding 12 months provided use of an average rate is reasonably likely to approximate the use of spot rates.

Associated entities cannot generally be used as the source of daily or average exchange rates. However, the ATO publishes a list of daily, monthly and end-of-year currency exchange rates to assist tax practitioners and taxpayers. Alternative reputable third-party suppliers of currency exchange rates can also be used.

You are expected to be able to identify the specific item number in s. 960-50(6) to justify the translation of foreign currency. You are also expected to be able to apply these conversion rules. However, the foreign exchange rates you are required to use will be provided for the purposes of the TAXAU module.

Note: The above exchange rate rules are contained in the income tax legislation and apply for income tax purposes. For GST purposes, s. 9-85 GST Act requires taxable supplies to be expressed in Australian currency. For ATO guidance, see the determinations FOREX 2018/1 and LVG 2018/1.

Example – Foreign currency translation

Eloise is an Australian Chartered Accountant who specialises in trans-Tasman business issues. On 1 June 2019, she goes online to the New Zealand Government website and purchases a publication relevant to her client work for NZ$50.

In calculating the Australian dollar deduction, Eloise has several options, which include the following:

(a) The daily exchange rate (s. 960-50(6))

Eloise could use the AUD/NZD currency exchange rate on 1 June 2019 (s. 960-50(6) item 8(a). Assume the daily rate for that date is: 1.3290. Eloise therefore could claim a deduction for A$37.62 (i.e. NZ$50 ÷ 1.3290).

(b) The monthly rate: ITAR 1997

Eloise is permitted to use average rates (Schedule 2 Part 1 item 1.3 ITAR 1997. Assume the monthly rate for June 2019 is 1.3183. Provided Eloise used this rate for all NZD transactions in June 2019, she could claim a deduction for A$37.93 (i.e. NZ$50 ÷ 1.3183).

(c) The yearly rate: ITAR 1997

Eloise could also use an annual rate under Schedule 2 Part 1 item 1.3 ITAR 1997. This exchange rate would need to apply to all her NZD transactions for the income year ended 30 June 2019. Assume the yearly rate to 30 June 2019 is 1.3205. Eloise could claim a deduction for A$37.86 (i.e. NZ$50 ÷ 1.3205).

Required reading

Section 960-50(6) ITAA 1997.

Schedule 2 Part 1 ITAR 1997.

Worked example 13.1: Foreign currency translation

[Available online in myLearning]

Foreign exchange gains and losses (Division 775)

Overview

Division 775 deals with foreign exchange (forex) gains and losses:

- Forex gains are assessable income under s. 775-15.
- Forex losses are deductible under s. 775-30.

In most cases, these gains and losses are recognised only when realised.

It does not matter that the amounts have not been converted into an equivalent amount of Australian currency. For example, an assessable gain or deductible loss could arise where a taxpayer converts US dollars to Euros.

Application

If the Division 230 TOFA rules apply to a forex gain or loss arising under a Division 230 financial arrangement, Division 230 will take precedence over the forex realisation event rules in Division 775 (refer to the notes to s. 775-15(4) and s. 775-30(4)).

If Division 230 does not apply to a financial arrangement under which the forex gain or loss arises, Division 775 takes precedence over other provisions of the income tax law, such as ss 6-5 and 8-1 (ss 775-15(4) and 775-30(4)).

In practical terms, therefore, Division 775 is relevant to:

- Taxpayers outside the scope of the Division 230 TOFA rules (e.g. individuals and small to medium enterprises, superannuation funds etc. whose assets do not exceed the Division 230 thresholds).
- Foreign currency denominated financial arrangements excluded from the scope of the Division 230 TOFA rules (e.g. leases, hire purchase agreements and short-term financing arrangements).
- Foreign currency denominated financial arrangements which pre-date the introduction of the Division 230 TOFA rules.

Note: When the Division 230 TOFA rules apply, the same principles would broadly apply as those under Division 775. This is because s. 960-50 requires all amounts to be translated into Australian currency and each forex contract would be a new financial arrangement under the TOFA rules. Therefore, there would either be a crystallisation under ordinary TOFA concepts (see s. 230-180) or a balancing adjustment under s. 230-135.

Exclusions

Forex gains are not assessable and forex losses are not deductible under Division 775 to the extent that they have the following nature.

When forex gains or losses are not assessable or deductible		
Nature of forex gain or loss	**Section (forex gain)**	**Section (forex loss)**
Of a private or domestic nature	775-15(2)	775-30(2)
Made or incurred in earning exempt income	775-20	775-35
Made or incurred in earning non-assessable, non-exempt income	775-25	775-35

Required reading

Sections 775-15 to 775-35.

Calculation method

A forex gain or loss is determined by reference to 'forex realisation events' (FRE). This means, in most cases, that the gain or loss must be realised before it is recognised for income tax purposes.

The way Division 775 works is similar to the capital gains tax provisions. It prescribes the events that trigger the realisation of forex gains or losses and provides specific rules for determining the resulting amount of forex gain or loss under each FRE.

When applying Division 775, it is useful to follow the three steps as set out below.

Step 1 – Determine if a gain or loss arises from foreign currency differences

Central to Division 775 is the concept of the 'currency exchange rate effect', an expression used in all foreign realisation events. The definition of currency exchange rate effect in s. 775-105(1) makes clear that it is only the gain or loss attributable to differences in the foreign currency exchange rates that are caught by Division 775. Other factors contributing to the gain or loss (such as a change in the market value of the asset that is not due to changes in the foreign exchange rate) are outside the scope of Division 775 and must be taken into account in applying other provisions of the income tax law, such as the CGT rules.

Example – Forex component of gains and losses

Investor Co (Investor) acquires a right to receive foreign currency for US$100 when the exchange rate is A$1.00 = US$0.80. Investor disposes of the right six months later when its value is US$110. The exchange rate at the time of disposal is A$1.00 = US$0.60.

Assume forex realisation event 1 (FRE 1) happens when Investor disposes of the right to receive foreign currency (s. 775-40) (FRE 1 will be discussed in further detail below).

Overall capital gain

The capital gain from the disposal of the right is determined by translating each receipt or payment (element) at the exchange rate applicable at the time of each transaction or event (s. 960-50(6)).

Capital gain = (US$110 ÷ 0.60) – (US$100 ÷ 0.80)
= A$183.33 – A$125
= A$58.33.

Non-forex component of the capital gain

The non-forex component of the capital gain is calculated by determining the US currency value of the net gain from the disposal and translating this amount into Australian currency at the exchange rate applicable at the time of disposal.

Non-forex component of the capital gain = (US$110 – US$100) ÷ 0.60 = A$16.67.

Amount attributable to a currency exchange rate effect

The forex realisation gain is the amount of the capital gain attributable to a currency exchange rate effect. The amount is calculated by taking the overall capital gain less the non-forex component of the capital gain.

Forex realisation gain = A$58.33 – A$16.67 = A$41.66.

The amount of the capital gain attributable to a currency exchange rate effect is A$41.66 and is assessable to Investor under s. 775-15(1).

The non-forex component of the capital gain amount is subject to the ordinary income or CGT provisions.

This example is adapted from TD 2006/32.

Step 2 – Determine if the 'short-term' exception applies

Division 775 contains rules that allow taxpayers to disregard Division 775 for short-term forex gains or losses under FRE 2 and FRE 4, in relation to depreciating assets and most types of CGT assets (ss 775-70 and 775-75). However, the short-term rules **do not** apply to trading stock.

There are three scenarios covered by the rules for short-term forex realisation gains or losses:

- Gains or losses on a right to receive foreign currency arising from realising a CGT asset (FRE 2).
- Gains or losses on an obligation to pay foreign currency for acquiring a CGT asset or increasing its cost (FRE 4).
- Gains or losses on an obligation to pay foreign currency where a capital allowance applies (FRE 4).

'Short-term' means the **due date for payment is**:

- **For CGT assets –** within **12 months** after the time when the asset is acquired, the relevant expenditure included in cost base is incurred, or the asset is disposed of.
- **For depreciating assets:**
  - Where the taxpayer starts to hold the asset – within **24 months**, that began 12 months before the time when the taxpayer began to hold the asset.
  - Where expenditure is included in cost – within **12 months** after the time when the relevant expenditure is incurred.

The short-term rules disregard the gain or loss under Division 775. Instead, it is integrated into the gain or loss associated with the asset. The outcome is summarised in the table below.

Short-term forex gain or loss relates to:	Relevant FRE	Gain or loss under Division 775 is disregarded, and:
CGT asset – realisation (i.e. disposal)	FRE 2	Short-term forex gain is treated as CGT event K10 Short-term forex loss is treated as CGT event K11
CGT asset – acquisition	FRE 4	The short-term gain or loss results in an adjustment to the CGT cost base (forex gain reduces cost base, forex loss increases cost base)
Depreciating asset – acquisition	FRE 4	The short-term gain or loss results in an adjustment to the cost of the asset (forex gain reduces cost, forex loss increases cost)

Note: The short-term rules do not apply to trading stock.

Election to opt out

The short-term rules apply by default and taxpayers must make an irrevocable election under s. 775-80 not to have the short-term rules apply (in which case the gain or loss will be assessable or deductible under the relevant FRE in Division 775).

The time limit for making this opt-out election is within 90 days of the:

- Division 775 commencement date of 1 July 2003 for taxpayers in existence at that date, or
- taxpayer coming into existence.

Example – Short-term forex rules and depreciating asset

Digger Pty Ltd (Digger) is an Australian company engaged in civil construction works. It orders an excavator from the manufacturer in the USA, taking advantage of a special discount if the order is accompanied by payment for half of the agreed purchase price, with the balance paid on delivery.

The relevant dates are as follows:

- 1 July 2018 – order placed and 50% of purchase price paid in USD.
- 1 February 2019 – excavator delivered and balance paid in USD.

Assume that:

- FRE 4 happens, resulting in a forex gain of A$20,000 (s. 775-55) (FRE 4 will be discussed in further detail below).
- Digger has not chosen to opt out of the short-term forex rules.

The timing of the transactions fits within the short-term rules for depreciating assets in item 3 of s. 775-70(1). The result is that the A$20,000 gain is not assessed under Division 775. Instead, item 3 reduces the cost of the excavator for Division 40 purposes by A$20,000.

Step 3 – Determine the FRE and calculate the forex gain or loss

There are five FREs covered in this unit (i.e. FRE 1 to FRE 5). Each FRE provision tells you when the event occurs and how to calculate the forex gain or loss.

There are four other FREs (i.e. FRE 6 to FRE 9) that only operate where a taxpayer has made certain choices. These FREs are not covered in this unit and are outside the scope of the TAXAU module.

Forex realisation events

Forex realisation event 1 (FRE 1)

FRE	Happens if …	Time of event
1	The taxpayer disposes of foreign currency or a right to receive foreign currency in circumstances that would satisfy the change of ownership requirements in CGT event A1 (s. 775-40)	Time of disposal

Example – FRE 1

Aussie Mining Ltd (Aussie Mining) plans to open a mine in Papua New Guinea. It acquires 50,000 kina in cash on 1 May 2019 (assume the Australian dollar equivalent is A$25,000, i.e. A$1 = 2 kina).

The kina is used to pay a local merchant for food and drink provided at a meeting of local villagers so that Aussie Mining can explain its plans. The merchant is paid on 20 May 2019, when 50,000 kina is worth A$24,000 (i.e. assume A$1 = 2.083 kina).

The FRE 1 loss is A$1,000.

Forex realisation event 2 (FRE 2)

FRE	Happens if …	Time of event
2	The taxpayer ceases to have the right to receive foreign currency (s. 775-45). The right must be one of the following: • A right to receive income or a right that represents ordinary income or statutory income • A right created in return for ceasing to hold a depreciating asset • A right created or acquired for paying or agreeing to pay Australian or foreign currency • A right created in return for a realisation event happening in relation to a CGT asset	When the right ceases

Example – FRE 2

On 1 October 2018, Aussie Sports Pty Ltd (Aussie Sports) sells soccer balls to a US sports store chain for US$100,000 (assume the Australian dollar equivalent is A$96,000).

Payment is received on 1 December 2018 when the goods clear the Port of Los Angeles. When Aussie Sports receive US$100,000, FRE 2 happens. Assume the AUD equivalent on that date is A$98,000.

The gain is calculated as follows:

FRE 2 calculation	A$
Amount received as a result of FRE 2 happening	98,000
Forex cost base[1]	96,000
FRE 2 gain	2,000[2]

Notes

1. This is the 'cost' to Aussie Sports of acquiring the right to receive foreign currency at the time it derived the income (i.e. A$96,000, the AUD value of the soccer balls sold on 1 October 2018) (ss 775-45(7) and 775-85).
2. This is in addition to the s. 6-5 ordinary income derived by Aussie Sports from the sale of trading stock at the time of sale, 1 October 2018 (i.e. A$96,000): see currency conversion rule in s. 960-50(6) item 6, assuming Aussie Sports does not use other permissible currency conversion rules such as average exchange rates.
3. The short-term rules do not apply to trading stock.

FRE 2 disregarded A forex gain or loss under FRE 2 is disregarded where the short-term forex rules apply (ss 775-70 and 775-75).

Forex realisation event 3 (FRE 3)

FRE	Happens if …	Time of event
3	The taxpayer ceases to have the obligation to receive foreign currency and the obligation was incurred in return for the creation or acquisition of a right to pay foreign or Australian currency (s. 775-50)	When the obligation ceases

Example – FRE 3

On 1 May 2019, Aussie Sports Pty Ltd (Aussie Sports) incurs a liability to a UK supplier of £100,000 (assume the Australian dollar equivalent is A$150,000). Payment is due on 1 June 2019. Aussie Sports enters into a forward contract with Globo Bank under which Aussie Sports has an obligation to receive £100,000 on 1 June 2019 and must pay the bank A$158,000.

FRE 3 will occur on 1 June 2019 when Aussie Sports receives £100,000 from the bank (i.e. when it ceases to have an obligation to receive foreign currency). At this date, assume £100,000 is worth A$162,000.

The amount received in respect of FRE 3 happening is A$162,000. The net cost of assuming this obligation is A$158,000 (there is no need to convert since the amount required to be paid to Globo Bank is already in AUD).

A gain of A$4,000 arises in respect of the forward contract under FRE 3 (the actual discharge of the liability to the UK supplier will trigger FRE 4 – see below).

Forex realisation event 4 (FRE 4)

FRE	Happens if …	Time of event
4	The taxpayer ceases to have the obligation to pay foreign currency (s. 775-55). The obligation must be one that: • Represents an expense the taxpayer can deduct • Is an element in the calculation of a net assessable or deductible amount • Forms part of the cost base of a CGT asset • Is incurred in relation to a depreciating asset or a project amount under the capital allowances regime • Was incurred in return for receiving Australian or foreign currency, or the right to receive such currency	When the obligation ceases

FRE 4 disregarded

A forex gain or loss under FRE 4 is disregarded where the short-term forex rules apply (ss 775-70 and 775-75).

Example – FRE 4

On 1 October 2018, Aussie Hardware Pty Ltd (Aussie Hardware) imported timber from New Zealand costing NZ$100,000 to sell in its hardware stores. The timber cleared Port Melbourne on 1 December 2018 and became trading stock on hand at that time. Assume that on 1 December 2018, NZ$100,000 was worth A$80,000.

Aussie Hardware was not required to pay for the timber until 31 January 2019. Paying NZ$100,000 on that date triggered FRE 4. The AUD equivalent on that date was A$85,000.

The loss is calculated as follows:

FRE 4 calculation	A$
Amount paid as a result of FRE 4 happening	85,000
Proceeds from assuming the obligation to pay[1]	80,000
FRE 4 loss	5,000[2]

Notes

1. This is the market value of the timber at the time it became stock on hand. This is when Aussie Hardware became entitled to a deduction for the timber (s. 775-55(7), and s. 775-95 read with s. 70-15).
2. This is in addition to the s. 8-1 deduction incurred by Aussie Hardware for the purchase of trading stock (i.e. A$80,000): see currency conversion rule in s. 960-50(6) item 8, assuming Aussie Hardware does not use other permissible currency conversion rules such as average exchange rates.

The short-term forex rules do not apply to trading stock.

Forex realisation event 5 (FRE 5)

FRE	Happens if …	Time of event
5	The taxpayer ceases to have a right to pay foreign currency and the right is created or acquired in return for assuming specified types of obligations in relation to either foreign or Australian currency (s. 775-60)	When the right ceases

For example, a buyer of a put option over foreign currency (i.e. an option to sell foreign currency) has the right to 'put' the foreign currency to the option seller. If the option is exercised, the buyer ceases to have a right to pay that foreign currency (but may take on the obligation to receive another foreign currency from the option seller, triggering FRE 3).

Priority when applying FREs

When more than one FRE applies, s. 775-65 prescribes which event takes priority. There are four types of priority rules. The one that is most likely to apply in practice (when there are no options or forward contracts involved) is the 'residual rule'. This rule tells you to apply the FRE that is the most appropriate (i.e. the event which best reflects economic and accounting practice in that circumstance).

Required reading

Section 775-65 ITAA 1997.

Worked example 13.2: Foreign exchange gains and losses

[Available online in myLearning]

Debt–equity rules

Overview

Companies can raise capital either:

- through the issue of shares (i.e. equity), or
- the raising of debt.

The debt–equity rules in Division 974 **characterise for income tax purposes** the instruments commonly used by companies to raise capital. The debt–equity rules apply only for specified income tax purposes. They are not relevant for corporate or commercial law purposes. This means that a financial instrument, which the corporate or commercial world treats as equity, may be treated as debt for income tax purposes or vice versa.

Application

The tax law characterisation of a financial instrument as debt or equity is only relevant for some, but not all, purposes of the income tax law.

The taxation treatment of debt and equity is set out in the table below, which also illustrates the relevance of the debt–equity distinction at both company and investor levels.

Taxation treatment of debt and equity		
	Equity	**Debt**
Payment from a company is called	Dividend payment/non-share distribution or dividend/return on non-share equity	Interest payment/dividend on non-equity share/return on debt-interest
Effect of the imputation system	May be frankable	Not frankable
Deductibility/assessability of payment	Company level – not deductible Investor level – assessable, unless NANE	Company level – usually deductible Investor level – assessable, unless NANE
Withholding tax if payment made to a non-resident	Dividend withholding tax applies to the extent the dividend is unfranked (see Unit 14)	Interest withholding tax applies (see Unit 14)

The debt–equity categorisation is also **relevant to**:

- The operation of the foreign equity distribution exemption in s. 768-5 and related debt deductions under s. 25-90 (these rules are discussed in Unit 14).

  The s. 768-5 exemption only applies to distributions made in respect of equity interests where the taxpayer has a participation interest of at least 10%. For example, the exemption does not apply to distributions on redeemable preference shares (issued by a foreign subsidiary to an Australian company) that are classified as debt interests (e.g. where they have a life of less than 10 years). These distributions would be assessable income and related debt deductions (i.e. in respect of borrowings made to acquire the redeemable preference shares) would be allowable deductions under s. 8-1 (the general deduction provision) rather than s. 25-90 (applicable to debt deductions on NANE income).
- The application of Australia's thin capitalisation rules (these are discussed in Unit 14).

Examples of areas in the income tax law where the debt–equity rules **are not relevant** include:

- Characterisation of borrowing costs (e.g. the characterisation of a convertible note as an equity interest does not mean that the legal fees on its issue would change in character from a borrowing cost deductible under s. 25-25 to a share issue cost deductible as blackhole expenditure under s. 40-880).
- The definitions of 'public company' and 'private company'.

Tax planning

The different tax treatment of debt and equity has led to financing structures which are designed to cater for the particular tax profile of financiers.

For example, a foreign-owned, Australian resident company might be financed predominantly by:

- Debt because the interest paid to non-residents is tax deductible (assuming the funds are put to an income-producing use and debt levels are within limits set by the thin capitalisation provisions).
- Equity because the company's business activities in Australia generate untaxed profits (e.g. there are significant deductions from capital allowances, interest deductions or carry forward losses) and there is a relevant tax treaty to reduce exposure to dividend withholding tax.

The impact of globalisation over the last decade has also created tax planning opportunities where the tax treatment of particular types of financial instruments differs between jurisdictions. For example, redeemable preference shares issued by a company might be treated as debt in Country A (where the company resides for tax purposes) and as equity in Country B (where the shareholders reside). Financial instruments with differing tax characteristics in different jurisdictions are usually referred to as 'hybrid' instruments.

Note: The Government has announced that it intends to crack down on hybrid instruments which create tax arbitrage opportunities (see Unit 14).

From an Australian tax law perspective, the debt–equity rules in Division 974 seek to provide certainty as to the tax classification of financial instruments regardless of the corporate or commercial law description. The rules adopt a 'substance over form' approach (see s. 974-10(2)); that is, they examine the substance of the financial instrument as distinct from the legal form of the arrangement.

Key terms

To identify parts of the law where the debt–equity rules are relevant, tax practitioners need to be alert to the use of legislative wording which identifies that the debt–equity characterisation applies. Key legislative terms used under the debt–equity rules are discussed below.

Debt interest

A debt interest is defined in s. 974-15 to include schemes that satisfy the debt test in s. 974-20(1) (see below).

Equity interest

An equity interest is defined in s. 974-70 to include schemes that satisfy the equity test in s. 974-75(1) and that are not also characterised as a debt interest (see below).

Non-equity shares (equity-like instruments treated as debt)

A 'non-equity share' is defined in s. 995-1(1) to mean a share that is not an equity interest (as per Division 974) in the company.

The interest withholding tax provisions can apply to a distribution on a non-equity share as the provisions in ITAA 1936 define 'interest' to include 'a dividend paid on a non-equity share' (s. 128A(1AB) ITAA 1936).

Conversely, the dividend imputation provisions make it clear that a distribution on a non-equity share is an unfrankable distribution (s. 202-45(d)).

Non-share equity (debt-like instruments treated as equity)

A 'non-share equity interest' is defined in s. 995-1(1) to mean an **equity interest** in a company that is not solely a single share.

Distributions relating to non-share equity are treated as dividends when applying the withholding and dividend imputation rules. The dividend withholding tax provisions in s. 128AAA(1) ITAA 1936 provide that dividend withholding applies to a non-share equity interest in the same way that it applies to a share.

Debt deductions

A debt deduction is defined in s. 820-40 (as part of the thin capitalisation provisions – discussed in Unit 14) to mean a cost incurred in relation to a debt interest issued by a taxpayer and that the taxpayer can (ignoring the application of the thin capitalisation provisions) deduct from its assessable income, to the extent the cost is:

- Interest.
- An amount in the nature of interest.
- Any other amount that is calculated by reference to the time value of money.

Examples of debt deductions include (but are not limited to):

- An amount in substitution for interest.
- A discount in respect of a security.
- A fee or charge in respect of a debt, including application fees, line fees, service fees, brokerage and stamp duty in respect of document registration or security for the debt interest.

Non-share capital account

Where a company's debt-like instruments are characterised as equity for income tax purposes, the tax law also creates a non-share capital account so that the instruments are treated similarly to equity when applying those parts of the tax law dealing with contributions to, and returns of, share capital (see Division 164). The non-share capital account is debited and credited to take account of amounts paid out or received on the non-share equity interests issued by the company.

The non-share capital account operates solely for income tax law purposes and does not affect the operation of the company's 'normal' share capital account.

Financing arrangement

Before applying the debt–equity tests, the arrangement must either be a financing arrangement or give rise to a membership interest in the company (see ss 974-20(1)(a) and 974-75(2)).

A financing arrangement is, broadly, an arrangement to raise finance for the entity issuing the instrument (s. 974-130).

The definition of 'financing arrangement' in s. 974-130 indicates that, generally, the following are **not** financing arrangements and hence the debt–equity rules will not usually apply to them:

- Derivatives used to manage financial risk.
- A personal services contract entered into in the ordinary course of business.
- Most types of leases.
- Securities lending arrangements.
- An insurance contract undertaken as part of the issuer's ordinary course of business.
- A scheme for paying royalties.

Financial benefit

A financial benefit is defined in s. 974-160 as being anything of economic value, including property or services. However, there is a specific meaning given to 'providing a financial benefit' in s. 974-30 that expressly excludes the issue of an equity interest (e.g. the issue of ordinary shares is not a financial benefit provided under a financing arrangement). Therefore, a financing arrangement that converts into ordinary shares or is redeemable for ordinary shares is unlikely to satisfy the debt test (see below).

Required reading

Section 820-40 ITAA 1997.

Debt test

Application

In practice, the debt test is applied first. This is because s. 974-70(1)(b) states that a debt interest cannot be an equity interest. There is also a 'tie-breaker' rule in s. 974-5(4) which states that if an interest satisfies both tests, it is treated as a debt interest and not an equity interest (i.e. the debt rules take priority).

If the financial instrument fails the debt test (i.e. it is not debt), then apply the equity test. Note that the equity test only applies to companies (i.e. it does not apply to partnerships, trusts, individuals, etc.).

Although rare, it is possible that neither test is passed. In such cases, the deductibility of the payment under the arrangement will be determined in accordance with the normal rules of s. 8-1.

Note also that short-term arrangements, such as trade credit, not exceeding 100 days are excluded from the debt test (refer s. 974-25).

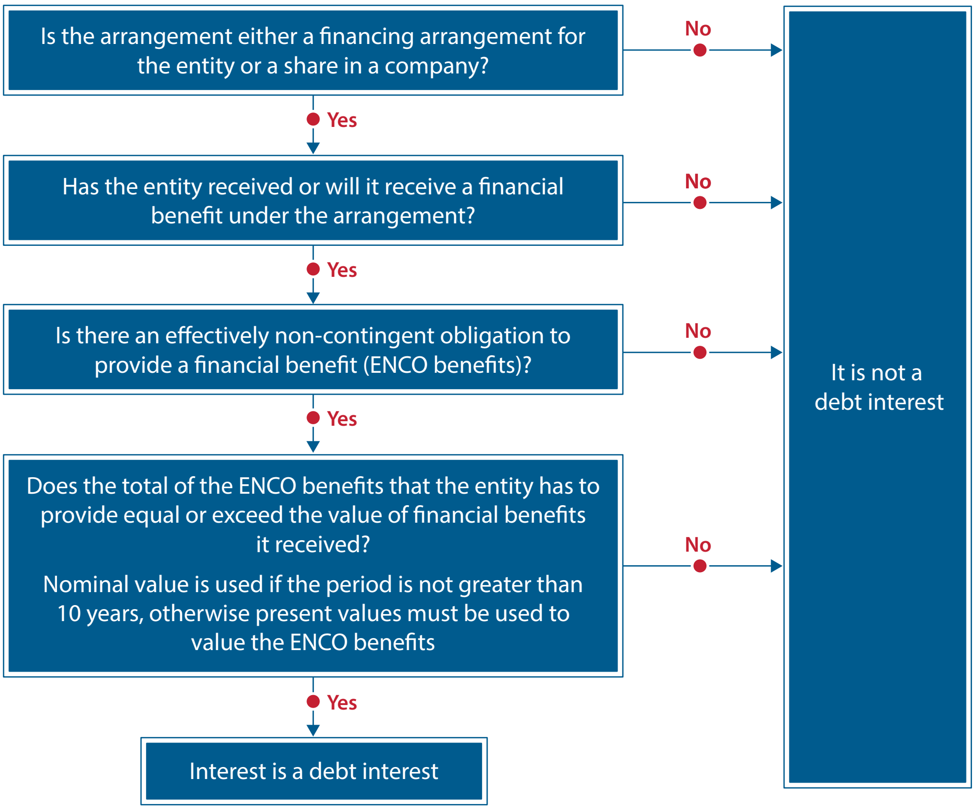
Requirements

The debt test is applied at the commencement of the financing arrangement (s. 974-15(1)).

To qualify as a debt interest, all of the following five requirements in s. 974-20(1) must be satisfied:

1. There is a scheme.
2. The scheme is a financing arrangement for the entity.
3. A financial benefit is received by the entity.
4. The entity issuing the instrument has an effectively non-contingent obligation (ENCO) to provide financial benefits in the future.
5. It is substantially more likely than not that the value of all the financial benefits identified in (4) will at least equal or exceed the value of the financial benefits received in (3).

The following flow chart summarises the requirements:



Methodology

The key to the debt test is that an instrument will be a debt interest if the entity issuing the instrument has to pay back an amount that is equal to or greater than the amount received. This is the basic concept of a debt (i.e. you have to repay at least the amount that you borrowed).

However, in determining what amounts you have to repay, only ENCO financial benefits are counted. This means that things that are not considered to be a provision of financial benefits are not counted. For example, the issuing of equity interests is not considered to be the provision of a financial benefit (s. 974-30(1)) and of financial benefits for which there is no ENCO to provide (e.g. where a payment is conditional).

In simple terms, ask the following question: 'Will the lender definitely (or almost certainly) get their money back within 10 years in the form of principal repayments and/or other returns, such as interest?' If the answer is 'yes', the debt test will generally be passed.

Step 1 – Financing arrangement and receipt of financial benefits

The first two requirements should be relatively straightforward in most instances; that is, it should be relatively easy to identify whether an instrument that has been issued is a financing arrangement and whether the issuer has received financial benefits (usually cash) from issuing the instrument.

Step 2 – ENCO to provide financial benefits

The ENCO requirement is usually the most complex.

Essentially an entity will have an ENCO to provide financial benefits if, having regard to the pricing, terms and conditions of the arrangement, there is an in-substance or actual ENCO to provide those financial benefits (s. 974-135).

This means that the entity **must** have to pay the financial benefits and that it is not subject to any contingency. Sometimes the contingency to a payment is found in the terms and conditions of the instrument itself, but not always. At other times, the contingency is found in non-tax legislation, such as the Corporations Act.

Example – No ENCO (debt test failed)

Borrower Pty Ltd (Borrower) issues debentures. Debentures are a type of fixed interest security issued by companies (as borrowers) in return for the medium and long-term investment of funds. Debentures are issued through a prospectus and are secured by a trust deed setting out the terms and conditions of the fundraising and the rights of debenture holders.

In deciding whether there is an ENCO, consider the 'pricing, terms and conditions' of the debenture (s. 974-135(1)).

The terms and conditions of the debenture are as follows:

- Interest at 6% per annum is paid semi-annually.
- Principal is repaid at the end of eight years.
- The directors of Borrower may suspend interest payments and defer the repayment of principal if they are of the opinion that the company has insufficient available profits.

There is no ENCO to pay interest or repay the principal because both events are subject to a contingency (i.e. the directors' ability to suspend interest payments and defer repayment of principal). The debenture will fail the debt test.

Consideration must therefore be given to the equity test (see below).

An easy way to determine whether an entity has an ENCO to provide financial benefits under the scheme is to determine all the potential benefits that the company has to provide under the arrangement.

Once all the potential benefits that the company may potentially be asked to provide have been identified, you can then determine which of those benefits are ENCO benefits. Only ENCO benefits are counted.

Step 3 – ENCO benefits provided must equal or exceed the value of financial benefits received

The last requirement is to look at whether the ENCO benefits that an entity has to provide are equal to or exceed the value of the financial benefits received. If so, the debt test is satisfied.

Broadly, the ENCO financial benefits are valued in nominal terms (i.e. there is no need to discount to their present value terms – you just take face values) if the term of the instrument is 10 years or less. If the term is more than 10 years, the ENCO financial benefits must be discounted to their present value terms (s. 974-35). The discount rate to be used is 75% of the entity's benchmark rate of return (s. 974-50).

Example – ENCO exists (debt test passed)

Borrower Pty Ltd (Borrower) issues mandatorily redeemable preference shares (MRPS) for $100 each. In deciding whether there is an ENCO, consider the 'pricing, terms and conditions' of the MRPS (s. 974-135(1)).

The terms and conditions of the MRPS are as follows:

- The holder of an MRPS is entitled to a semi-annual cumulative dividend.
- Payment of the dividend is subject to:
  - the directors, at their discretion, declaring the dividend to be payable, and
  - there being funds legally available for the payment of dividends.
- The MRPS have a maturity date of five years after the issue date.
- The amount that must be redeemed at maturity is the issue price plus any accrued dividends outstanding on the MRPS at the redemption date.

The financing arrangement has a term of five years and, therefore, nominal values are used.

The payment of dividends on the MRPS before redemption does not satisfy the ENCO requirement because of the directors' discretion (i.e. the dividends are subject to a contingency).

However, under the terms of the MRPS issue, the issue price plus any accrued dividends is payable on maturity. Borrower has, on redemption of the MRPS, an ENCO to provide a financial benefit to the holders of the MRPS which equals or exceeds the financial benefit Borrower received (i.e. $100).

The MRPS therefore will pass the debt test and the financing arrangement will be treated as debt.

Adapted from: ATO ID 2003/527.

Note: One issue that the ATO is currently looking at is dividend access shares. Consider a shareholder that injects a redeemable share into a company for $1. The share is redeemable within three years at face value. The company then purports to pay a $10 million franked dividend in relation to these shares. The dividend will **not** in fact be frankable because the redeemable share is debt. This is because the benefit received by the company (i.e. $1) equals the amount to be repaid (i.e. $1) within 10 years. Had the share been redeemable for $0.99, it would be equity, and the dividend would be frankable. So a one cent difference can be critical. Moreover, had the shares been redeemable after 10 years, they would also be equity because the discounting rules would apply.

Another issue is the application of the general anti-avoidance provisions in Part IVA ITAA 1936 (see TD 2014/1 and Unit 15).

Required reading

Sections 974-15, 974-20, 974-25 and 974-30 ITAA 1997.

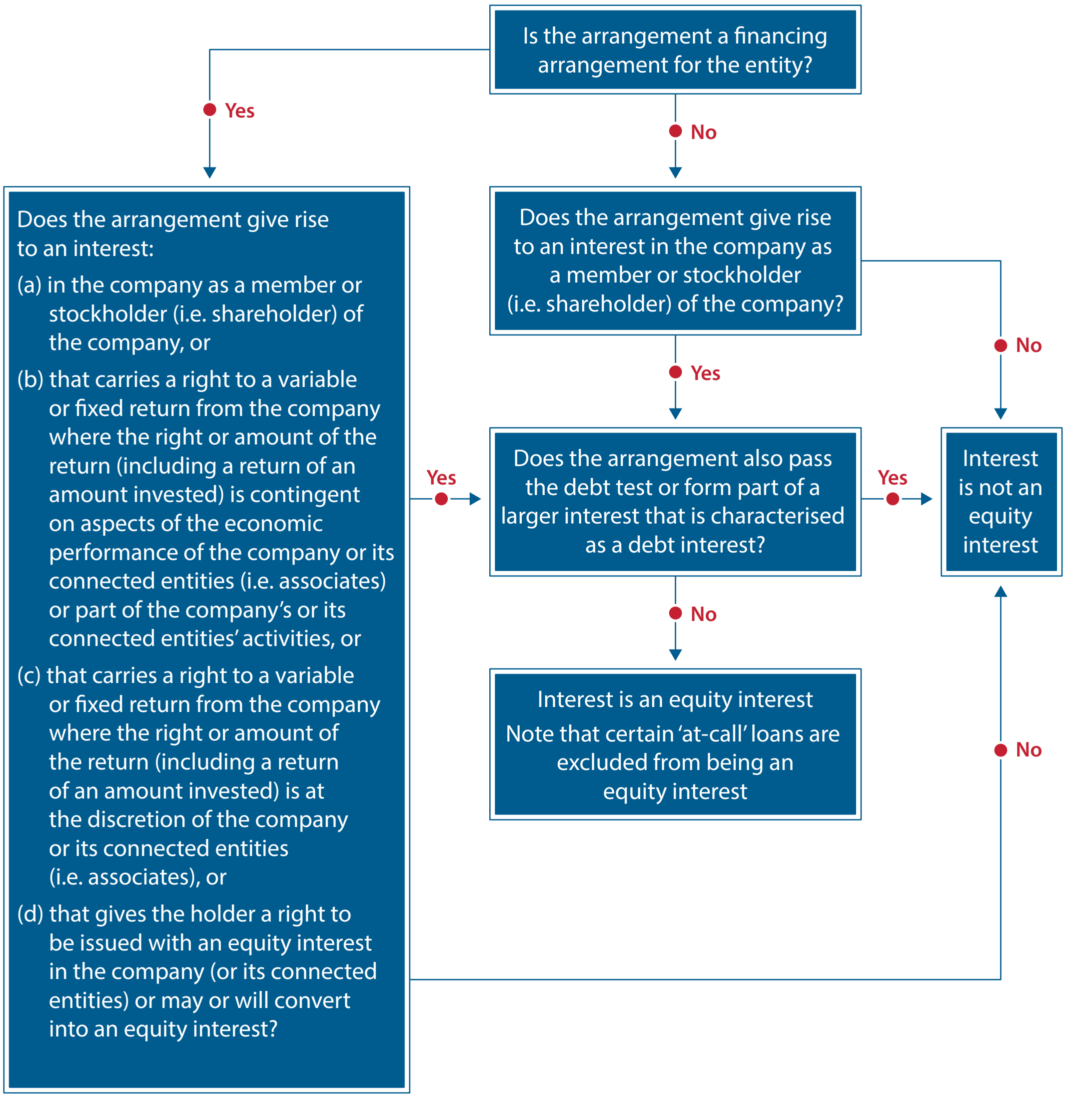
Equity test

Application

As noted earlier, the debt test takes precedence over the equity test. Thus, when the debt test is failed an entity must apply the equity test.

Requirements

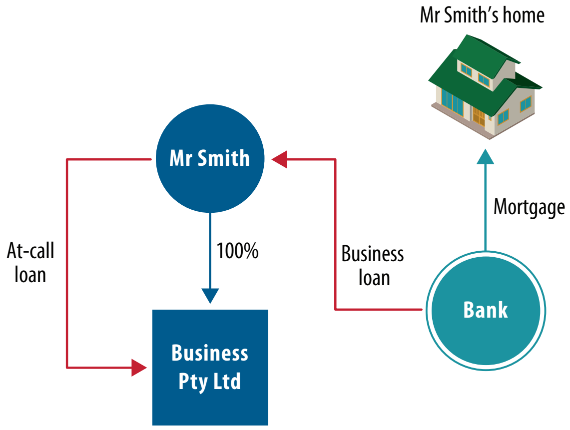
The following flow chart summarises the steps in determining whether an equity interest exists:



At-call loan exception

At-call loans typically made by shareholders to companies would normally be classified as equity interests rather than debt interests if the normal debt–equity rules were to be applied.

The debt–equity rules are particularly important when advising cash-strapped private companies whose shareholders borrow against personal assets and on-lend the funds as business finance to the company (see the diagram below).



The consequences of classifying an at-call loan as equity may impose an onerous burden on the company and the shareholders in that they must maintain a non-share capital account and may have to comply with the benchmark franking rule if they later decide that interest would be charged on the loan. The potential application of the capital streaming rules of s. 45B ITAA 1936 would also be an issue if the loan was repaid.

As a result, there is an exception in the legislation which specifically provides that certain types of at-call loans are excluded from being classified as equity interests and are **deemed to be a debt interest**, even though they pass the equity test (and fail the debt test). To qualify for the exception, the loan must meet all of the following four requirements in ss 974-75(6) and (7):

1. The loan is made to the company by a connected entity (e.g. the controlling shareholder).
2. The loan does not have a fixed term.
3. The loan is repayable on demand by the connected entity or on the death of the connected entity.
4. The company's GST turnover (determined in accordance with the GST Act) at the end of the income year is less than $20 million (note that there are no 'aggregation' provisions with associated companies – each company's turnover is considered on a standalone basis).

If all of the above requirements are satisfied, the loan is deemed to be a debt interest even if it does not pass the debt test and regardless of whether it passes the equity test.

Required reading

Sections 974-70 and 974-75 ITAA 1997.

Consequences

The franking provisions apply to non-share equity interests, equity holders and non-share dividends in the same way as they apply to shares, shareholders and dividends. Other than these provisions and the thin capitalisation provisions, the most important effects of the debt–equity rules are those that allow deductions to a certain extent on debt interests when previously none was allowed, or those that deny such deductions on equity interests. A detailed explanation is provided below.

Equity interest

The following table summarises the taxation treatment of returns (dividends and non-share distributions) on equity interests at the recipient (i.e. investor) and company (payer) levels.

Treatment of returns on equity interests for investor	
Resident investor	**Non-resident investor**
Received from resident payer: • Include non-share distribution in assessable income under s. 6-5, or dividend in assessable income under s. 44(1) ITAA 1936 • Include the amount of franking credit in assessable income (i.e. gross-up) and receives the benefit of the franking offset, where a franked distribution has been received Received from non-resident payer: • Assessable as above, unless NANE income under foreign equity distribution exemption (s. 768-5). (Note: Debt deductions relating to s. 768-5 NANE income are deductible under s. 25-90) (See Unit 8 and Unit 14)	Received from resident payer: • Non-assessable, non-exempt (NANE) income (s. 128D ITAA 1936) • Subject to withholding tax at the rate of 30% (i.e. dividend withholding tax rate) if unfranked. However, rate may be reduced under a double taxation agreement Received from non-resident payer: • Not applicable/no Australian source, therefore not subject to taxation in Australia (s. 6-5 or s. 44(1) ITAA 1936) (See Unit 14)

Treatment of returns on equity interests for payer	
Resident payer	**Non-resident payer**
Paid to resident investor: • Dividend/non-share distribution paid is not deductible under s. 26-26 • Dividend/non-share distribution paid is generally frankable in accordance with the rules governing frankability • Company must maintain a share capital account/non-share capital account Paid to non-resident investor: • As above for resident investor • Franked distribution paid is not subject to withholding tax • Unfranked distribution paid is subject to withholding tax (See Unit 8 and Unit 14)	Paid to resident/non-resident investor: • Not applicable/no Australian source; therefore not subject to taxation in Australia (s. 6-5 or s. 44(1) ITAA 1936)

Debt interest

The following table summarises the taxation treatment of returns (interest and dividend payments) on a debt interest at the recipient and company levels.

Treatment of returns on debt interests for investor	
Resident investor	**Non-resident investor**
Received from resident/non-resident payer: • Includes interest payment in assessable income under s. 6-5, or dividend on non-equity share in assessable income under s. 44(1) ITAA 1936 (Note: Foreign equity distribution exemption in s. 768-5 not applicable for debt interests. Therefore, debt deductions related to deriving assessable income are deductible under s. 8-1 rather than s. 25-90) • No franking as interest or dividend on non-equity share is not frankable (s. 202-45(d))	Received from resident payer: • NANE income (s. 128D ITAA 1936) • Subject to withholding tax at a rate of 10% (i.e. interest withholding tax rate). However, rate may be reduced under a double taxation agreement Received from non-resident payer: • Not applicable/no Australian source, therefore not subject to taxation in Australia (s. 6-5, or s. 44(1) ITAA 1936) (See Unit 14)

Treatment of returns on debt interests for payer	
Resident payer	**Non-resident payer**
Paid to resident investor: • Interest payment is usually deductible under s. 8-1 and dividend payment on non-equity share is deductible subject to limit under s. 25-85 • Interest payment/dividend is not frankable • Thin capitalisation rules may apply Paid to non-resident investor: • As above for resident investor • Interest or dividend payment subject to withholding tax • Transfer pricing rules may apply on related party debt (See Unit 8 and Unit 14)	Paid to resident/non-resident investor: • Not applicable/no Australian source, therefore not subject to taxation in Australia (s. 6-5, or s. 44(1) ITAA 1936)

Note: The debt–equity rules do not limit the operation of the transfer pricing rules. Thus, where the transfer pricing rules apply, the debt–equity rules classify the interest that arises under the transfer pricing scheme by reference to the arm's-length conditions, not the actual conditions. This could alter the arrangement's debt–equity characterisation and therefore, the tax treatment of the return on the arrangement (see TD 2019/10 and Unit 14).

Required reading

Sections 25-85 and 26-26 ITAA 1997.

Worked example 13.3: Debt and equity interests

[Available online in myLearning]

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

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Unit 14: International transactions

Contents

Learning outcomes

At the end of this unit you will be able to:

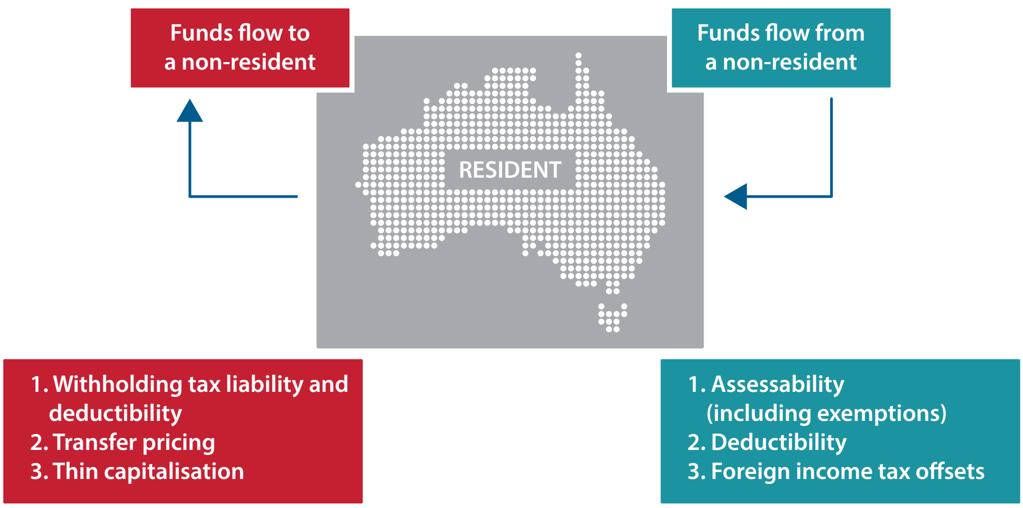
1. Explain and calculate the tax payable of taxpayers in receipt of foreign income.
2. Explain and calculate a taxpayer's liability to interest, dividend and royalty withholding tax.
3. Explain and apply double taxation treaties.
4. Explain and apply the attribution rules in non-complex international transactions.
5. Outline the transferor trust provisions.
6. Explain and apply the thin capitalisation provisions.
7. Discuss the transfer pricing provisions.

Introduction

This unit considers Australia's international tax system which deals with transactions into and out of Australia.

While the unit discusses issues facing both residents and non-residents, the following diagram provides a broad overview of the issues facing Australian tax residents when dealing with international transactions with a focus on the flow of funds.

Issues Australian tax residents need to consider when dealing with international transactions



The international taxation system consists of many regimes and is heavily based on legislation (i.e. there is currently very little case law on these regimes). It is important to understand the role each one plays. It is often the case that a single cross-border transaction triggers a number of Australia's tax provisions; therefore, it is necessary to identify all of those that apply.

The international taxation regimes covered in this unit are organised as follows:

International tax regimes		
Topic	**Themes**	**Relevant regimes**
Taxation of foreign income (outbound investments resulting in income coming into Australia)	Regimes to avoid double taxation	• Exemption regimes • Foreign income tax offsets • Temporary residents measure
	Regimes dealing with deductions	• Foreign debt deductions (s. 25-90 ITAA 1997)
Taxation of foreign residents (inbound investments resulting in income flowing out of Australia)	Withholding type regimes	• Dividend, interest and royalty (DIR) withholding tax • Managed investment trust (MIT) withholding tax • Foreign resident withholding tax (Schedule 1 TAA 1953)
Taxation treaties	Allocation of taxing rights	• Australia's network of tax treaties/double taxation agreements
Anti-avoidance (integrity) measures	Attribution regimes	• Controlled foreign companies (CFCs) (Part X ITAA 1936) • Transferor trusts (TTs) (Division 6AAA ITAA 1936)
	Regimes dealing with deductions	• Thin capitalisation (Division 820 ITAA 1997)
	Regimes dealing with pricing of international transactions	• Transfer pricing (Subdivision 815-B and 815-C ITAA 1997)
	Regimes to prevent double non-taxation or long term deferral of taxation	• Hybrid mismatch arrangements (Division 832)

This unit looks at the taxation of funds flowing into and out of Australia and the impact of double taxation treaties on these flows. It then looks at the integrity measures.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

Taxation of foreign income

Overview

As outlined in Unit 1, while non-residents are taxed only on their Australian-sourced income, **Australian residents** are taxed on their worldwide income (i.e. both domestic and foreign income), regardless of whether or not the income is repatriated to Australia.

In other words, when an Australian resident taxpayer makes an investment in another country, the income derived from holding and/or selling that investment (i.e. the foreign income) is usually taxable in Australia.

Unit 1 also outlined the framework for the calculation of taxable income (i.e. assessable income less allowable deductions) and tax payable.

The following formula applies that calculation framework to a resident taxpayer that has only foreign income:

Foreign income derived (net)	+	Foreign tax paid thereon	–	Exempt income and non-assessable, non-exempt (NANE) income	=	Assessable foreign income
Assessable foreign income	–	Allowable deductions against assessable foreign income			=	Taxable net foreign income
Taxable net foreign income	×	Tax rate	–	Foreign income tax offsets	=	Tax payable on foreign income

Key concepts

The calculation of tax payable on foreign income links the following three concepts together:

1. Assessability of income (including exemptions).
2. Deductibility of expenses.
3. Tax offsets.

These concepts are discussed below:

- **Assessability of income (including exemptions)**

  When a resident derives foreign income, it is assessable income under s. 6-5 or a specific provision (e.g. dividends under s. 44(1) ITAA 1936) unless a specific exclusion applies. It is the gross amount of foreign income (i.e. the pre-tax amount) that is included in assessable income.

  Assessable income specifically excludes exempt income and 'non-assessable non-exempt' (NANE) income under s. 6-15. The particular kinds of NANE in respect of international transactions are listed in s. 11-55.

- **Deductibility of expenses**

  A resident taxpayer is entitled to an allowable deduction under s. 8-1 for expenditure incurred in gaining or producing assessable foreign income.

  Expenses incurred in deriving exempt income and NANE income are specifically non-deductible, in accordance with s. 8-1(2)(c). However, a specific deduction provision can allow a deduction, notwithstanding that the expenditure relates to income which is not assessable. For example, debt deductions may be allowable under s. 25-90 when there is a nexus with certain NANE dividends (see below).

When a resident taxpayer has a tax loss (carried forward and/or current year), exempt income reduces (i.e. wastes) the amount of the tax loss. However, NANE income does not waste tax losses.

- **Tax offsets**

  A resident taxpayer may be entitled to a tax offset under the foreign income tax offset (FITO) system for the foreign taxes paid.

  Foreign income, foreign expenditure and foreign taxes paid are converted to Australian dollars, in accordance with Subdivision 960-C. Broadly, under this subdivision, each transaction that forms part of the calculation of tax payable on foreign income is separately converted to Australian dollars (see Unit 13 on financial transactions).

Key factors impacting taxation consequences

Just as there are specific taxation provisions applicable to different taxpayer types, (i.e. individuals, companies, partnerships, superannuation funds and trusts, as outlined in earlier units), there are specific taxation provisions that are applicable to different **types of offshore investment**. For this reason, offshore investments are commonly grouped as follows:

- Foreign subsidiary – controlled foreign company (CFC).

  A CFC is an offshore company that is controlled by the taxpayer. Where this type of investment structure exists, certain foreign income may be taxed in Australia before it is actually received (i.e. the income is 'attributed' or included in assessable income on an unearned basis).

- Foreign investment – at least 10% interest.

  This is an offshore company in which the taxpayer:

  - For the operation of the foreign equity distribution exemption under s. 768-5 – holds a participation interest in the foreign company of at least 10% (see later in this unit).
  - For the operation of other rules – holds a 'non-portfolio interest' as defined in s. 317 ITAA 1936. Broadly, this is the case where the taxpayer holds a voting interest in the foreign company of at least 10%.

- Foreign investment – less than 10% interest.

  This is an offshore company in which the taxpayer holds a participation interest in the foreign company of less than 10% (i.e. does **not** hold a 'non-portfolio interest'), as defined under s. 317 ITAA 1936. This is commonly called a 'portfolio interest'.

- Foreign branch.

  A 'branch' is a permanent establishment (PE) as defined under s. 6(1) ITAA 1936, or a double taxation agreement (where applicable) of an entity at or through which it carries on business. A branch is not a separate legal entity. A branch arises, for example, when a company carries out a business activity at a separate location without the use of another entity.

  Income paid by a branch to the taxpayer retains its character. This is because the profits of a branch are simply part of the overall profits of the taxpayer (i.e. an internal transaction).

- Foreign rental property asset.

  In this circumstance, the taxpayer merely holds property in a foreign country from which it earns rental income and does not carry on a business. The taxpayer does not have a branch at which, or through which, it carries on business in that foreign country.

- Foreign hybrid.

  A 'foreign hybrid' is a foreign entity that is prima facie a 'company' for Australian income tax purposes but is treated as a partnership for foreign income tax purposes. Under Division 830, such an entity is deemed to be a partnership for Australian income tax purposes. A detailed understanding of these rules is outside the scope of the TAXAU module.

The type of offshore investment influences the **type of foreign income** received. For example, a foreign subsidiary company can repatriate its profits to Australia as dividend income, whereas a foreign branch cannot because a branch does not have a separate legal capacity.

The most common types of foreign income from offshore investments and transactions include dividends, interest, royalties, business profits and/or capital gains. As outlined in Unit 1, the type of income received determines the basis and timing of its inclusion in assessable income.

The application of the taxation provisions can also differ based on the **location of the foreign investment**. Australia divides foreign countries into one of two categories, namely: as a listed country, or an unlisted country, in accordance with s. 320 ITAA 1936. In principle, there are more exemptions that apply to exclude foreign income from taxation in Australia in respect of investments in listed countries than in unlisted countries. This is broadly because listed countries have comprehensive taxation systems like in Australia (i.e. they are comparably taxed and hence the assumption is made that the investment is for genuine business and commercial reasons and not tax-driven).

Regimes to minimise double taxation

When a taxpayer derives foreign income (directly or indirectly), it may be taxed both in the foreign country and in Australia. This is known as 'double taxation'. Double taxation can be minimised by:

- Excluding the income from being taxed in Australia (i.e. through exemption). The key **exemptions** include:
  - Foreign branch income and capital gains exemption under s. 23AH ITAA 1936.
  - Foreign equity distribution exemption under s. 768-5 ITAA 1997 (Subdivision 768-A).
  - Previously attributed income exemption under s. 23AI ITAA 1936.
  - CGT participation exemption under s. 768-505 ITAA 1997 (Subdivision 768-G).
  - Conduit foreign income (CFI) exemption under Division 802 ITAA 1997.

  Exemption provisions have the effect of removing an item of income from the Australian tax net. Some provisions make these amounts exempt while others make them NANE. It is important to understand the difference between these two terms, as this has an effect on the availability of tax offsets, deductions, tax losses and applicable tax rates.
- Giving **tax offsets** for the foreign taxes paid through the FITO rules in Division 770.
- Allowing **special tax treatment to foreign employees** who come to Australia temporarily to work but who satisfy the technical requirements of being an Australian tax resident (i.e. the **temporary resident provisions**).
- Australia's taxation agreements with other countries (i.e. **double taxation treaties**). Broadly, a double taxation treaty is a reciprocal agreement between two countries in respect of taxing rights. As outlined in Unit 1, taxing rights are usually determined on the basis of residency and source. Thus, where a double taxation treaty exists between Australia and another country:
  - It will usually contain 'tie breaker' rules which overcome scenarios where a taxpayer might otherwise be resident in both jurisdictions (i.e. under each jurisdiction's domestic legislation).
  - It may allocate the source of particular types of income or gains to Australia or the treaty partner country using the tie breaker definition of resident.

  When applying the framework for the calculation of tax payable on foreign income, an Australian resident taxpayer must consider both the implications under Australian domestic law and the impact of the applicable double taxation treaty, if any.

The above regimes that minimise double taxation are subject to the application of integrity measures (e.g. transfer pricing and hybrid mismatch arrangements as analysed later in this unit).

Foreign branch income and capital gains exemption (s. 23AH ITAA 1936)

Section 23AH ITAA 1936 excludes income and capital gains earned by foreign branches of Australian companies from being taxed in Australia if certain conditions are met.

Application

The key elements of s. 23AH ITAA 1936 are set out below.

- **Only available to an Australian company operating a foreign branch**

  The exemption only applies to foreign income, including capital gains, derived (i.e. earned) by an Australian **company** through its **permanent establishment (i.e. branch)** in another country. It does not apply if the foreign entity is a company (s. 23AH(2) and (3) ITAA 1936).

  'Permanent establishment' (PE) is defined in s. 23AH(15) ITAA 1936. It adopts the meaning in the double taxation treaty if one is applicable, or the definition in s. 6(1) ITAA 1936 if no treaty applies. TR 2002/5 explains the general concept of a PE under s. 6(1) ITAA 1936.

- **Does not apply to branch hybrid mismatch income**

  From 1 January 2019, under s. 23AH(4A) ITAA 1936, the exemption does not apply if the foreign income derived by the Australian company is branch hybrid mismatch income (see the section on hybrid mismatch arrangements later in this unit).

- **Both income and capital gains exempt**

  Section 23AH(2) ITAA 1936 exempts foreign income, while s. 23AH(3) ITAA 1936 exempts foreign capital gains on assets used in the branch's business. Section 23AH(4) ITAA 1936 mirrors s. 23AH(3) ITAA 1936 by disregarding foreign capital losses.

  Capital gains derived by an Australian resident company's foreign branch are disregarded provided the asset is not taxable Australian property (see Unit 4 for guidance) and is used for the purpose of producing foreign income in carrying on a business at or through a PE.

  Section 23AH(9) deems amounts derived in disposing of the branch's business as being derived in carrying on that business.

- **Applicable if there is an interposed trust or partnership**

  Section 23AH ITAA 1936 can also apply if there are one or more interposed partnerships or trusts that exist between the Australian company and its foreign PE (ss 23AH(10) and (11) ITAA 1936). The Australian company is deemed to derive the amount made by the interposed trust or partnership through the company's branch in that foreign country. For example, if 20 companies equally own units in a unit trust which carries on business in New Zealand, each company would potentially get the s. 23AH exemption. The fact that each company only has an indirect stake of 5% is not relevant.

- **Exceptions exist**

  Exceptions to s. 23AH ITAA 1936 are contained in ss 23AH(5), (6), (7) and (8). The following table summarises these:

Exceptions		
Item	**PE in listed country**	**PE in unlisted country**
Income	Exemption does not apply if the: • PE fails the active income test, **and** • Foreign income is both adjusted tainted income and eligible designated concession income (EDCI) (s. 23AH(5))	Exemption does not apply if the: • PE fails the active income test, **and** • Foreign income is adjusted tainted income (s. 23AH(7))

Exceptions		
Item	**PE in listed country**	**PE in unlisted country**
Capital gain or loss	Exemption does not apply if the: • Capital gain or loss is from the disposal of a tainted asset, **and** • Capital gain is EDCI (or the capital loss would be EDCI had it been a capital gain)(s. 23AH(6))	Exemption does not apply if the capital gain or loss is from the disposal of a tainted asset (s. 23AH(8))

The definitions applicable to these exceptions are:

- **Listed and unlisted countries**

  'Listed countries' and 'unlisted countries' are defined in s. 23AH(15) ITAA 1936 by reference to the meaning in the CFC rules (Part X ITAA 1936).

  Listed countries are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States (see Regulation 19 ITAR 2015).

  All other countries are unlisted countries.

  As noted earlier, there are more exemptions that apply to exclude foreign income from taxation in Australia in respect of investments in listed countries than unlisted countries. This is broadly because listed countries have comprehensive taxation systems like Australia and they have comparable tax regimes. The assumption is made that these investments are made for genuine commercial reasons.

- **Active income test**

  The 'active income test' is defined in s. 23AH(12) ITAA 1936, which refers to s. 432 ITAA 1936. This is the active income test that is used in the CFC rules.

  Broadly, the purpose of this test is to see whether the taxpayer is carrying on an active business (as opposed to passive investment) in the foreign country. If the answer is 'yes', the income will not be taxed. If the answer is 'no', the assumption is that the taxpayer has shifted income offshore and the branch's income may be taxed in Australia.

  The active income test is passed if the branch's income from ineligible activities (i.e. 'gross tainted turnover') is less than 5% of its 'gross turnover'. The 'tainted income ratio' (s. 433 ITAA 1936) is calculated as follows:

Gross tainted turnover	÷	Gross turnover	=	Tainted income ratio

  Gross tainted turnover (s. 435 ITAA 1936), broadly, is passive income (which includes dividends, interest, royalties, rent and capital gains on tainted assets) and certain income from dealings with related parties (i.e. tainted sales s. 447 ITAA 1936 and tainted services s. 448 ITAA 1936).

  Gross turnover (s. 433 ITAA 1936), broadly, is the total revenue (including capital gains) that would be disclosed in a set of statutory accounts for the foreign branch.

- **Adjusted tainted income**

  Adjusted tainted income is defined in s. 23AH(13) ITAA 1936, which refers to the meaning in the CFC rules. Adjusted tainted income for CFC purposes is defined in s. 386 ITAA 1936. It refers to passive income, tainted sales income and tainted services income that is adjusted for certain items. The adjustments are outside the scope of this unit.

- **Eligible designated concession income**

  Eligible designated concession income (EDCI) is defined in s. 23AH(15) ITAA 1936, which refers to the meaning in the CFC rules. Broadly, it is specified income that is taxed concessionally (or is untaxed) by the listed country (s. 317 ITAA 1936 and Regulations 16 and 17 ITAR 2015).

The most common example of EDCI is the tax-free gain on disposal of a tainted asset (e.g. a rental property or shares) in New Zealand, as New Zealand does not have a CGT regime. Determining EDCI is outside the scope of this unit.

- **Tainted assets**

  Tainted assets are defined in s. 23AH(15) ITAA 1936, which refers to the meaning in the CFC rules. Tainted assets, for the purpose of the CFC rules, are defined in s. 317 ITAA 1936. They include financial instruments or contracts but **exclude** trading stock and assets used solely in carrying on a business (e.g. factories and goodwill). Broadly, tainted assets are the PE's assets from which tainted income is earned.

Note: The CFC rules are further discussed later in this unit.

Broadly, the application of s. 23AH ITAA 1936 to the income of a foreign branch can be summarised as follows:

- Active income – exemption **always** applies.
- Passive income where the branch passes the active income test – exemption **always** applies.
- Passive income where the branch fails the active income test:
  - Unlisted country – exemption **never** applies.
  - Listed country and EDCI – exemption **does not** apply.
  - Listed country and non-EDCI – exemption **does** apply.
- Capital gains or losses on active assets – exemption **always** applies.
- Capital gains or losses on tainted assets
  - Unlisted country – exemption **never** applies.
  - Listed country and EDCI – exemption **does not** apply.
  - Listed country and non-EDCI – exemption **does** apply.

Consequences

The effect where s. 23AH ITAA 1936 applies is to make the foreign branch income **non-assessable non-exempt (NANE) income**. This raises the following issues:

Issue	Explanation
Expenses incurred in earning s. 23AH ITAA 1936 income	Section 8-1 ITAA 1997 only allows a deduction to the extent expenditure is incurred in gaining or producing assessable income. Further, s. 8-1(2)(c) specifically denies deductions for expenses incurred in deriving NANE income. No deductions will therefore be allowed for expenses incurred to earn s. 23AH ITAA 1936 NANE income There is no specific provision which provides a tax deduction for expenses which relate to s. 23AH ITAA 1936 NANE income. Contrast this to s. 25-90 ITAA 1997 which allows a tax deduction for debt deductions incurred in deriving s. 768-5 ITAA 1997 or s. 23AI ITAA 1936 NANE income (see below)
FITO	One of the requirements to get relief for foreign taxes paid is that the foreign tax is paid in respect of an amount that is included in assessable income. To the extent the foreign branch income is NANE income under s. 23AH ITAA 1936, there is no amount included in assessable income and no FITO is available
Losses	NANE income does not waste tax losses

Required readings

Section 23AH ITAA 1936

Section 6(1) ITAA 1936 – definition of 'permanent establishment'.

Worked example 14.1: Foreign branch income exemption

[Available online in myLearning]

Foreign equity distribution exemption (s. 768-5)

In broad terms, s. 768-5 exempts from taxation in Australia the distributions (e.g. dividends) received by an Australian corporate tax entity (e.g. company) from an equity interest in a foreign company if its participation interest in the foreign company is at least 10%. Where the exemption applies, the distribution is NANE income (i.e. not included in the taxpayer's calculation of taxable income).

Application

The key elements of s. 768-5 are set out below.

- **Only applies where participation interest is at least 10%**

  The exemption only applies to distributions received where the recipient company has a participation interest of at least 10% (i.e. 10% or more) in the payer company. Participation interests include both direct and indirect interests in share capital, voting rights and distribution rights (disregarding rights on winding up). However, in simple terms, this often means holding at least 10% of the ordinary shares.

  The intent is to exempt distribution income arising from business activities done through a foreign company, and not distributions derived from passive investments.

- **Does not apply to distributions entitled to foreign income tax deduction**

  From 1 January 2019, the exemption is generally denied where all or part of the distribution gives rise to a foreign income tax deduction (s. 768-7). However, the exemption will not be denied where the foreign entity is a collective investment entity, and foreign income tax or a withholding-type tax was payable in respect of the distribution (see the section on hybrid mismatch arrangements later in this unit).

- **Only applies to distributions on equity interests**

  The exemption is only applicable to a 'foreign equity distribution'. Foreign equity distribution is defined in s. 768-10 to include a distribution (i.e. a dividend or something taken to be a dividend) or a non-share dividend (i.e. a distribution that is not debited to share capital) made by a company that is a foreign resident in respect of an equity interest in the company. An equity interest is defined in s. 974-70 of the debt–equity rules (see Unit 13). Therefore, the exemption can apply to a return on a non-share equity interest (e.g. a convertible note issued by a foreign subsidiary to an Australian company that is classified as an equity interest).

  The exemption does **not** apply to distributions on debt interests (e.g. redeemable preference shares issued by a foreign subsidiary to an Australian company that are classified as debt interests because they have a life of less than 10 years). Distributions on debt interests would be included in assessable income as interest income (under s. 6-5) or as dividend income (under s. 44(1) ITAA 1936) and therefore, expenditure incurred in deriving the assessable income (including debt deductions) would be allowable deductions (under s. 8-1).

- **Only available to corporate tax entities**

  The exemption is only available to Australian resident corporate tax entities. Corporate tax entity is defined to include a company, corporate limited partnership, corporate unit trust or public trading trust (s. 960-115). The exemption does **not** apply to individuals or other types of trusts or partnerships receiving distributions from a foreign company.

- **Payer is either a foreign company, interposed trust or interposed partnership**

  Section 768-5(2) allows the exemption where distributions flow through an interposed trust or partnership (other than one that is a corporate tax entity). This is consistent with the foreign branch exemption in s. 23AH ITAA 1936. For ATO guidance refer TD 2017/21 and TD 2017/22.

Consequences

The effect where s. 768-5 applies is to make the foreign equity distribution **NANE income**. This raises the following issues:

Issue	Explanation
Expenses incurred in earning s. 768-5 income	No deductions are allowed for expenses to the extent incurred to earn s. 768-5 income under s. 8-1(2)(c) However, s. 25-90 ITAA 1997 allows the taxpayer to deduct 'debt deductions' (principally interest or amounts in the nature of interest) to the extent incurred in gaining s. 768-5 income, provided that offsetting distributions are expected. Debt deductions are defined in s. 820-40 In TD 2009/21, the ATO states that s. 25-90 only applies where there is a reasonable expectation, having regard to the objective circumstances, that a dividend will be paid in the future (e.g. directors' minutes, cash flow statements). This can be contrasted to s. 23AH ITAA 1936 above, where there are no specific provisions to allow deductions against the NANE income derived
FITO	As with s. 23AH ITAA 1936, where the distribution is NANE income under s. 768-5, there are no amounts included in assessable income and, therefore, no FITO will be available Where both ss 768-5 and 23AI ITAA 1936 (discussed below) apply, s. 23AI ITAA 1936 has priority and a foreign income tax offset may be available for foreign income taxes paid on the dividend (TD 2006/51)
Losses	NANE income does not waste tax losses

Required reading

Sections 25-90, 768-5, 768-10, and 768-15 ITAA 1997.

Activity 14.1: Foreign equity distribution exemption

[Available online in myLearning]

Previously attributed CFC income exemption (s. 23AI ITAA 1936)

Application and consequences

Under the CFC rules (explained in detail later in this unit), income that is accumulated in a foreign company may be deemed to be assessable income of a person (i.e. Australian resident shareholder) before it is actually received as a distribution (e.g. foreign dividend).

Under s. 23AI ITAA 1936, a distribution (e.g. foreign dividend) that is subsequently received by a person (i.e. Australian resident shareholder) that was paid out of previously attributed CFC income (i.e. income previously taxed in the hands of the person in Australia) is NANE income.

Again, the NANE character of the income raises the following issues:

Issue	Explanation
Expenses incurred in earning s. 23AI ITAA 1936 income	Deductions will generally be allowed under s. 8-1 ITAA 1997 (despite the exclusion in s. 8-1(2)(c)), because s. 23AI(2) ITAA 1936 says to ignore the NANE status of the income for the purposes of working out deductions. In addition, s. 25-90 ITAA 1997 allows the taxpayer to deduct 'debt deductions' (defined in s. 820-40 ITAA 1997) incurred in gaining s. 23AI ITAA 1936 NANE income. Debt deductions primarily include interest and payments in the nature of interest (see above comments)

Issue	Explanation
FITO	Where foreign income is NANE, no amount is included in assessable income and usually no relief for foreign taxes paid will be available. However, s. 770-10(2) ITAA 1997 allows FITOs in respect of s. 23AI ITAA 1936 income (typically for foreign withholding taxes paid on repatriation) to be offset against other foreign income which the taxpayer may earn in the income year. If the only foreign income is s. 23AI ITAA 1936 income, the withholding tax would be lost (i.e. it would not be able to be used) As the CFC income would have already been subject to tax in Australia at the time of attribution, allowing FITOs ensures that the same income is not taxed twice (i.e. not subject to Australian income tax (levied at the time of attribution) and to foreign income tax (levied at the time of repatriation to the Australian taxpayer)). Contrast this to income from foreign branches (s. 23AH ITAA 1936) and dividends from foreign companies (s. 768-5 ITAA 1997), where only foreign tax would have been levied on that income
Losses	NANE income does not waste tax losses

Example – Previously attributed CFC income exemption

AusCo, an Australian company, owns all the ordinary shares in IndiaCo, an Indian resident company. IndiaCo made a $10,000 profit and this amount was previously attributed to AusCo under s. 456 ITAA 1936 (the CFC provisions). IndiaCo declared a $1,000 dividend out of this profit in the income year ended 30 June 2019.

As an Australian resident, AusCo is taxed on its worldwide income, which includes the dividend income from IndiaCo for the income year ended 30 June 2019. However, an exemption may apply to eliminate double taxation.

Dividends received by Australian taxpayers may be excluded from being taxed under either s. 768-5 ITAA 1997 or s. 23AI ITAA 1936. However, s. 768-5 does not apply to the extent that s. 23AI ITAA 1936 applies (TD 2006/51).

The key requirement that must be satisfied to apply each section is:

- For s. 768-5 to apply, the entity claiming the exemption must be a resident company that holds a participation interest in a foreign company of at least 10% and the investment must be an equity interest as defined under the debt–equity rules.
- For s. 23AI ITAA 1936 to apply, the entity claiming the exemption must be a resident taxpayer and the dividend must be paid out of previously attributed income.

As the dividend was paid out of the $10,000 pool of income that was subject to attribution under s. 456 ITAA 1936, the exemption under s. 23AI ITAA 1936 applies. Therefore, the dividend is NANE income and no amount of the dividend will be included in AusCo's assessable income for the current income year. AusCo will not be subject to tax twice on the same income. Note that if IndiaCo was required to withhold and remit foreign income tax on the $1,000 dividend, AusCo may be entitled to claim a FITO in respect of the foreign withholding tax.

Required reading

Section 23AI ITAA 1936.

CGT 'participation exemption' (s. 768-505)

As detailed above, s. 23AH ITAA 1936 exempts the capital gain derived by an Australian company on the disposal of the assets of its foreign branch if the assets were used solely in carrying on a business and were not tainted assets. The CGT participation exemption in Subdivision 768-G provides the same concession for companies that set up their overseas structure using a foreign company. It excludes from Australian tax the capital gain or capital loss arising from the disposal of a non-portfolio investment in a foreign company to the extent that the assets of the foreign company are used to carry on an active business (as compared with the holding of passive assets).

Application

The operative provision is s. 768-505. The key elements of that section are set out below.

- **Only Australian companies can get the CGT reduction**

  The CGT reduction does not apply to shareholders which are trusts, partnerships or individuals. There is no scope for Australian companies to hold the shares indirectly via a partnership or trust (ss 768-505(1) and 768-555). This can be contrasted with s. 23AH ITAA 1936 and s. 768-5 (discussed above).

- **Australian company must hold shares in a foreign company**

  The Australian company must hold shares in a foreign company, but the shares cannot be eligible finance shares or widely distributed finance shares (s. 768-505(1)(b)). Effectively, finance shares are shares where the payment of dividends may reasonably be regarded as the payment of interest on a loan.

- **Shareholding must be non-portfolio**

  The Australian company must have a direct voting percentage of 10% or more in the foreign company (s. 768-505(1)(a)); that is, at least 10% of the shareholder votes in the foreign company (s. 768-550).

- **Non-portfolio shareholding must be held for a requisite period**

  The non-portfolio shareholding must be held continuously for at least 12 months in the two years before the CGT event. Effectively, the 10% or more direct voting interest need not be present at the time of the CGT event (s. 768-505(1)(a)).

- **Reduction only applies to gains or losses from certain CGT events**

  The CGT reduction only applies to certain CGT events happening to shares held in the foreign company (s. 768-505(1)(c)). CGT event A1 (i.e. a disposal of shares) is included and a number of other CGT events are included that closely relate to a disposal.

- **Active foreign business asset percentage**

  The amount of capital gain or capital loss is reduced by the active foreign business asset percentage (s. 768-505(2)). 'Active foreign business asset percentage' is defined in s. 768-510. This concept is used to determine the extent that the foreign company's assets are used in an active business.

  The active foreign business asset percentage is expressed as follows:

  $$\text{Active foreign business asset percentage} = \frac{\text{Value of active foreign business assets}}{\text{Value of total assets of foreign company}}$$

  An active foreign business asset is an asset used in carrying on the foreign company's business (refer to the definition in s. 768-540). Broadly, this includes assets used or held ready for use in the course of carrying on a business, including goodwill, but excludes taxable Australian property, a membership interest in an Australian company or resident trust, financial instruments, insurance policies and assets that are primarily investment assets.

For the purposes of determining the 'active foreign business asset percentage', assets are valued on either a:

- Market value method.
- Book value method.

The Australian taxpayer must elect to use one of these methods otherwise the default method will apply (s. 768-515). Under the default method, a capital gain is fully assessable in the usual manner while a capital loss is completely reduced to nil.

The market value method adopts the market value of the assets at the time of the CGT event (s. 768-520). The book value method adopts the average value of the assets in the foreign company's recognised accounts (s. 768-525).

The active foreign business asset percentage is rounded to the nearest whole percentage. However, under the method statements in ss 768-520 and 768-525, the percentages are treated as follows:

If the percentage calculated is:	… then the active foreign business asset percentage is treated as:
Less than 10%	0%
10% or more, but less than 90%	The actual percentage as calculated
90% or more	100%

Consequences

The effect where s. 768-505 applies is to reduce the capital gain or loss by the active foreign business asset percentage. The gain not included in the net capital gain is not assessable income.

Example – CGT participation exemption

AusCo held 15% of the ordinary shares in NZCo, a New Zealand resident company. The shares were all acquired in the income year ended 30 June 2006. In the income year ended 30 June 2019, AusCo disposed of its shares in NZCo and made a capital gain of $500,000.

NZCo predominantly carries on a manufacturing business but also derives some of its income from leasing commercial properties. NZCo's assets comprise the following:

Asset	Market value $
Manufacturing plant	800,000
Rental property	150,000
Cash	50,000
Total	1,000,000

AusCo is generally taxable on its worldwide income, which includes the capital gain on disposal of NZCo shares (ss 6-5 and 102-5). However, as AusCo is a resident company and held a non-portfolio interest in NZCo (i.e. at least 10%) for the requisite period (i.e. at least 12 months in the two years preceding the disposal), the CGT participation exemption under s. 768-505 can apply to reduce AusCo's assessable capital gain.

The assessable capital gain is reduced by the active foreign business asset percentage, calculated under s. 768-510 (i.e. it is reduced to the extent that the assets of NZCo are used to carry on an active business). The 'active' concept used in this section is similar to that used for the foreign branch exemption under s. 23AH ITAA 1936 (see definition in s. 768-540). Therefore, NZCo's active asset is the manufacturing plant.

Using the market value method, NZCo's active foreign business asset percentage is calculated as follows:

Active foreign business asset %	=	Value of active foreign business assets	÷	Value of total assets of foreign company
0.80 or 80%	=	$800,000	÷	$1,000,000

The non-assessable income portion of the capital gain is calculated as follows:

Non-assessable income portion of capital gain	=	Total capital gain	×	Active foreign business asset %
$400,000	=	$500,000	×	80%

The amount of the net capital gain included in assessable income under s. 102-5 for the income year is $100,000 (i.e. $500,000 – $400,000).

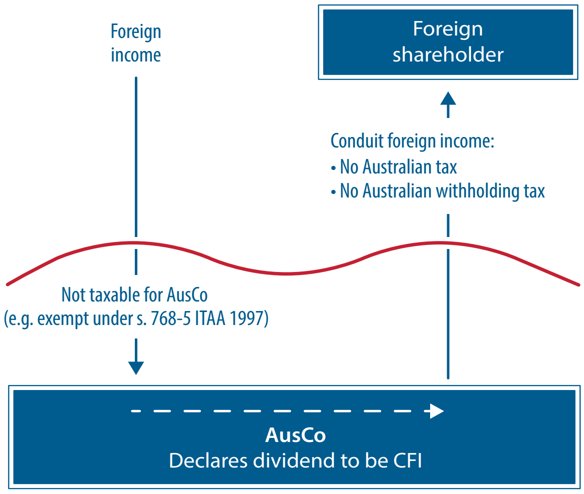
Required reading

Section 768-505 ITAA 1997.

Conduit foreign income exemption (Division 802)

The conduit foreign income (CFI) exemption regime applies to unfranked dividends that are distributed by Australian resident companies to non-residents. Such a dividend will be NANE income and not be subject to tax (either under assessment or under the withholding tax provisions) if the dividend is declared to be CFI (s. 802-15(1)).

The following diagram provides an example of how the CFI regime works.



Broadly, CFI is foreign income derived by an Australian resident company (net of related expenses) that is **not** subject to Australian tax in the company's hands. In accordance with s. 802-25, CFI includes:

- Foreign branch income that is NANE under s. 23AH ITAA 1936.
- Foreign previously attributed CFC income that is NANE under s. 23AI ITAA 1936 (s. 802 30(4)).
- Foreign equity distribution income that is NANE under s. 768-5 (s. 802-30(3)).
- Foreign trust income that is not assessable under s. 99B(2)(e) ITAA 1936 (s. 802-30(4)).
- Foreign capital gains that are disregarded under the CGT participation exemption in s. 768-505 (s. 802-35).
- Foreign capital gains that are NANE income under s. 23AH(3) ITAA 1936 (i.e. gains on assets used to carry on business through a permanent establishment in a foreign country) (s. 802-35).
- Foreign income that is effectively not subject to Australian tax because of the FITO system (s. 802-40).
- Adjustments for capital losses that are disregarded under s. 768-505 (i.e. the CGT participation exemption) and s. 23AH(4) ITAA 1936 (i.e. the foreign branch income exemption) (s. 802-35).

The purpose of the CFI regime is to ensure that foreign income ultimately derived by non-residents, but which is channelled through Australian companies, is not subject to Australian tax. This is to restore parity with non-residents who earn foreign income directly (i.e. not through Australian companies).

When calculating CFI, related expenses must be taken into account (s. 802-30(5)), effectively reducing CFI that can be distributed. In working out related expenses, foreign income tax (e.g. in relation to branch income) should also be taken into account to reduce the net foreign CFI income, as would a foreign branch loss.

Note: CFI that passes through more than one Australian company can also get the concession, provided certain timing and declaration requirements are satisfied (s. 802-20).

Foreign income tax offset (FITO) system

Overview

Exempting foreign income from Australian tax is one way to avoid double taxation. Giving a tax offset for foreign taxes paid on that foreign income is another way.

Division 770 deals with foreign income tax offsets (FITOs). Sections 770-1 and 770-5 set out the basic principles of the Division. In addition, the ATO's *Guide to foreign income tax offset rules* provides a useful summary.

A FITO effectively reduces the Australian tax that would be payable on foreign income by an amount up to the foreign income tax paid.

Application

Section 770-10(1) describes when an entity is eligible for a FITO. The key requirements are as follows:

Entitlement to FITO	
Requirements	**Explanation**
Foreign income tax	**Foreign income tax** is defined in s. 770-15(1) to mean foreign taxes on income, gains and profits, as well as any taxes covered under the tax treaties The payment of a 'credit absorption tax' or a 'unitary tax' (both defined in s. 770-15) does not qualify for a FITO (s. 770-10(5)) The note under s. 770-15 makes it clear that where a foreign tax authority is not authorised to impose the tax in the first place because of, for example, a double tax agreement, the tax will not qualify as a foreign tax
Foreign income tax must have been **paid**	**Any taxpayer** (either resident or non-resident) who has paid foreign income tax may be eligible for a FITO. For example, the Australian branch of a UK resident earning assessable income and which paid tax in the United States on that income, may get a FITO for the US tax paid
	No FITO for residence-based tax – If a taxpayer paid foreign income tax because they were a resident of a foreign country, they will not get a FITO (s. 770-10(3)). For example, the Australian branch of a UK resident earning assessable income and which paid UK tax as a UK resident, will not get a FITO for the UK tax paid
	Paid – Generally, foreign income tax can be paid by the taxpayer or by someone else on their behalf (s. 770-130) For example, a FITO may be available in situations where foreign income tax has been paid by: • Deduction at source or withholding • The trustee of a trust of which the taxpayer is a beneficiary • A partnership in which the taxpayer is a partner • The taxpayer's spouse Subject to an exception discussed below, a shareholder is not taken to pay the underlying tax paid by the company **CFC exception** – If a company (but not an individual) has a 10% or more direct or indirect interest in a CFC and there is attribution of income, the company is taken to have paid its share of the foreign income taxes paid by the CFC on that income (s. 770-135). This is the only exception to the 'no underlying tax' rule described above By contrast, s. 770-140 describes when a taxpayer is **not** considered to have paid foreign income tax. Paragraph (b) which refers to any other benefit is essentially an anti-avoidance provision. For example, a taxpayer is not considered to have paid foreign tax when the taxpayer is entitled to a refund of that foreign tax

Entitlement to FITO	
Requirements	**Explanation**
Cont.	Note 1 to s. 770-10(1) provides that the foreign income tax need not be paid in the current income year. In other words, it does not have to be paid in the same income year the amount is included in assessable income, so long as the foreign income tax is paid by the time the FITO is claimed. For example, assume that foreign interest income is assessable on an accruals basis in Year 1. Foreign tax is paid in Year 2. When the foreign tax is paid, a FITO can be claimed in Year 1. This may require an amended assessment if the income tax return for Year 1 is lodged before the foreign tax is paid. Having said that, if it is clear that the foreign tax will be paid, in practice, many companies claim the FITO upfront, rather than going down the amendment route
Foreign income tax must have been paid on an **assessable** amount	Foreign income tax paid on exempt or NANE amounts do not qualify for a FITO Note 2 to s. 770-10(1) provides that if only part of the income was assessable to the taxpayer, then the taxpayer will only get a portion of the FITO ATO ID 2010/175 explains how the FITO rules apply to capital gains that are not fully assessable. Also in *Burton v. FCT* the taxpayer was entitled to the 50% CGT general discount and it was held that the taxpayer was only entitled to 50% of the foreign income taxes paid as a FITO Section 770-10(2) provides an exception to the general rule. A distribution by a CFC that was previously subject to attribution under Part X ITAA 1936 (CFC rules) will be eligible for a FITO if any taxes were paid on repatriation (e.g. withholding tax). Even though the distribution paid out of previously attributed amounts is NANE income under s. 23AI ITAA 1936, the CFC income would have already been subject to tax in Australia at the time of attribution. Allowing the FITO ensures the same income is not taxed twice
FITO is available in the year the amount was included in **assessable** income	This requirement describes the timing of the FITO The FITO is not available in the year the taxpayer paid foreign income taxes but in the year the income was assessed in Australia, assuming foreign income taxes have been paid If an amount was assessed in one year and foreign income tax was paid in a later year, the taxpayer will have to amend their assessment to claim a FITO. The usual amendment time period will not apply. For FITO purposes, the taxpayer has up to four years from the time they paid foreign income tax to amend their assessment (s. 770-190)

The operation of the FITO rules in a consolidated group is covered by Subdivision 717-A. Division 770 applies to the head company as it would have applied to the subsidiary member (see Unit 12).

Calculation method

The amount of a FITO is the amount of foreign income tax paid (s. 770-70). However, s. 770-75 places a limit on the amount of FITO, which is the **greater of**:

- $1,000
- the FITO cap amount.

Taxpayers do not have to perform the FITO cap calculation if they do not intend to claim more than $1,000 in FITOs, even if they paid more than $1,000 in foreign income tax.

For taxpayers who have paid more than $1,000 of foreign income tax and wish to claim more than $1,000 of FITOs, the FITO cap amount is calculated in accordance with ss 770-75(2), (3) and (4). Broadly, if the foreign tax paid is within the FITO cap amount, the FITO will equal the foreign tax paid. If the foreign tax paid exceeds the FITO cap, the FITO will equal the FITO cap amount (see below for excess amounts of foreign tax paid).

The FITO cap calculation is illustrated in the following diagram:

FITO limit = **Income tax payable on taxable income** – **Income tax payable on modified taxable income**

Income tax payable on taxable income:

Include Medicare levy* but ignore other tax offsets

Income tax payable on modified taxable income:

Include Medicare levy* but ignore other tax offsets.
Based on the assumptions in s. 770–75(4), including:

- Exclude from assessable income
  - any amount on which eligible foreign income tax was paid, and
  - any amount of assessable income that is foreign-sourced
- Exclude from allowable deductions
  - debt deductions attributable to overseas PEs (e.g. branches), and
  - any allowable deductions (other than debt deductions) reasonably attributed to income items excluded above

* Section 90-1 Schedule 1 TAA 1953.

Section 770-80 increases the FITO limit (whether $1,000 or a calculated amount) for any amounts of foreign income tax paid on amounts previously attributed under the CFC regime. In other words, there is no limit on the amount of a FITO a taxpayer can get for eligible foreign income taxes paid on s. 23AI ITAA 1936 amounts.

Excess amounts

Section 63-10 makes it clear that:

- Foreign income taxes paid that are not claimed as a FITO **cannot be carried forward** for use in later years (i.e. a 'use it or lose it' rule applies).
- Excess FITOs **cannot be transferred** to another entity.
- The income does not need to be from a foreign source in order to be eligible for a FITO (foreign tax simply has to be paid).

It is also generally considered that excess FITOs are **not deductible** because the imposition of tax is a 'below the line' issue.

Where a company has both a prior year loss and a FITO entitlement, the loss utilisation should be reduced under s. 36-17(2), so that FITOs are not wasted (bearing in mind that excess FITOs cannot be carried forward). That is, a deduction for prior year losses should not be taken which will then result in taxable income in respect of which Australian tax is payable and a FITO is allowed. This will utilise the FITO that would otherwise be lost and will preserve prior year losses for potential use in a later income year.

Example – FITO entitlement

Bob Jones is an Australian resident individual taxpayer. Bob has taxable income of $87,000 which comprises $37,000 of Australian sourced income, $40,000 of net foreign sourced income, and $10,000 of foreign income taxes paid. During the current income year Bob also received a net foreign dividend of $9,000 that was paid out of previously attributed CFC income. Bob paid foreign withholding tax of $1,000 on this dividend. The foreign dividend of $9,000 is NANE income under s. 23AI ITAA 1936.

Bob's FITO cap under s. 770-75 is calculated as follows:

Tax on taxable income of $87,000 (including Medicare levy):

= $19,822 + ($87,000 × 2%) = $21,562

Tax on modified taxable income $37,000 (including Medicare levy):

= $3,572 + ($37,000 × 2%) = $4,312

FITO cap:

= $21,562 – $4,312 = $17,250

However, in accordance with s. 770-80, Bob increases the FITO cap by the foreign tax paid on foreign dividend that is paid from income previously attributed under the CFC regime. Therefore, his total FITO cap is:

= $17,250 + $1,000 = $18,250

As his FITO cap exceeds the total eligible FITOs (i.e. $10,000 + $1,000 = $11,000), Bob's FITO entitlement is equal to his eligible FITOs.

Therefore Bob's tax payable for the income year is:

= $21,562 – $11,000 = $10,562

Required reading

Sections 770-1, 770-5, 770-10(1) and related Notes, and 770-75 ITAA 1997.

Worked example 14.2: Tax payable for an individual with foreign income tax offsets

[Available online in myLearning]

Activity 14.2: Tax payable of a company with foreign income tax offsets

[Available online in myLearning]

Temporary residents

The temporary residents regime was introduced to give special tax treatment to foreign employees who come to Australia temporarily to work but have satisfied the technical requirements of being an Australian tax-resident. It was considered inappropriate that the worldwide income of these workers be taxed in Australia, so Subdivision 768-R was introduced. The Subdivision provides as follows:

- The ordinary income and statutory income of a temporary resident which has a foreign source is NANE income if it was derived when the person was a temporary resident (s. 768-910).

  Note: See Unit 1 for a discussion on the meaning of 'source'.
- The exclusion does not apply to capital gains from assets that are taxable Australian property (ss 768-910(1) and 768-915). Such gains continue to be taxable under the CGT provisions.

  Note: See Unit 4 for a discussion on taxable Australian property.
- Other exceptions to Subdivision 768-R are listed in s. 768-910(3).

Taxation of foreign residents

Overview

Under s. 6-5 ITAA 1997 non-residents are generally taxed on their **Australian-sourced income** (see Unit 1). Therefore, when a non-resident invests in Australia, the income from holding and/or selling that investment (i.e. the Australian-sourced income) is taxable in Australia unless a specific exclusion applies. **Exclusions** exist for non-residents:

- Under the **capital gains tax (CGT) regime** for disposal gains and losses of a **capital nature** made on direct investments into Australian assets that do not relate, directly or indirectly, to Australian real property or an Australian trading business (i.e. that are not taxable Australian property – see Unit 4).
- Under the **investment management regime** (IMR) for disposal gains and losses of a **revenue nature**, to the extent it is not attributable to Australian real property, made:
  - through a widely held foreign fund, on investments into Australian assets of a portfolio nature (i.e. less than 10% of the total), or
  - through an independent Australian fund manager, on investments into Australian assets of a portfolio nature and foreign assets (including non-portfolio investments for the 2015–2016 and later income years).

  The IMR in Subdivision 842-I ITAA 1997 is outside the scope of the TAXAU module.

In addition, when a non-resident carries on a business in Australia at or through a **permanent establishment**, the non-resident is taxable in Australia on:

- Business profits, to the extent they are attributable to the permanent establishment (see later in this unit under Double tax treaties, Transfer pricing and TR 2001/11).
- Dividends it receives from an Australian resident company that are attributable to the permanent establishment, irrespective of the source of profits from which those dividends are paid (s. 44(1)(b) and (c) ITAA 1936 – see Unit 8).

It is often impractical for Australia (through the ATO) to enforce the collection of tax from non-residents. Therefore, provisions exist that require tax to be withheld from certain types of income of a non-resident taxpayer. Australia's withholding tax regimes include:

- **Dividend, interest and royalty (DIR) withholding** (Division 11A ITAA 1936)

  DIR withholding tax applies to certain interest, dividend and royalty payments made by an Australian resident to a non-resident. This regime is analysed in detail below.

- **Managed investment trust (MIT) withholding** (Division 840)

  MIT withholding tax applies to fund payments made by a MIT to a non-resident beneficiary (where no permanent establishment in Australia). Fund payments are broadly the distributions of income by a MIT **excluding** capital gains and losses in relation to a CGT asset that is not taxable Australian property, amounts that are subject to DIR withholding tax and amounts that are foreign sourced income (Schedule 1 s. 12-405 TAA 1953). Therefore, fund payments generally consist of rental income and capital gains from TAP.

  Like DIR withholding, the non-resident beneficiary is liable for the MIT withholding tax, while the collection obligation rests with the payer (Schedule 1 s. 12-385 TAA 1953). Income that is subject to MIT withholding tax is NANE income of the non-resident beneficiary under s. 840-815. Therefore, the usual trust provisions (refer Unit 10 on trusts) do not apply.

  The rate of MIT withholding tax where the recipient is in a country with which Australia has an exchange of information (EOI) agreement or double taxation agreement is 15% (except to the extent it is non-concessional MIT income) and 30% in other cases (Schedule 1 s. 12-385 and 12-390 TAA 1953). EOI countries are listed in Regulation 34 TAR 2017 and are not the same as a country with which Australia has a double taxation agreement.

A detailed understanding of MITs is outside the scope of the TAXAU module.

- **Non-resident withholding – certain activities** (Schedule 1 s. 12-315 TAA 1953)

  Non-resident withholding tax applies to payments made for promoting or operating a gaming junket, for sports and entertainment activities, and for construction and related activities (Regulation 31, 32 and 33 TAR 2017).

  The non-resident withholding regime is outside the scope of the TAXAU module.

- **Non-resident withholding – taxable Australian property** (Schedule 1 s. 14-200 TAA 1953)

  A 12.5% non-final withholding tax applies on the disposal by non-residents of certain taxable Australian property. Like the other withholding regimes, it is the purchaser who is required to pay 12.5% of the purchase price to the ATO as withholding tax. This withholding tax obligation does not apply to residential property valued at less than $750,000. This is discussed further in Unit 4.

DIR withholding tax

DIR withholding tax is imposed by Division 11A ITAA 1936. Section 128B ITAA 1936 is the operative provision. DIR withholding is levied when interest, dividend and royalty income is 'paid' under certain conditions.

Dividend application

As outlined in Unit 8, a dividend is defined in s. 6(1) ITAA 1936. A 'return on equity interests', as defined in the debt–equity rules in Division 974 ITAA 1997 (s. 128AAA ITAA 1936), is also a dividend for withholding tax purposes.

The basic scenario (and the one that arises most often) is when a resident pays a dividend to a non-resident. Withholding tax will apply under s. 128B(1) ITAA 1936.

The key elements of s. 128B(1) ITAA 1936 are as follows:

- **Non-residents bear withholding tax liability**

  The provision applies to income that is derived by a non-resident. This means it is the non-resident who bears the withholding tax liability (although the payer has the tax remittance obligation).

- **'Paid' not 'source'**

  The provision applies when a dividend is paid to a non-resident. The use of 'paid' as the criterion for triggering s. 128B(1) ITAA 1936 means source is irrelevant where withholding tax applies.

The following tables summarise when withholding tax will or will not apply to dividends:

When dividend withholding tax will apply		
Payer	**Pays**	**Payee**
Australian company	to	Non-resident (s. 128B(1) ITAA 1936)

When dividend withholding tax will not apply		
Payer	**Pays**	**Payee**
Whoever	to	Non-resident deriving dividend to the extent fully franked (s. 128B(3)(ga) ITAA 1936)
Whoever	to	Non-resident deriving dividend via Australian permanent establishment (s. 128B(3E) ITAA 1936)
Australian company	to	Whoever deriving an unfranked dividend declared to be CFI (s. 802 15(1))

Interest application

'Interest' is defined in s. 128A(1AB) ITAA 1936. It covers the ordinary meaning of interest, which is compensation for the loss of the use of money and also the return on 'debt interests' as defined under Division 974. Returns on debt interests include amounts in the nature of interest, such as a discount on a debt instrument like a bill of exchange. Sections 128AA to 128AD ITAA 1936 deem certain amounts to be interest.

The basic scenario (and the one that arises most often) is when a resident pays interest to a non-resident. Withholding tax will apply under s. 128B(2) ITAA 1936.

As for dividends, it is the non-resident who bears the liability for the withholding tax, which arises when the interest is paid (again, the taxpayer has the tax remittance obligation).

The following tables summarise when withholding tax will or will not apply to interest:

When interest withholding tax will apply		
Payer	**Pays**	**Payee**
Resident	to	Non-resident (s. 128B(2)(b)(i) ITAA 1936)
Non-resident incurring interest via Australian permanent establishment	to	Non-resident (s. 128B(2)(b)(ii) ITAA 1936)
Resident	to	Resident earning interest through a permanent establishment overseas (s. 128B(2A)(b)(i) ITAA 1936)
Non-resident incurring interest through an Australian permanent establishment	to	Resident earning interest through a permanent establishment overseas (s. 128B(2A)(b)(ii) ITAA 1936)

In other words, withholding tax is payable when interest is paid from an Australian connection to an offshore connection.

When interest withholding tax will not apply		
Payer	**Pays**	**Payee**
Resident incurring interest through a permanent establishment overseas (i.e. where wholly incurred in carrying on a business through that overseas permanent establishment)	to	Non-resident (s. 128B(2)(b)(i) ITAA 1936) Resident (s. 128B(2A)(b)(i) ITAA 1936)
Whoever	to	Non-resident deriving interest through an Australian permanent establishment (s. 128B(3)(h)(ii) ITAA 1936)

Example – Interest withholding tax

Applying interest withholding tax	
Situations where interest withholding tax will be payable	**Reason**
AustCo's branch in China places its surplus working funds on deposit in a Sydney branch of an Australian bank and earns interest on them	An Australian resident is paying to another resident interest that is earned through the resident's overseas permanent establishment (s. 128B(2A)(b)(i) ITAA 1936)
AustCo's branch in China places its surplus working funds on deposit in a Sydney branch of a Chinese bank and earns interest on them	The interest is paid through the Australian permanent establishment of a non-resident to a resident deriving interest through an overseas permanent establishment (s. 128B(2A)(b)(ii) ITAA 1936)
ChinaCo earns interest from a loan it has extended to James, an Australian resident	A resident is paying a non-resident (s. 128B(2)(b)(i) ITAA 1936)

Applying interest withholding tax	
Situations where interest withholding tax will NOT be payable	**Reason**
AustCo's branch in China places its surplus working funds on deposit in a Beijing branch of a Chinese bank and earns interest on them	A non-resident is paying interest to a resident that was not incurred by the non-resident via an Australian permanent establishment
ChinaCo's branch in Australia earns interest from a loan it has extended to James, an Australian resident	A resident is paying a non-resident with a branch in Australia (s. 128B(3)(h)(ii) ITAA 1936)

Royalty application

'Royalty' is defined in s. 6(1) ITAA 1936 and extends to income as well as capital receipts (e.g. where the payment for the purchase of intangibles is structured like royalties). A double taxation treaty definition may also be applicable (see the section on double taxation treaties later in this unit).

The basic scenario (and the one that arises most often) is when a resident pays royalties to a non-resident. Withholding tax will apply under s. 128B(2B) ITAA 1936.

As for dividends and interest, it is the non-resident that bears the liability for the withholding tax and the liability arises when the royalty is paid (again, the payer has the tax remittance obligation).

The following two tables summarise when withholding tax will or will not apply to a royalty:

When royalty withholding tax will apply		
Payer	**Pays**	**Payee**
Resident	to	Non-resident (s. 128B(2B) ITAA 1936)
Non-resident incurring royalty through an Australian permanent establishment	to	Non-resident (s. 128B(2B) ITAA 1936)
Resident	to	Resident deriving royalty through a permanent establishment overseas (s. 128B(2C) ITAA 1936)
Non-resident incurring royalty through an Australian permanent establishment	to	Resident earning royalty through a permanent establishment overseas (s. 128B(2C)(b)(ii) ITAA 1936)

In other words, withholding tax is payable where the royalty is paid from an Australian connection to an offshore connection.

When royalty withholding tax will not apply		
Payer	**Pays**	**Payee**
Resident incurring royalty through a permanent establishment overseas	to	Non-resident (s. 128B(2B)(b)(i)) Resident (s. 128B(2C)(b)(i))
Whoever	to	Non-resident in a treaty country deriving royalty through an Australian permanent establishment (s. 17A(4) *International Tax Agreements Act 1953* (ITA Act 1953))

Example – Royalty withholding tax

Applying royalty withholding tax	
Situations where royalty withholding tax will be payable	**Reason**
HKCo (a Hong Kong resident) earns royalties from James, an Australian resident	An Australian resident pays a royalty to a non-resident (s. 128B(2B) ITAA 1936)
HKCo's branch in Australia earns royalties from James, an Australian resident	An Australian resident pays a royalty to a non-resident (s. 128B(2B) ITAA 1936) **Note:** Section 17A ITA Act 1953 is not applicable, as Hong Kong is not a treaty country

'Paid'

'Paid' is defined in s. 128A(2) ITAA 1936 as including 'reinvested, accumulated, capitalised … or otherwise dealt with on behalf of the other person or as the person directs' (i.e. a constructive payment). This would generally include the crediting of an amount to an intercompany loan account. In contrast, a mere accrual of interest which is not credited (i.e. applied) to the intercompany account would generally not give rise to a payment.

The TAA 1953 contains a similar constructive payment condition. Therefore, a physical flow of funds is not required.

Withholding tax rates

Unless altered by a double taxation treaty, the withholding tax rates, in accordance with the *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974*, are as follows:

Rates of withholding tax	
Tax on	**Rate (%)**
Interest	10
Dividends	30
Royalties	30

Consequences

Recipient

Amounts that are subject to DIR withholding tax are **NANE income** of the foreign resident, under s. 128D ITAA 1936. As the income is not assessable to the recipient, expenses incurred in deriving the income will not be deductible under s. 8-1(2)(c).

From a practical perspective, DIR withholding tax is commonly referred to as a 'final tax' on income. That is, there is neither a need for a non-resident taxpayer who only received DIR income from which tax has been withheld to calculate tax payable (under the framework as outlined in Unit 1), nor to complete an Australian income tax return in respect of that income.

Payer

It is the non-resident who bears the liability for withholding tax. However, it is impracticable for the ATO to pursue the collection of tax from the non-resident. It is easier to collect the tax from the resident payer of the income.

As a result, the pay-as-you-go (PAYG) rules in the TAA 1953 (see Unit 1) **require a payer** of a dividend, interest or royalty **to withhold an amount and remit** it to the ATO if the payer has to pay that amount to a place outside Australia, or if the recipient has an overseas address (Schedule 1 ss 12-210, 12-245 and 12-280 TAA 1953).

An Australian resident receiving a dividend, interest or royalty on behalf of a non-resident must also deduct PAYG withholding as outlined above (Schedule 1 ss 12-215, 12-250 and 12-285 TAA 1953).

If no withholding tax is payable on the interest, dividend or royalty (e.g. because a dividend is franked or a dividend is declared to be conduit foreign income), no amount is required to be withheld under the PAYG rules (Schedule 1 s. 12-300 TAA 1953).

If a payer does not comply with the PAYG rules, not only is the payer subject to penalties for breaching the TAA 1953, but s. 26-25 ITAA 1997 will disallow any deductions for the interest or royalty that the payer would otherwise get until the PAYG withholding is paid to the ATO.

When the PAYG withholding is paid, the interest or royalty is retrospectively deductible in the year in which it was incurred under s. 26-25(3). Section 170(10AA) ITAA 1936 permits the normal amended assessment period to be extended indefinitely to ensure the retrospective interest or royalty deduction is available once the PAYG withholding is paid. Therefore, when the PAYG is paid, the deduction is reinstated as per normal.

Example – Consequences for Australian resident payer

AC Toys (an Australian resident company) has entered into an agreement with HKCo (a company resident in Hong Kong) that makes 'Magic Fairytale Castle' toys. Under the agreement, AC Toys will have rights to sell the Magic Fairytale Castle toys in Australia, but will have to pay a royalty of 5% to HKCo for each sale.

As a non-resident, HKCo is liable for tax in Australia in respect of any Australian-sourced royalty payments from AC Toys (s. 6-5). Withholding tax at a rate of 30% applies to the royalty payments from AC Toys (s. 128B(2B) ITAA 1936 and *Income Tax (Dividends, Interest and Royalties Withholding Tax) Act 1974*). This rate is subject to the operation of double taxation treaties. However, Australia does not have a double taxation treaty with Hong Kong.

As the royalty payment is to a location outside Australia, AC Toys is required to withhold and remit the withholding tax to the ATO on behalf of HKCo (s. 12-280 TAA 1953).

AC Toys is not entitled to a deduction for the royalty payments until the withholding tax is actually paid (s. 26-25). Once paid, the royalty is retrospectively deductible in the year in which it was incurred. Therefore AC Toys may need to lodge an amended income tax return to claim the deduction.

The royalty income received by HKCo will be NANE income under s. 128D ITAA 1936.

Required reading

Sections 128A(2), 128B(1), (2) and (2B) and 128D ITAA 1936.

Section 26-25 ITAA 1997.

Double tax treaties

Overview

As noted earlier in this unit, double taxation can be eliminated either by excluding income from being taxed in Australia or by giving offsets for the foreign taxes paid against the domestic tax. Australia's double tax treaties (or double tax agreements) also deal with double taxation by allocating the rights to tax and the obligations to grant a tax offset.

This unit does not look at every double tax treaty, each of which are similar but different. Instead, it looks at the broad principles that apply to most treaties, with reference to particular examples that illustrate those principles. In practice, it is advisable to read the specific double tax treaty, as modified by the Multilateral Convention where applicable, when dealing with international transactions.

Australia's double tax treaties, as modified by the Multilateral Convention where applicable, form a significant part of Australia's international tax regime. The double tax treaties and the Multilateral Convention are given the force of law by the ITA Act 1953. For example, s. 5 ITA Act 1953 gives effect to the Australia–United Kingdom double tax agreement (UK Agreement) and the Multilateral Convention (generally with effect from 1 January 2019 for withholding taxes and from 1 July 2019 for all other taxes).

The relationship between the ITA Act 1953 and the two income tax assessment Acts (i.e. ITAA 1936 and ITAA 1997) is expressed in s. 4 ITA Act 1953. The provisions of the ITA Act 1953 (and, by extension, of the double tax treaties) have priority if there is any inconsistency (other than Part IVA ITAA 1936, which is discussed in Unit 15).

Australia negotiates its double tax treaties following the OECD Model Convention, with modifications to suit the particular circumstances. The OECD Model Convention includes commentary that explains how it applies. The High Court in *Thiel v. FCT* held that the OECD's Model Convention and commentary are aides to interpreting Australia's double tax treaties. Further guidance is found in TR 2001/13, which discusses how to interpret Australia's double tax treaties.

The aim of a double tax treaty is to avoid double taxation, to prevent fiscal evasion and, sometimes, to assist in tax collection. The purpose of more modern treaties is to eliminate (rather than avoid) double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (such as treaty shopping arrangements).

The aim of the Multilateral Convention is to broadly allow Australia (and other signatories) to quickly modify their bilateral double tax treaties to implement measures, designed to better address multinational tax avoidance, developed under the OECD Base Erosion and Profit Shifting (BEPS) project. Existing modifications deal with hybrid mismatches, treaty abuse, and the avoidance of permanent establishment status.

Each double tax treaty classifies income and gains into 'baskets' or classes of income and then allocates the right to tax to one of the countries. Most double tax treaties:

- Grant taxing rights to the source country (i.e. the country where the income is sourced).
- Do not prohibit the country of residence (i.e. the country that the taxpayer is a tax resident of) from taxing the same item but requires it to give relief against double taxation.

See Article 22 of the UK Agreement.

Please note that in this section of the unit, all Article references are to the UK Agreement as modified by the Multilateral Convention unless otherwise specified.

Resident of a contracting state

It is important to understand that a person gains access to the benefits of a tax treaty only if the person is a resident of one of the countries to the treaty (i.e. a 'resident of a contracting state'). There are three things to remember in this regard:

1. A tax treaty does not itself determine whether a person is a resident of a contracting state. This is left to the domestic laws of each country. Section 6(1) ITAA 1936 determines whether a person is a resident of Australia for tax purposes.
2. Only if a person is a resident of a contracting state can the person rely on a particular treaty.
3. If a person is a resident of both contracting states, the treaty will 'allocate' residence to a country under the 'tie breaker' rule. This allocation is necessary because some treaty provisions give taxing rights to the country where the taxpayer is a resident (i.e. country of residence).

See Articles 4(4) and 4(5) as modified by Article 4(1) of the Multilateral Convention. Under the Multilateral Convention, the 'tie breaker' rule requires that the competent authorities determine by mutual agreement a single jurisdiction of tax residence. For an entity, this determination must be made having regard to the entity's place of effective management, the entity's place of incorporation or constitution, and any other relevant factors. If a mutual agreement is not reached, the person is not entitled to any relief or exemption from tax provided by the tax treaty.

Treatment of income and gains

As explained above, tax treaties classify income and gains into 'baskets' or classes of income. The classes of income and gains examined in this unit include:

- Business profits.
- Dividend income.
- Interest income.
- Royalty income.
- Personal services income.

Business profits

Business profits, or more precisely 'the profits of an enterprise', are dealt with under the *Business Profits Article* (Article 7).

The *Business Profits Article* operates as follows:

- **It applies to 'profits of the enterprise'.**

  The word 'profits' is to be read as 'taxable income' (s. 3(2) ITA Act 1953).

  The Article applies to any profit from a commercial or business transaction, including single isolated transactions entered into for business or commercial purposes. *Thiel v. FCT* stated that the word 'enterprise' has a wide meaning and covers any activity that was carried out in a business or commercial framework.

- **Priority is given to country of residence unless there is a PE in the host country.**

  The right to tax business profits is given to the country in which the taxpayer is a tax resident (i.e. country of residence) unless the profit is connected to a PE in the other country, in which case the other (host) country may tax (Article 7(1)).

- **Profit attributable to a PE is calculated as if it were a separate enterprise (see TR 2001/11) and is given deductions.**

  Profit attributable to a PE is to be calculated as if it were a separate and distinct enterprise to the taxpayer (Article 7(2)) and is allowed deductions for expenses incurred in deriving its income (Article 7(3)).

Subservience: Where another Article also applies to an item of income or gain, priority is given to the other Article (Article 7(6)). Common examples are interest, dividends or royalties which are subject to specific Articles. In other words, income covered by other Articles cannot form part of the profit of an enterprise. However, other Articles may give priority back to the *Business Profits Article*.

The concept of a PE and the income that is attributable to a PE is pivotal to the operation of the *Business Profits Article*. Each treaty has an article defining a PE (Article 5). The purpose of the PE concept is to see if a taxpayer has enough economic presence in a particular country to allow that country to tax the income.

A taxpayer who carries on a business at a 'fixed place' will have a PE in that place (e.g. a branch). Central to the definition of a PE are:

- The degree of permanence, both temporally (i.e. time) and geographically.
- Whether a person in the other country has, and habitually exercises, an authority to conclude contracts on behalf of the taxpayer.

Attributing income to a PE is not the same as asking if the income is sourced from the PE. However, the 'deemed source rule' in every tax treaty (Article 21) deems income attributable to a PE to be sourced in the place where the PE is located.

TR 2002/5 discusses the concept of PE as defined in s. 6(1) ITAA 1936. This discussion should assist with understanding the concept of PE generally.

TR 2001/11 explains how income is attributable to a PE. Broadly, income is attributable to a PE based on the functions undertaken by the PE, the assets it uses to perform the function and the risks the PE assumes in carrying out its functions.

Dividend income

'Dividend' under a tax treaty generally takes its meaning from the domestic law of the country where the payer resides (Article 10(4)). This means that amounts treated as dividends under Australia's debt–equity rules (Division 974) are included. This is confirmed by s. 3(2A) ITA Act 1953.

Dividend income is generally treated as follows:	
Treaty	**Explanation**
Taxing rights given to country of residence	The country in which the person who is beneficially entitled to the dividend income resides (i.e. country of residence) has the right to tax (Article 10(1)). Note the use of the term 'beneficially entitled' means it is necessary to trace through a trust to the ultimate beneficiary of the dividend
Secondary taxing right given to country of source	The country from which the dividend is paid (i.e. country of source) can also tax the dividend but is limited to no more than (usually) 15% of the gross amount (but this will vary depending on the specific double tax agreement). However, Australia's policy on the 15% cap is beginning to change, mainly to facilitate investment flow (Article 10(2)). Practically, a DTA has no effect in relation to a fully franked dividend paid by a resident company to a non-resident as the withholding tax is reduced to nil under s. 128B(3)(ga) ITAA 1936
Business Profits Article applies if a dividend is connected to a PE	If a dividend is connected to a PE, the *Dividend Article* will not apply and the *Business Profits Article* will apply instead (Article 10(5))

Interest income

'Interest' for the purposes of the *Interest Article* has its ordinary meaning and is broadly defined. This means that a return on debt interests under Australia's debt–equity rules (Division 974) will be treated as interest under the *Interest Article* (Article 11(5)).

Interest income is generally treated as follows:	
Treaty	**Explanation**
Taxing rights given to country of residence	The country in which the person who is beneficially entitled to the interest income resides (i.e. country of residence) has the right to tax (Article 11(1)). Note the use of the term 'beneficially entitled' means it is necessary to trace through a trust to the ultimate beneficiary of the interest
Secondary taxing right given to country of source	The country from which the interest is paid (i.e. country of source) can also tax the interest but is limited to no more than (usually) 10% of the gross amount (Article 11(2)). Australia's policy on this is beginning to change. Interest earned by financial institutions is generally now not taxable by the country of source (Article 11(3)), but this will vary depending on the specific double tax agreement
Business Profits Article applies if interest is connected to a PE	If the interest is connected to a PE, the *Interest Article* will not apply and the *Business Profits Article* will apply instead (Article 11(6))

Royalty income

The *Royalty Article* generally has a definition of 'royalty' (Article 12(3)) which may be different to the domestic meaning of 'royalty' in s. 6(1).

Royalty income is generally treated as follows:	
Treaty	**Explanation**
Taxing rights given to country of residence	The country in which the person who is beneficially entitled to the royalty income resides (i.e. country of residence) has the right to tax (Article 12(1)). Note the use of the term 'beneficially entitled' means it is necessary to trace through a trust to the ultimate beneficiary of the royalty
Secondary taxing right given to country of source	The country from which the royalty is paid (i.e. country of source) also can tax the royalty, but the tax is limited to a specified amount (Article 12(2))
Business Profits Article applies if interest is connected to a PE	If the royalty is connected to a PE, they will be outside the scope of the *Royalty Article* and the *Business Profits Article* will apply (Article 12(5))

Personal services income

The treatment of personal services income is usually scattered across a number of provisions in a tax treaty. For example, in the UK Agreement, personal exertion income is covered by the following Articles:

- Article 14 *Income from employment.*
- Article 15 *Fringe benefits.*
- Article 16 *Entertainers and sportspersons.*
- Article 18 *Government service.*

It is necessary to read the specific provision of the tax treaty to determine the treatment of income from a particular service rendered.

Required reading

Articles 5, 7, 10, 11, 12 UK Agreement as modified by the Multilateral Convention.

Activity 14.3: Double taxation treaties

[Available online in myLearning]

Attribution regimes

Overview

The international attribution system refers to the regimes that include certain foreign income of a non-resident in the taxable income of an Australian resident. They do this by attributing (or imputing) foreign income of the non-resident to the Australian resident. In other words, the foreign income is deemed to have been derived by the Australian resident and is included in the Australian resident's assessable income for taxing in Australia.

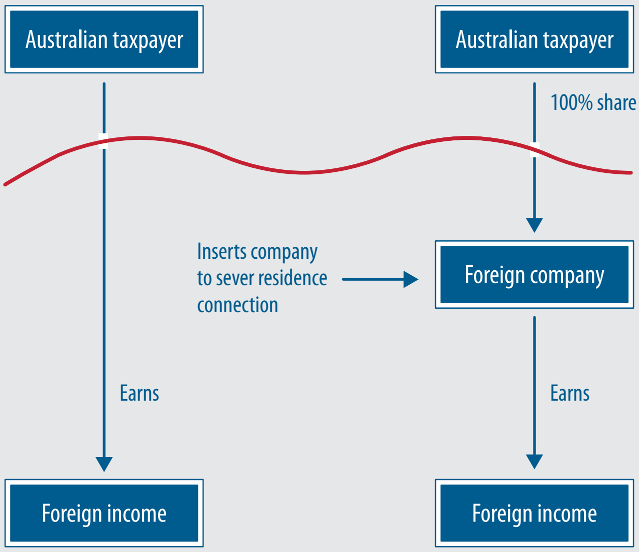
Attribution regimes are designed to prevent income from being accumulated in a foreign jurisdiction that does not comparably tax that income. Attribution regimes are commonly referred to as 'anti-deferral regimes'.

As outlined in Unit 1, 'residency' and 'source' generally establish Australia's tax jurisdiction. That is, resident taxpayers are taxed on their worldwide income. Non-residents are taxed on their Australian-sourced income. The attribution regimes are exceptions to the source-residence principle.

The exceptions are necessary because residency and source may be easily manipulated.

Example – Residency manipulation

The residence connection is easily severed by inserting a non-resident company offshore.



Where the Australian resident taxpayer derives foreign income directly, that income will be taxed under s. 6-5 unless another specific provision applies. Conversely, where a foreign company derives the income, that income is not subject to Australian tax provided that the foreign company is not an Australian tax resident (i.e. it does not carry on business in Australia or have its central management and control in Australia). If the foreign company is subject to a low or zero tax rate in the foreign country, the foreign income could be subject to minimal foreign tax or escape it altogether. However, the Australian taxpayer continues to enjoy the economic benefit of the foreign income by holding all the shares in the foreign company and the Australian tax is deferred until dividends are paid or the shares in the foreign company are sold.

Australian tax is avoided altogether if it is never repatriated or if s. 768-5 ITAA 1997 (foreign equity distribution on participation interests) exempts the dividends from tax or if Subdivision 768-G exempts any gain on sale from tax.

For passive income such as interest and royalties, a non-resident can manipulate the source of the income by ensuring that the contracts are negotiated and executed overseas (i.e. by ensuring that more factors weigh towards an offshore source).

Example – Source manipulation

AUS Co Ltd (AUSCO) is an entity which operates in Australia. AUSCO also has a subsidiary in Singapore.

An independent Singapore-based company, Singapore Co (SingaporeCO), negotiates a contract with AUSCO to manufacture and sell its products in Singapore. SingaporeCO sends an executive to Australia to negotiate and sign the contract with AUSCO. Royalties are payable to AUSCO under the contract. The royalties would prima facie have an Australian source, therefore AUSCO would be taxable on those royalties in Australia.

However, if AUSCO's Singapore subsidiary and SingaporeCO negotiate and sign the contract in Singapore, then these factors weigh towards the royalty income having a Singapore source. If the royalty income is derived by the Singapore subsidiary, then Australia would not be able to tax that income.

The attribution regimes seek to tax the Australian taxpayer on certain income that is not comparably taxed from the time the foreign income is derived by the non-resident. Hence, these regimes are also referred to as the 'accruals regimes' (i.e. income is taxed as it is earned by the controlled entity rather than when it is repatriated to the Australian resident taxpayer (e.g. as a dividend)).

This unit considers two attribution regimes in respect of foreign entities:

- **Controlled foreign companies (CFC) rules (Part X ITAA 1936).**

  The CFC rules are very complex and this unit provides only a working knowledge of them. It covers when the rules may apply and the effects of their application. To this end, it explains some of the major concepts that underpin Part X.
- **Transferor trust (TT) rules (Division 6AAA ITAA 1936).**

  This unit provides an overview of the TT rules. It covers the existence of the TT rules and when they might apply. A detailed understanding of the TT rules is outside the scope of the TAXAU module.

Controlled foreign companies (CFC)

Overview

The CFC regime is contained in Part X ITAA 1936. It applies when an Australian resident controls a foreign company (hence 'controlled foreign company'). It seeks to attribute the foreign income earned by a foreign company back to an Australian 'attributable taxpayer' in certain circumstances.

The CFC regime is essentially an anti-deferral regime. It is not intended to catch ordinary active business transactions – it is targeted only at those transactions where assets have been shifted offshore to enable income to be taxed in a low-tax jurisdiction.

If a taxpayer moves an active business offshore, the CFC rules would generally not apply, reflecting what is known as the 'active income test' in the CFC rules. The active income test is considered in greater detail later. However, if that taxpayer moved assets offshore for a tax reason (e.g. instead of receiving an overseas dividend directly, the taxpayer set up an interposed company overseas to own the shares that receive dividends), the CFC rules might apply.

The discussion that follows sets out three steps to follow when considering a CFC problem. The three steps address the components of the CFC rules covered in this unit.

In addition, definitions for terms used in Part X can be found in s. 317 ITAA 1936.

Methodology

Step 1 – Application

The CFC regime applies if an Australian resident controls a foreign company. In this context, the concept of a 'controlled foreign company' is important.

The key points of s. 340 ITAA 1936 are as follows:

- Only a company can be a CFC.

  A trust or partnership cannot be a CFC; they can only be a controlled foreign trust (CFT) or a controlled foreign partnership (CFP), which is relevant only for the purpose of tracing through a chain of entities. Tracing is outside the scope of this unit.
- To be a CFC, the company must be 'foreign' (i.e. a non-resident) and controlled by Australian residents.

  This is reflected in the words 'company is a resident of a listed or of an unlisted country' (refer ss 332 and 333 ITAA 1936).
- There are three 'control' tests:
  1. The strict control test (s. 340(a) ITAA 1936).

     A foreign company is a CFC if it is at least 50% owned (directly or indirectly) by a group of five or fewer Australian residents.
  2. The assumed controller test (s. 340(b) ITAA 1936).

     A foreign company is a CFC if a single Australian entity has an associate-inclusive control interest of at least 40% and the foreign company is not otherwise controlled by unrelated entities (e.g. there is not another 60% shareholder).
  3. The de facto control test (s. 340(c) ITAA 1936).

     A foreign company is a CFC if it is otherwise controlled (as a matter of fact) by a group of five or fewer Australian residents, either alone or together with their associates.

  Central to s. 340 are the definition of 'associate' (s. 318 ITAA 1936) and the concept of when a company is 'sufficiently influenced' (*FCT v. BHP Billiton Ltd*), and the concept of 'associate-inclusive control interest' (s. 349 ITAA 1936).

The ownership test takes into account an 'entitlement to acquire an interest' (e.g. an option to acquire shares).

Step 2 – Active income test

If a CFC passes the active income test, the CFC rules will generally not apply to attribute an amount back to Australia. The active income test is found in Division 8 of Part X ITAA 1936.

The key aspects of the active income test are as follows:

- The active income test is designed to see if offshore operations carried on by the foreign company are active as opposed to passive. The test achieves this by classifying income from certain activities as 'tainted' (or ineligible) and establishing an upper limit to which a CFC can earn income from these activities. Generally, Australia does not tax foreign active income (or the sale of active assets) even if the income or gain is earned in a low tax country (i.e. a tax haven).
- The trading income and trading assets of a genuine offshore business are generally active. If income (or an asset) is not considered 'active', it is 'tainted'. Conceptually, tainted income can be thought of as non-business income (i.e. passive-type income such as interest, dividends, royalties and rent). It also includes capital gains from the disposal of 'tainted assets' and certain related party sales or services income. Broadly, tainted assets are assets from which tainted income flows (e.g. investment properties and shares). Tainted assets exclude assets used solely in carrying on a business (e.g. a warehouse, factory and goodwill).
- The active income test is reflected in the concepts of 'gross turnover', 'gross tainted turnover' and 'tainted income ratio'.

  The 'tainted income ratio' under s. 433 ITAA 1936 is calculated as follows:

Gross tainted turnover	÷	Gross turnover	=	Tainted income ratio

'Gross turnover' and 'gross tainted turnover'	
Concept	**Explanation of concept**
Gross turnover	Refers to the CFC's gross turnover broadly per its statutory accounts (s. 434 ITAA 1936)
Gross tainted turnover	Refers to the CFC's gross turnover that consists of passive income, tainted sales income and tainted services income (s. 435 ITAA 1936). These, in effect, are the amounts designated as 'tainted' (or ineligible) 'Passive income' includes dividend, interest, royalty and capital gains on the disposal of 'tainted assets' (ss 317 and 446 ITAA 1936) 'Tainted sales income' refers to related party sales income with an Australian connection (s. 447 ITAA 1936) 'Tainted services income' refers to services income with an Australian connection (s. 448 ITAA 1936)

- If a CFC's tainted turnover is at least 5% of its gross turnover, it fails the active income test; otherwise, it passes the test (refer to s. 432(1)(f) ITAA 1936).

Step 3 – Calculate the amount attributable

Section 456 ITAA 1936 is the operative provision that assesses an amount of the CFC's net income to certain Australian resident taxpayers. In effect, the formula is as follows:

CFC attributable income	×	Attribution percentage	=	Amount assessable

Central to s. 456 are the concepts of a CFC's 'attributable income', 'attributable taxpayer' and 'attribution percentage'.

<table>
<tr><th colspan="2">'Attributable income', 'attributable taxpayer' and 'attribution percentage'</th></tr>
<tr><th>Concept</th><th>Explanation of concept</th></tr>
<tr><td>CFC attributable income</td><td>A CFC's attributable income is the CFC's 'taxable income' calculated on certain assumptions (s. 382 ITAA 1936). This is a notional calculation of taxable income, as the CFC, being a non-resident entity, would not be required to lodge an income tax return in Australia
Basic assumptions:

To perform this notional taxable income calculation, a basic assumption is that the CFC is a taxpayer and a resident of Australia (refer s. 383(a) ITAA 1936)

This means that the ITAA 1936 and ITAA 1997 apply to the CFC as they would apply to a resident taxpayer normally, subject to the modifications described in s. 383(c) ITAA 1936. Applying the basic assumption, the attributable income of a CFC consists of its (notional) assessable income less any (notional) allowable deductions

Modifications are beyond the scope of this unit. However, broadly, they require the CFC's taxable income to be calculated disregarding certain provisions (e.g. exemptions, taxation of financial arrangement provisions, thin capitalisation provisions and debt equity provisions)</td></tr>
<tr><td>CFC attributable income - (notional) assessable income</td><td>The (notional) assessable income of a CFC depends on where the CFC is resident:
Listed country additional assumptions:

If the CFC is a resident of a listed country, there are additional assumptions (s. 385). Section 385 ITAA 1936 describes what amount is (notional) assessable income of the CFC. Everything else is (notional) exempt income

Listed countries are generally those with a broad-based taxation system similar to Australia's. Listed countries are Canada, France, Germany, Japan, New Zealand, the United Kingdom and the United States (Regulation 19 ITAR 2015). All other countries are unlisted countries

Broadly, the (notional) assessable income of a company located in a listed country is limited to income where the active income test is failed and that is both:
– adjusted tainted income, and
– concessionally taxed in a listed country

From a practical perspective, where the CFC is located in a listed country, only certain types of passive income that are concessionally taxed and capital gains that are exempt from tax in the listed country will be attributed to Australian attributable taxpayers. These types of income and gains are called 'eligible designated concession income'. For example, a capital gain derived by a New Zealand company from a sale of a tainted asset is exempt under that country's tax legislation. Therefore, a capital gain on a sale of a tainted asset derived by a New Zealand company (e.g. the sale of shares) is an example of eligible designated concession income

Regulations 16 and 17 ITAR 2015 provide a list of designated concession income

However, there is also a de minimis test that may apply to exclude amounts of designated concession income from being attributed (s. 385(4) ITAA 1936). This test requires the designated concession income to be less than $50,000 and 5% of the gross turnover (whichever is lesser)
Unlisted country additional assumptions:

If the CFC is a resident of an unlisted country (generally those countries with which Australia does not have a comparable tax jurisdiction – a tax haven such as the Cayman Islands is an example), there are additional assumptions (s. 384 ITAA 1936). Section 384 describes what amount is (notional) assessable income of the CFC. Everything else is (notional) exempt income

Broadly, the (notional) assessable income of a company located in an unlisted country is its adjusted tainted income where it fails the active income test. From a practical perspective, this includes passive income (i.e. interest, dividends and rental), tainted sales income and tainted services income. The concept of adjusted tainted income is similar to gross tainted turnover used in the active income test. The adjustments are outside the scope of this unit</td></tr>
</table>

'Attributable income', 'attributable taxpayer' and 'attribution percentage'	
Concept	**Explanation of concept**
CFC attributable income - (notional) allowable deductions	In order to work out the (notional) allowable deductions of a CFC: • Applying the basic assumption detailed above, expenditure incurred in gaining or producing (notional) assessable income is a (notional) allowable deduction • The actual allocation of expenditure between the (notional) assessable and (notional) exempt components of a CFC's income is difficult. However, from a practical perspective, an allocation based on the portion of (notional) assessable income to total income is used in this unit • Section 393 ITAA 1936 allows a (notional) allowable deduction for tax paid (both foreign and Australian) in respect of amounts included in (notional) assessable income **Note**: There is a reference to the 'active income test' in ss 384(2)(a) and 385(2)(a) ITAA 1936. The discussion on the active income test above is relevant here. If the CFC passes the active income test, no amounts will be attributable under these sections; however, amounts may be attributable under other sections. The operation of the other sections are outside the scope of this unit
Attributable taxpayer	'Attributable taxpayer' is defined in s. 361 ITAA 1936. This is generally the Australian taxpayer who has an associate inclusive interest of 10% or more in a CFC. Even if there is a CFC, income will not be attributed unless there is an attributable taxpayer. In calculating the 10% interest, an 'entitlement to acquire' (e.g. an option to purchase shares) is taken into account
Attribution percentage	'Attribution percentage' is defined in s. 362 ITAA 1936. It is the attributable taxpayer's direct and indirect interest in the CFC

Example – CFC attributable income

AusCo is an Australian resident company. It owns all of the shares in NewCo, a New Zealand resident company. NewCo operates a small manufacturing business and has a rental property (i.e. a passive asset) on which it earns rental income (i.e. passive income). NewCo disposes of the rental property during the current income year and makes a gain of $200,000. Rent is taxed in New Zealand at the normal rates.

NewCo is a CFC located in a listed country. New Zealand does not have a capital gains tax regime (i.e. gains on the disposal of capital assets are not taxable in New Zealand). Therefore, if NewCo fails the active income test for the current income year, the gain on disposal of the New Zealand property may be attributed to AusCo. Rent is not designated concession income in New Zealand and will not be attributed to AusCo.

AusCo is an attributable taxpayer and has an attribution percentage of 100%. Therefore, 100% of $200,000 is potentially assessable in Australia in the current income year.

Note: When the gain is repatriated to Australia as a dividend, to avoid double taxation, the dividend would be NANE income under s. 23AI ITAA 1936 (i.e. as the gain is previously attributed CFC income). If the rent is repatriated as a dividend, the dividend would be NANE income under s. 768-5 ITAA 1997 (i.e. the foreign equity distribution exemption applies as the rent is not previously attributed CFC income).

Note: In the first year a company becomes a CFC there is nothing in the CFC provisions which specifically allows a taxpayer to disregard pre-acquisition (current year) profits. Therefore, a proper due diligence is required if a CFC is acquired during a year.

Required reading

Sections 340, 432 and 456 ITAA 1936.

Worked example 14.3: CFC attribution

[Available online in myLearning]

Transferor trusts

The transferor trust (TT) regime is set out in Division 6AAA (of Part III) ITAA 1936.

Unit 10 outlined that Division 6 ITAA 1936 (the general trust provisions) either taxes an amount to the trustee or to the beneficiary. Division 6 is easy to avoid, simply by ensuring that the trustee is overseas and ensuring that the beneficiary does not have an interest in the trust (e.g. it is a discretionary trust).

The TT regime introduces a third taxing point, being the settlor of the trust. It applies if a person transfers an amount or property to a foreign trust. An amount determined under a statutory formula is then taxed to the transferor (s. 102AAZD ITAA 1936).

The application of the transferor trust provisions is outside the scope of the TAXAU module.

Thin capitalisation

Overview

'Thin capitalisation' occurs when a multinational entity finances its Australian operation with a lot of debt (e.g. bank loans and related party loans) compared to its equity (e.g. share capital, reserves and retained earnings). When this happens, the multinational entity's equity capitalisation in Australia is said to be 'thin' (i.e. inadequate). Thin capitalisation (i.e. a high debt–equity ratio) is attractive to multinational entities because debt generates interest deductions, whereas dividends paid in respect of equity investments are not deductible. By having debt in Australia, rather than a lower taxing foreign country, the multinational pays less tax on a global basis. The interest deductions would arise in Australia, with the interest income assessed at the lower rate in the foreign country. In this way, profit is effectively shifted from Australia (a higher-taxing country) to the foreign country (a lower-taxing country). For example, if profits are subject to 30% tax in Australia, this is a lot more than interest which is only subject to 10% withholding tax.

Division 820 ensures that a multinational entity does not have an excessive amount of debt in Australia by setting an upper limit on the amount of debt it can have. Where the limit is exceeded, the deductions on the excess debt are disallowed. For the majority of non-bank multinationals, this upper debt limit is the amount allowed as the safe harbour debt amount, which is broadly a debt–equity ratio of 1.5:1. That is, for every $1.50 of debt the multinational has in Australia, it must have $1 of equity.

The application of Division 820 to interest expenditure does not override or prevent the application of other taxation rules. Interest withholding tax would still be payable even if interest is not deductible under the thin capitalisation provisions (refer earlier in this unit, in the section on the taxation of foreign residents). In addition, the transfer pricing rules may still apply to deny or limit an interest deduction, even if the interest is otherwise fully deductible under the thin capitalisation provisions (TR 2010/7).

Division 820 is complex and this unit looks only at its fundamental aspects. It includes how to classify taxpayers into the relevant category and how to apply the basic thin capitalisation rules for the categories covered. To tackle a thin capitalisation problem in practice, the ATO's guidance materials on thin capitalisation are useful. Also, the table of subdivisions at the start of Division 820 is a helpful navigational tool.

Methodology

When dealing with a thin capitalisation problem, the following methodology may be useful.

Step 1 – Application

The thin capitalisation rules apply to all Australian entities (refer to s. 995-1 for the meaning of 'entity', which includes, but is not limited to, companies, partnerships, trusts and individuals).

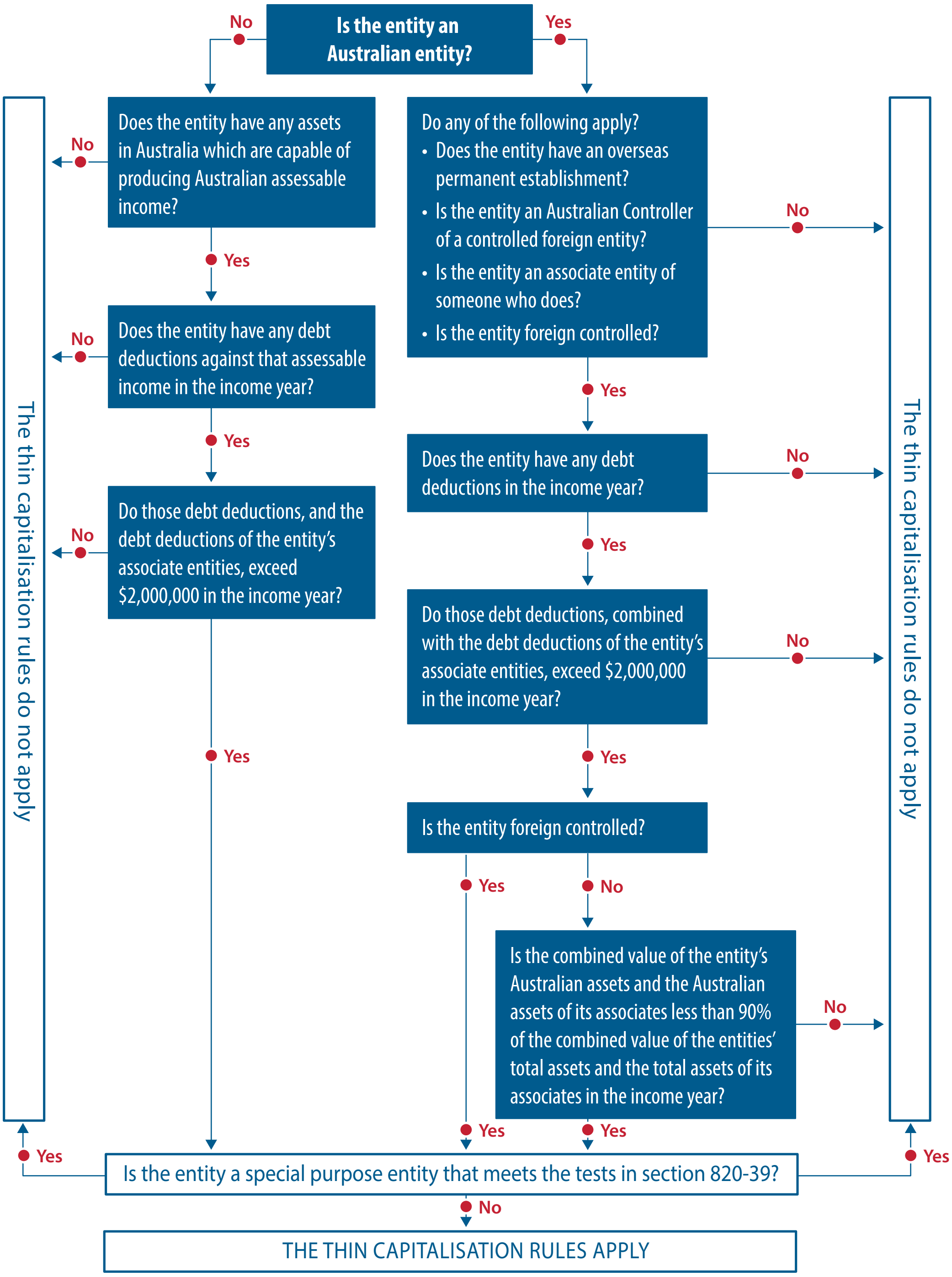
There are a number of situations where Division 820 **does not** apply. Basically, these are:

- Where an entity **does not have any debt deductions** for the income year.

  The phrase 'debt deductions' is defined in s. 820-40. It includes certain expenses that are both incurred by the entity in relation to a debt interest and are otherwise deductible to the entity. Note that the term is defined by reference to 'debt interests', a concept imported from the debt–equity rules in Division 974 and includes amounts that are deductible under s. 25-85 (i.e. in respect of non-equity shares). Examples of debt deductions include interest, amounts substituted for interest, discounts in respect of a security and fees and charges in respect of a debt (e.g. application fees, line fees, service fees, brokerage and stamp duty for document registration). Certain expenses are excluded from being debt deductions, including rental expenses on certain leases and some foreign currency losses.

- Where the **debt deductions** for an entity and its associates total **$2,000,000 or less**, the *de minimis* exception applies (s. 820-35).
- Where an Australian resident entity is neither an inward-investing entity nor an outward-investing entity (i.e. is a **wholly onshore operation**).
- Where a foreign entity has no investment or presence in Australia (i.e. it is a **wholly offshore operation**).
- Where an outward investor is not foreign controlled and **meets the asset threshold test**.
  The asset threshold test is set out in s. 820-37. Basically, it asks: 'Are the entity's assets in Australia, together with the entity's associates' assets, at least 90% of its worldwide total assets (by value)?' If the answer is 'yes', the test is passed. This is, however, only a very general explanation of the test and s. 820-37 details its precise application.
  Note: 'Assets' here means assets as per the Accounting Standards (TR 2002/20).

The following flow chart, taken from the ATO's 'Thin Capitalisation: Flowchart of who is affected', is a useful tool in summarising the above concepts.



Step 2 – Classify the taxpayer

Division 820 broadly recognises three types of taxpayers: authorised deposit-taking institutions (ADIs), financial entities and non-ADIs. For each type of taxpayer, it distinguishes between inward investing taxpayers and outward investing taxpayers. This unit focuses on non-ADI (general) taxpayers, of which there are three categories:

- Outward investing entity.
- Inward investment vehicle.
- Inward investor.

For thin capitalisation purposes, non-ADI and non-financial taxpayers are classified as follows:

Method of investment	Direction of investment	
	Inward	**Outward**
Indirectly via controlled entity (entity defined in s. 995-1)	Controlled entity is called an inward investment vehicle (s. 820-185(2)(a))	Investor is called an outward investing entity (s. 820-85(2))
Directly via a permanent establishment	Investor is called an inward investor (s. 820-185(2)(c))	

Notes:

- If an entity is both an inward investing entity and an outward investing entity, the outward investing entity rules apply under the 'tie breaker' rule (s. 820-185). However, from 1 July 2019 foreign controlled consolidated groups and multiple entry consolidated groups that control a foreign entity are treated as both an outward investing entity and an inward investment vehicle. As a result, such entities will not be able to use the tests that are only intended to apply to outward investors.
- Where a taxpayer transitions from an inward classification to an outward classification (and vice versa), there are two separate thin capitalisation periods (s. 820-120).
- If a tax consolidated group is both an inward and an outward entity, it is deemed not to be an inward entity (s. 820-583(5)).

Example – Classification of entities

Classification of entities	
Assume the following facts	**Classification**
An Australian company has a subsidiary in New Zealand. Both the Australian company and the New Zealand subsidiary carry on a marketing business	The Australian company is classified as an 'outward investor (general)'
An Australian company is established by a New Zealand company. Both the Australian company and its New Zealand foreign parent carry on a marketing business	The Australian company is classified as an 'inward investment vehicle (general)'
An Australian branch (which amounts to a permanent establishment) is established by a New Zealand company. The New Zealand company carries on a marketing business	The New Zealand company is classified as an 'inward investor (general)' in respect of its Australian branch

Step 3 – Identify the relevant rules

For all three categories, the rules are similar. Only the statutory provisions are different. The following table provides a summary of the two key rules and the applicable provisions.

Rules			
Details	**Outward-investing entity: Section**	**Inward investor: Section**	**Inward investment vehicle: Section**
Rule 1			
Does the entity's adjusted average debt exceed its maximum allowable debt?	820-85(1)	820-185(1)	820-185(1)
Adjusted average debt means the average debt of the entity adjusted for certain factors. Only debts giving rise to debt deductions are included and debts used in the entity's foreign operations are excluded (see relevant provision) Average values are calculated in accordance with Subdivision 820-G	820-85(3)	820-185(3)	820-185(3)
Maximum allowable debt is the greater of the entity's safe harbour debt amount, arm's-length debt amount or the worldwide gearing debt amount (in certain circumstances)	820-90	820-190	820-190
Safe harbour debt amount is 3/5 (i.e. 60%) of the average value of the entity's assets used to produce Australian assessable income. This excludes assets used in the entity's overseas operations Again, average values are calculated in accordance with Subdivision 820-G	820-95	820-205	820-195
Arm's-length debt amount is the amount of debt that the entity could borrow from a third party	820-105	820-215	820-215
Worldwide gearing debt amount gives an entity the ability to gear up to 100% of the gearing of the entity's worldwide group	820-110 820-111 (where both outward and inward)	820-218	820-216
Rule 2			
If the entity's adjusted average debt exceeds its maximum allowable debt, debt deductions are proportionately denied	820-115	820-220	820-220

Step 4 – Calculate the debt deduction denied

Apply the calculation rules for each of the three categories. The first step (or rule) in applying the thin capitalisation provisions for each type of taxpayer is to compare adjusted average debt with maximum allowable debt. The second step (or rule) is to disallow part of the debt deductions if the adjusted average debt (AAD) exceeds the maximum allowable debt.

Adjusted average debt

An entity's adjusted average debt is calculated as follows:

Adjusted average debt			
	Outward investing entity s. 820-85	**Inward investor s. 820-185**	**Inward investment vehicle s. 820-185**
Average value of debt capital that gives rise to debt deductions (Debt capital as per Accounting Standards (s. 820-680))	Step 1	Step 1	Step 1
Less: Associate entity debt (Lending to an associate entity who used money to generate Australian assessable income (s. 820-910))	Step 2	Step 2	Step 2
Less: Controlled foreign entity debt (Lending to a foreign entity that is controlled by the taxpayer (s. 820-885))	Step 3		
Add: Borrowed securities amount	Step 4	Step 3	Step 3
Add: Cost-free debt capital (Debt interests that have no debt deductions (s. 820-946))	Step 5	Step 4	Step 4
Equals: Adjusted average debt			

Key terms

- **Average values**

  There are three methods for calculating average values for entities that are not ADIs, in accordance with Subdivision 820-G. The most common is the opening and closing balances method. As the name implies, the average value is calculated as follows:

  $$\text{Average value} = \frac{\text{Opening balance} + \text{closing balance}}{2}$$

- **Debt capital**

  Debt capital is defined in s. 995-1. It **includes** amounts that give rise to debt deductions such as interest (e.g. loans from banks and related parties). It **excludes** non-debt liabilities (refer below for explanation) as these do not give rise to debt deductions (e.g. provisions for restructuring, trade creditors, accruals, annual leave provisions).

  The classification of debt and equity under the rules in Division 974 (i.e. the debt–equity provisions) applies for thin capitalisation purposes (i.e. the legal classification and the classification per the Accounting Standards do not apply). Examples of debt interests under Division 974 include loans, bills of exchange or a promissory note. Certain interest-free debt (such as an arm's-length trade creditor) does not count as part of an entity's debt.

  Under s. 820-680 an entity must comply with the Accounting Standards in determining its liabilities and in calculating the value of its liabilities. In addition, from 1 October 2019, an entity must also align the value of its liabilities (including debt capital) with the values included in its financial statements.

  For draft ATO guidance on debt capital see TR 2018/D4.

- **Other components**

  There are other components to the calculation of adjusted average debt that are outside the scope of the TAXAU module.

Maximum allowable debt

An entity's maximum allowable debt for an income year is the greater of the safe harbour debt amount, the arm's-length debt amount, or the worldwide gearing debt amount (in certain circumstances).

Safe harbour debt amount

The safe harbour debt amount is, in essence, ⅗ (i.e. 60%) of the average value of the entity's assets used to produce Australian assessable income. It excludes assets used in the entity's overseas operations (as these do not produce Australian assessable income and any related expenses are non-deductible under s. 8-1(2)(c)).

As noted earlier, for the majority of non-bank multinationals, the upper limit of debt the entity can have before debt deductions are denied on any excess, is broadly, a debt–equity ratio of 1.5:1. That is, for every $1.5 of debt the multinational has in Australia, it must have $1 of equity.

An entity's safe harbour debt amount is calculated as follows:

Safe harbour debt amount			
	Outward investing entity s. 820-95	**Inward investor s. 820-205**	**Inward investment vehicle s. 820-195**
Average value of entity's assets (Assets as per Accounting Standards (s. 820-680) but excluding deferred tax assets (s. 820-682))	Step 1		Step 1
Average value of entity's assets attributable to Australian permanent establishment or earning assessable income		Step 1	
Less: Average value of excluded equity interests (Equity holdings in the taxpayer that is younger than 180 days (s. 820-946))	Step 1A	Step 1A	Step 1A
Less: Average value of associate entity debt (Lending to an associate entity who used money to generate Australian assessable income (s. 820-910)).	Step 2	Step 2	Step 2
Less: Average value of associate entity equity (Equity in an Australian entity that is an associate of the taxpayer (s. 820-915))	Step 3	Step 3	Step 3
Less: Average value of controlled foreign entity debt (Lending to a foreign entity that is controlled by the taxpayer (s. 820-885))	Step 4		
Less: Average value of controlled foreign entity equity (Equity in foreign entity that is controlled by the taxpayer (s. 820-890))	Step 5		
Less: Average value non-debt liabilities (Liabilities that are not Division 974 debt interests – e.g. provisions (s. 995-1) but excluding deferred tax liabilities (s. 820-682))	Step 6	Step 4	Step 4

Safe harbour debt amount			
	Outward investing entity s. 820-95	**Inward investor s. 820-205**	**Inward investment vehicle s. 820-195**
Multiply by: $\frac{3}{5}$	Step 7	Step 5	Step 5
Add: Average value of associate entity excess amount	Step 8	Step 6	Step 6
Equals: Safe harbour debt amount			

Key terms (not previously discussed)

- **Assets**

  Under s. 820-680 an entity must comply with the Accounting Standards in determining what are its assets and in calculating the value of its assets (for ATO guidance see TR 2002/20). However, in working out the value of an entity's assets (and non-debt liabilities – see below), deferred tax assets (and deferred tax liabilities) are excluded (refer s. 820-682).

  In addition, from 1 October 2019 an entity must also align the value of its assets with the values included in its financial statements. From this time, an entity no longer has the ability to revalue assets specifically for thin capitalisation purposes (e.g. internally generated intangibles subject to transitional rules – these are outside the scope of the TAXAU module).

- **Non-debt liabilities**

  As the classification under the debt–equity rules is used for thin capitalisation purposes, not all liabilities under the Accounting Standards are debt interests for tax purposes. Where there are liabilities on the balance sheet (i.e. under the Accounting Standards) that are not debt interests for tax (e.g. creditors, accruals and provisions), these amounts are ignored in the adjusted average debt calculation and are included as a reduction in the value of assets in the safe harbour debt amount calculation.

- **Other components**

  There are other components to the calculation of the safe harbour debt amount that are outside the scope of the TAXAU module. These include associate entity debt, equity and excess amounts. These components broadly ensure that the same tax outcomes under the thin capitalisation regime apply to more complex multinational structures (i.e. those with multiple entities in Australia).

Arm's-length debt amount

The arm's-length debt amount is the amount of debt that the entity could borrow from a third party. This limit seeks to benchmark commercial or independent debt outcomes.

For ATO guidance on the arm's length debt amount, see TR 2019/D2 and PCG 2019/D3.

The determination of the arm's-length debt amount (ss 820-105, 820-215) is outside the scope of the TAXAU module. You will be provided with values where applicable.

Worldwide gearing debt amount

The effect of the worldwide gearing debt rule is to allow the Australian operations, in certain circumstances, to be geared at up to the same level of the gearing of the Australian entity's worldwide group.

An inward investing entity is **not** eligible to apply the worldwide gearing debt amount if any of the following apply (s. 820-190(2)):

- The entity's statement worldwide equity, or statement worldwide assets is nil or a negative amount. Statement worldwide equity and assets are the amounts shown in the audited consolidated financial statements of the worldwide group (i.e. of the parent entity) for the particular period (i.e. they include the assets and equity of foreign subsidiaries).

- Audited consolidated financial statements for the worldwide group do not exist.
- An assets threshold is satisfied. It is satisfied if the average Australian assets of the entity divided by the statement worldwide assets of the entity for the income year is greater than 0.5.

  Broadly, this threshold requires that the entity's Australian assets represent no more than 50% of the consolidated group's worldwide assets. This threshold removes access to the worldwide gearing debt rule for high gearing structures, such as private equity investment schemes, where a foreign entity with high levels of related party debt (often provided by shareholders) acquires an Australian target company, being the worldwide group's main asset.

An outward investing entity is not eligible to apply the worldwide gearing amount if the entity has worldwide equity of a negative amount (s. 820-90(1)).

An entity which is both an outward and an inward investing entity (other than consolidated groups which are deemed not to be inward entities) must calculate its worldwide gearing debt amount under s. 820-111 (i.e. using a methodology similar to outward investing entities).

It is not mandatory to apply the worldwide gearing debt test. For example, if an inward investing entity applies the relevant safe harbour debt limit and determines that it has not exceeded its maximum allowable debt, then it does not need to also apply the worldwide gearing debt test.

An entity's worldwide gearing debt amount is calculated as follows:

Worldwide gearing debt amount				
	Outward investing entity s. 820-110	**Both outward and inward investing entity s. 820-111**	**Inward investor s. 820-218**	**Inward investment vehicle s. 820-216**
Divide: The average value of all the entity's worldwide debt for the income year by the average value of all the entity's worldwide equity for that year	Step 1			
Divide: The entity's statement worldwide debt for the income year by the entity's statement worldwide equity for that year		Step 1	Step 1	Step 1
Add: 1 to the result of step 1	Step 2	Step 2	Step 2	Step 2
Divide: The result of step 1 by the result of step 2	Step 3	Step 3	Step 3	Step 3
Multiply: The result of step 3 in this method statement by the result of step 6 in the method statement in s. 820-95 (i.e. by the safe harbour debt calculation amount before the 3/5 is applied)	Step 4	Step 4		
Multiply: The result of step 3 in this method statement by the result of step 4 in the method statement in s. 820-205/s. 820-195 (i.e. by the safe harbour debt calculation amount before the 3/5 is applied)			Step 4	Step 4
Add: To the result of step 4 the average value, for that year, of the entity's associate entity excess amount	Step 5	Step 5	Step 5	Step 5
Equals: Worldwide debt amount				

Note: Due to a drafting anomaly s. 820-110 does not have a Step 2 (i.e. in the legislation Step 2 is labelled Step 3 and subsequent steps are also incremented by one). This anomaly has been removed in the table above.

Further explanation of the above steps:

- **Step 1 – Determine the worldwide debt–equity ratio**

  This step determines how much debt the worldwide group has for every $1 of equity.

  The statement worldwide debt, equity and asset values used in this step are determined from the amounts shown in the audited consolidated financial statements for the worldwide group for the particular period. Broadly, statement worldwide debt is calculated by reducing total liabilities by provisions, trade payables, deferred and current tax liabilities, deferred revenue, etc. but not below zero (ss 820-932, 820-933, 820-935).

  The determination of these amounts (i.e. for the purpose of completing Step 1) is outside the scope of the TAXAU module. You will be provided with worldwide debt and worldwide equity values where applicable.

- **Steps 2 and 3 – Determine the worldwide debt to asset ratio**

  By adjusting the ratio determined in Step 1 above, the result of Step 3 is to determine how much assets the worldwide group has for every $1 of debt.

  Note: This is the equivalent to the ⅗ debt to asset ratio under the safe harbour debt rules.

- **Step 4 – Apply the worldwide debt to asset ratio to the entity's Australian adjusted assets**

  Broadly, this step multiplies the amount of the entity's Australian adjusted assets (i.e. as determined by completing Steps 1 to 6/Steps 1 to 4 of the safe harbour debt amount calculation for outward investors and inward investing entities respectively) by the worldwide debt to asset ratio (i.e. the result of Step 3). This step determines the amount of debt the entity would have if all entities in the worldwide group were geared to the same level (i.e. had the same ratio of debt to equity).

- **Step 5 and other components**

  There are other components to the calculation of the worldwide gearing debt amount that are outside the scope of the TAXAU module. This includes the associate entity components to the calculation (e.g. associate entity excess amount). As for the safe harbour debt amount calculation, the inclusion of these components broadly ensures that the same tax outcomes under the thin capitalisation regime apply to more complex multinational structures (i.e. those with multiple entities in Australia).

As noted earlier, an entity may choose the method used to calculate maximum allowable debt (i.e. it is not mandatory to calculate all three alternatives). Under the safe harbour debt amount, for every $1.50 of debt an entity must have $1 of equity. If the amount calculated in Step 1 of the worldwide gearing debt amount (see above) is more than 1.5 (or the amount calculated in Step 3 is more than ⅗ (i.e. 60%)), then the worldwide gearing debt amount will be more than the safe harbour debt amount.

Thus, if an inward investing entity applies the relevant safe harbour debt limit and determines that it has exceeded its maximum allowable debt, then it should complete Step 1 of the worldwide gearing debt amount calculation. If the result in Step 1 is equal to, or less than, 1.5, the entity does not need to complete the remainder of the calculation (as it will not achieve a better outcome). However, if the result in Step 1 is more than 1.5, the entity should complete the calculation, as applying the worldwide gearing debt test would achieve a better outcome (i.e. reduce the amount of debt deductions to be disallowed).

Debt deductions denied

If debt deductions exceed the *de minimis* threshold of $2,000,000 and the adjusted average debt exceeds the maximum allowable debt, under ss 820-115 and 820-220 the amount of debt deductions to be disallowed is calculated as follows:

$$\text{Debt deductions} \times \frac{\text{Adjusted average debt} - \text{Maximum allowable debt}}{\text{Average debt}} = \text{Debt deductions denied}$$

The debt deduction allowable under the thin capitalisation provisions would therefore be:

$$\text{Total debt deductions} - \text{Amount of debt deductions disallowed} = \text{Allowed debt deductions}$$

For draft ATO guidance on the deductibility of the costs of debt funding (i.e. one category of debt deductions) see TD 2019/12.

Required reading

Sections 820-40, 820-185, 820-190, 820-195 and 820-220 ITAA 1997.

Division 974 ITAA 1997 – definition of 'debt interests'.

Section 995-1 ITAA 1997 – definition of 'entity'.

Activity 14.4: Thin capitalisation rules

[Available online in myLearning]

Transfer pricing

Overview

Pricing of international dealings between two parties (whether related or not) should reflect a fair return for the activities performed, the assets used and the risks assumed in performing the activities. Pricing that is not in accordance with the transfer pricing rules contained in the tax legislation may be termed 'international profit shifting'.

Example – Transferring profits

Company A normally buys goods for $100 and sells them for $110, with a $10 profit. Company A could sell the goods for $105 to Company B, with the effect that a $5 profit would be transferred to Company B because Company B's cost price is $5 lower.

Transfer pricing can occur between two domestic entities or between a resident and a non-resident. It can occur between related parties, which is usually the case, or between unrelated parties. Transfer pricing that occurs between two domestic entities is not a problem from an Australian tax perspective because, usually, what is allowable as a deduction to one entity is assessable to the other. Further, market value substitution rules may apply (e.g. trading stock disposed of outside the ordinary course of business). However, if one of the parties is a non-resident, Australian tax can be avoided. This can occur where:

- Deductions are shifted to Australia (e.g. a resident buys goods from a non-resident at an inflated price).
- Income is shifted offshore (e.g. a resident sells goods to a non-resident at a discounted price or an interest-free loan is made offshore).

Transfer pricing rules designed to counter this are contained in Subdivisions 815-B and 815-C.

The application of the arm's-length principle in Australia's domestic transfer pricing rules in Subdivisions 815-B and 815-C is aligned with international transfer pricing standards, especially those of our major investment partners. These standards are currently set out in the *OECD Transfer Pricing Guidelines*. Unlike the former rules, Subdivisions 815-B and 815-C are self-executing in their operation and better align Australia's domestic transfer pricing rules with the design of the overall tax system, which generally operate on a self-assessment basis.

Subdivision 815-B seeks to ensure that the amount brought to tax in Australia from cross-border conditions that operate **between entities** reflects the arm's-length contribution made by an entity's Australian operations. Any such amounts should reflect the conditions that might be expected to operate between independent entities dealing at arm's length (s. 815-105).

Subdivision 815-C seeks to ensure that the amount brought to tax in Australia by entities operating **at or through a permanent establishment** is not less than it would be if the permanent establishment were a distinct and separate entity engaged in the same or comparable activities under the same or comparable circumstances, but dealing wholly independently with the other part of the entity (s. 815-205).

Application

The key points of Subdivision 815-B and 815-C are as follows:

- **There must be a transfer pricing benefit**

  An entity gets a transfer pricing benefit (from conditions that operate between the entity and another entity in connection with their commercial or financial relations) if:

  - The actual conditions that operate between the entities (or within the entity and its permanent establishment) differ from the arm's-length conditions. The arm's-length conditions are broadly those that would exist if the entities were operating independently in comparable circumstances – ss 815-125 and 815-225 (i.e. they must be acting in their own best interests – refer *Granby Pty Ltd v. FCT*).
  - The actual conditions satisfy the cross-border test. Broadly, the cross-border test under s. 815-120(3) requires:
    - either or both entities to be non-residents who are not operating an Australian permanent establishment
    - either or both entities to be Australian residents who operate an overseas permanent establishment, or
    - a business that the entity carries on to be in an area covered by an international tax treaty.

    (**Note:** This is not an express requirement under Subdivision 815-C as it is inherent in the operation of overseas permanent establishments).
  - Had the arm's-length conditions operated, instead of the actual conditions, the amount of the entity's taxable income or withholding tax liability would be greater; or the amount of a particular loss or tax offset would be less (see below table).

  The identification of the arm's-length conditions must (subject to certain exceptions) be based on the commercial or financial relations in connection with which the actual conditions operate, having regard to both the form and substance of those relations – s. 815-130. However, the exceptions allow the ATO to 'reconstruct' the transaction to what it would otherwise be if the actual transaction which was entered into would not have been entered into by related parties. The ATO's views on the application of s. 815-130 are contained in TR 2014/6.

  Note:

  - The relationship between the parties does not determine if the actual conditions are arm's-length. It is possible for two related parties to deal at arm's-length with each other, and for two unrelated parties **not** to deal at arm's-length with each other.
  - Subdivisions 815-B and 815-C cannot be used to create a better result for the taxpayer – for example, it cannot decrease a taxpayer's taxable income. However, if an Australian company borrows interest free, this would give rise to a withholding tax liability benefit. If interest was imputed so that interest withholding tax is paid, there should be a compensating interest deduction under the consequential adjustment provision – s. 815-145. The result is that the taxable income would be lower. Having said that, the ATO does not have to make this adjustment. There is an element of discretion in its application.
  - ATO guidance to assist taxpayers to self-assess the transfer pricing risk for certain types of purchases is contained in PCG 2017/1 and PCG 2017/1DC2.
  - ATO guidance on issues related to inbound distribution arrangements is contained in PCG 2019/1.

- **Consequences of receiving a transfer pricing benefit (i.e. substituting arm's-length conditions or profit amounts)**

  The following table describes the type of transfer pricing benefit an entity could receive and the consequence of receiving one:

Transfer pricing benefit		
Type	**Consequence**	
	Subdivision 815-B (s. 815-115) **The arm's-length conditions operate instead of the actual conditions between an entity and another entity which results in:**	**Subdivision 815-C (s. 815-215)** **Arm's-length profit amounts are taken to be attributed to the permanent establishment instead of the actual profits which results in:**
Taxable income is less than it otherwise would be	Increase in taxable income (s. 815-120(1)(c)(i))	Increase in taxable income (s. 815-220(1)(b)(i))
Tax loss (including net capital loss) is more than it otherwise would be	Decrease in tax loss (s. 815-120(1)(c)(ii))	Decrease in tax loss (s. 815-220(1)(b)(ii))
Tax offset is more than it otherwise would be	Decrease in tax offset (s. 815-120(1)(c)(iii))	Decrease in tax offset (s. 815-220(1)(b)(iii))
Interest withholding tax or royalty withholding tax is less than it otherwise would be	Increase in interest withholding tax or royalty withholding tax (s. 815-120(1)(c)(iv))	N/A

- **Selecting the transfer pricing methodology**

  Pursuant to the guidance rules in s. 815-135, entities must have regard to the OECD Transfer Pricing Guidelines in identifying arm's-length conditions. The main transfer pricing methodologies used to determine arm's-length conditions are:

  - Comparable uncontrolled price method.
  - Cost plus method.
  - Resale price method.
  - Transactional net margin method.
  - Profit split method.

  The appropriate transfer pricing methodology to adopt is the one that is most appropriate having regard to:

  - The respective strengths and weaknesses of the possible transfer pricing methods.
  - The circumstances, including the functions performed, the assets used and the risks borne by the entities.
  - The availability of reliable information required to apply a particular method.
  - The degree of comparability between the actual circumstances and the comparable circumstances, including the reliability of any adjustments to eliminate the effect of material differences between those circumstances.

  The method must be capable of practicable application and produce an arm's-length outcome that is a reasonable estimate of what would have been expected if the dealings had been undertaken between independent entities dealing wholly independently with one another.

  Note: The ATO's views on transfer pricing methodologies are contained in TR 97/20. The rules pertaining to transfer pricing methodologies are outside the scope of the TAXAU module.

- **Documentation**

  Subdivision 284-E of Schedule 1 to the TAA 1953 contains rules related to transfer pricing documentation that must be maintained in relation to Subdivisions 815-B and C. In order to satisfy the requirements of Subdivision 284-E, transfer pricing documentation must be prepared before lodging the relevant tax return and it must be maintained in Australia. Having an overseas parent maintain the documentation will not suffice.

  Failure to keep adequate documentation prevents an entity from establishing a reasonably arguable position and administrative penalties can be imposed where the Commissioner issues an amended assessment, which results in an additional amount of income tax or withholding tax under Subdivisions 815-B and 815-C. In other words, if there is no documentation in place and an adjustment is made, penalties will automatically apply even if the position is reasonably arguable. Administrative penalties are discussed in Unit 1.

  Note: The ATO's views on transfer pricing documentation requirements are contained in TR 2014/8 and ATO guidance on the simplified transfer pricing record keeping options are contained in PCG 2017/2. This is designed to reduce compliance cost for small businesses, distributors, intra-group services and low level loans. The rules pertaining to transfer pricing documentation are beyond the scope of the TAXAU module.

Country-by-country reporting (Australia Local File)

Under Subdivision 815-E ITAA 1997, significant global entities (see Unit 15) have country-by-country reporting obligations. The reporting obligations require an annual statement to be provided to the ATO in a standardised format that must be electronically filed via standard business report (SBR) methods. This annual statement is known as the 'Australia Local File'. It provides the ATO with information such as location of economic activity undertaken, descriptions of business operations, and details of cross-border related party transactions. This information enables the ATO to carry out transfer pricing risk assessments (see LCR 2015/3).

Note: The Government had proposed to introduce from 1 July 2018 a new concept of a country-by-country reporting entity. At the time of writing legislation has yet to be finalised and therefore it is outside the scope of the TAXAU module.

Example – Scope of transfer pricing

Applying transfer pricing	
Scenario	**Scope of application**
A taxpayer sold financial advice to a non-resident related entity for less than they would normally charge	In this case, the transfer pricing provision may apply. The consideration received was less than arm's-length and the parties are related; however, it needs to be shown that the parties were not dealing with each other at arm's-length. There might be a commercial explanation why a lesser price was charged
A taxpayer sold financial advice to a non-resident related entity for more than they normally charge	In this case, the transfer pricing provisions do not apply, as they generally cannot operate to decrease the taxpayer's assessable income
A taxpayer sold an asset to a non-resident related entity for less than they would normally charge	In this case, the transfer pricing provisions could arguably apply. They clearly apply to revenue assets, but in regard to capital assets, the CGT provisions and capital allowance provisions (for depreciating assets) have their own market value substitution rules
A taxpayer pays excessive interest to a non-resident related entity in respect of a loan. The taxpayer's adjusted average debt is less than its maximum allowable debt under the thin capitalisation rules	In this case, the transfer pricing provisions may apply. Transfer pricing considers whether the parties are dealing with each other at arm's-length and may substitute an arm's-length outcome in respect of the interest payment. The thin capitalisation provisions are then applied to determine if a further portion of the arm's-length interest payment is denied in respect of excess debt For example, if the parties are not dealing at arm's-length and the taxpayer

Applying transfer pricing	
Scenario	**Scope of application**
	pays interest at a rate of 7% per year on a loan of \$100,000 when the arm's-length interest rate is 5%. The taxpayer will have a decreasing transfer pricing adjustment of \$2,000 [i.e. \$100,000 × (7% – 5%) = \$2,000]
A taxpayer classifies a financial instrument under the debt-equity rules based on its actual conditions that differ to the arm's-length conditions	The debt–equity rules does not limit the operation of the transfer pricing rules. Thus, where the transfer pricing rules apply, the debt–equity rules classify the interest that arises under the transfer pricing scheme by reference to the arm's-length conditions, not the actual conditions. This could alter the arrangement's debt–equity characterisation and therefore, the tax treatment of the return on the arrangement (see TD 2019/10)

Example – Transfer pricing risks

AustCo Pty Ltd (AustCo), an Australian resident company, owns the intellectual property for a vaccine against a common foot infection. It provides the following information about a proposal for the manufacture and distribution of the vaccine that it is considering with EvronCo, an unrelated company. EvronCo is resident of a non-treaty country.

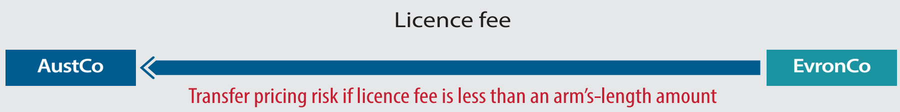
AustCo has approached EvronCo to produce the vaccine for worldwide sale. AustCo will license its intellectual property to EvronCo to allow it to produce the vaccine. EvronCo will be required to pay AustCo a licensing fee. EvronCo will manufacture the vaccine and sell it back to AustCo.

AustCo has also agreed that EvronCo will be its gateway to China and so will allow EvronCo to sell some of the vaccine to Chinese customers. EvronCo will be required to pay royalties to AustCo on these sales. Similarly, AustCo will be required to pay EvronCo a distribution fee.

Transfer pricing is a risk to AustCo in this scenario because there are three cross-border agreements: the licensing of the intellectual property, the manufacturing contract and the distribution contract.

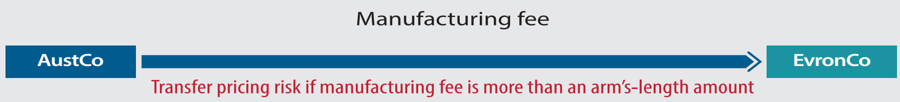
Licensing of intellectual property

The royalty under a licensing agreement for EvronCo to use AustCo's intellectual property presents a transfer pricing risk to AustCo.



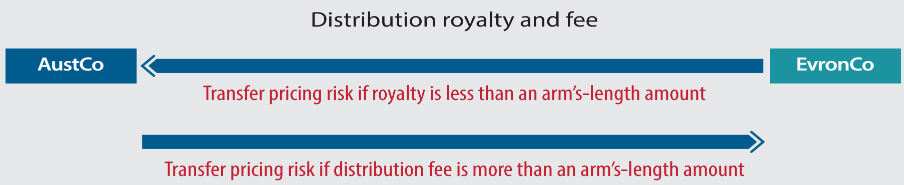
Manufacturing contract

The manufacturing fee charged by EvronCo to AustCo presents a transfer pricing risk to AustCo.



Distribution contract

The royalty for the distribution rights charged to EvronCo by AustCo presents a transfer pricing risk to AustCo. Any distribution fee charged by EvronCo to AustCo also presents a transfer pricing risk to AustCo.



Hybrid mismatch arrangements

Overview

Note: The following rules apply to income years commencing on or after 1 January 2019, with the exception of the imported hybrid rules which apply from 1 January 2020. A detailed understanding of the hybrid mismatch rules is outside the scope of the TAXAU module.

As previously discussed, Australia has rules designed to minimise the double taxation of foreign income. Other countries also have similar provisions. As a result, some entities have been able to exploit the differences between the tax treatment of an arrangement in different countries (i.e. double non-taxation, double tax benefits, or the long term deferral of taxation). For example, an entity may be able to claim a tax deduction in respect of one payment in two (or more) different jurisdictions.

These arrangements were specifically identified by the OECD as part of its BEPS project and are referred to as hybrid mismatch arrangements. Based on recommendations from the OECD, Australia has introduced Division 832 which is an integrity regime to prevent entities from exploiting hybrid mismatch arrangements. The ATO expects taxpayers to restructure out of these mismatch arrangements (see PCG 2018/7 and Unit 15).

The hybrid mismatch provisions are generally only applicable where the relevant parties are in the same **control group**, or the mismatch arose under a **structured arrangement** (for ATO guidance see LCR 2019/3 and PCG 2019/6). Mismatch outcomes include:

- **Deduction/non-inclusion mismatch** (s. 832-105) – This arises where a payment gives rise to a deduction or foreign income tax deduction for the payer entity, **and** the amount of that deduction exceeds the amount of the payment that is subject to foreign or Australian income tax for the recipient entity (e.g. a non-resident claiming a tax deduction for dividends paid to an Australian resident company which are NANE income under s. 768-5).
- **Deduction/deduction mismatch** (s. 832-110) – This arises where a payment gives rise to both a foreign income tax deduction **and** an Australian income tax deduction (e.g. both an Australian resident partner in a foreign partnership and the foreign partnership claiming a tax deduction for the same payment).

A mismatch is only subject to the hybrid mismatch rules if it is a:

- Hybrid financial instrument mismatch (Subdivision 832-C)
- Hybrid payer mismatch (Subdivision 832-D)
- Reverse hybrid mismatch (Subdivision 832-E)
- Branch hybrid mismatch (Subdivision 832-F)
- Deducting hybrid mismatch (Subdivision 832-G)
- Imported hybrid mismatch (Subdivision 832-H)

To the extent the hybrid mismatch provisions apply, the mismatch is neutralised by either **including an amount in assessable income** or **not allowing the deduction**.

Note: Income that is taxed in two countries is **dual inclusion income** (Subdivision 832-I). It can be applied to reduce the neutralising amount for the hybrid payer mismatch and the deducting hybrid mismatch. A further **integrity rule** applies for interest payments (Subdivision 832-J – for ATO guidance see LCR 2019/D1).

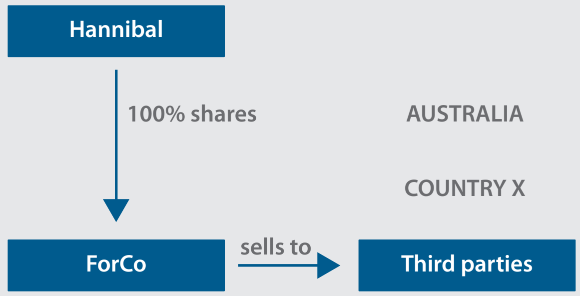
Other key resources

How to identify international tax implications

While there are many ways to approach international tax problems in practice, one way is simply to follow the money trail.

Example – Dealing with international tax questions

Hannibal Barca, an Australian resident individual, establishes ForCo, a company resident in Country X, a foreign country with which Australia does not have a treaty. ForCo carries out manufacturing activities and sells the products to third parties. Country X imposes tax of 20% on business profits and 10% withholding tax on dividends.



The tax implications for Hannibal are outlined in the following table:

The money trail and the international tax implications for Hannibal	
Event	**Tax implications**
Money flows from Hannibal to establish ForCo	The shares are an equity interest, so returns on the investment will be dividends and the amount paid for the shares will form part of their cost base for CGT purposes
ForCo produces the goods, sells them and earns money	Country X taxes business profits at 20%; therefore, ForCo must pay tax at 20% Consider if Hannibal is also taxable on ForCo's income under the attribution regime. In this case, the CFC regime will not apply because the active income test is satisfied
ForCo sends money to Hannibal	ForCo is a company; therefore, the profit repatriated will be in the form of dividends Country X imposes 10% dividend withholding tax; therefore, 10% will be deducted from the dividend amount repatriated by ForCo When Hannibal receives the dividend, the Australian tax rules will apply. In this case, Hannibal would be taxed on the dividend (s. 44(1) ITAA 1936) grossed up for the withholding tax. Hannibal would be entitled to a FITO since the dividend is assessable. Section 768-5 ITAA 1997 is not applicable, because Hannibal is not a company

Other

Quick reference guides
14.1: Summary of taxation of foreign income
14.2: Summary of taxation of foreign residents
[Available online in myLearning]

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 15: Tax planning, control and anti-avoidance

Contents

Learning outcomes

At the end of this unit you will be able to:

1. Examine what constitutes ethical tax advice by explaining the difference between tax planning, avoidance and evasion.
2. Explain the statutory and professional requirements applicable to a tax agent.
3. Outline the operative provisions of recent developments.
4. Explain and apply the anti-avoidance provisions.

Introduction

Tax planning involves organising one's tax affairs to get the best tax outcome. Good tax planning generally means legally reducing (or minimising) the amount of tax that is payable. However, as taxes underpin our society, there are limits on the way taxpayers (with or without the assistance of tax advisors) can minimise tax payments. Although most tax advisors can spot examples of tax evasion, identifying the line between legitimate tax planning and tax avoidance arrangements is a challenging task (the line is very grey). Much of the guidance in this area comes from judicial decisions rather than the tax legislation.

The provision of taxation services by tax advisors is a highly regulated profession with complex guidelines, rules and regulations that control professional conduct. Understanding these rules and regulations is crucial. However, you cannot assume that an action (e.g. a tax planning strategy) is acceptable merely because it follows those rules and the specific tax legislative requirements (if any).

Ethics helps a tax advisor to navigate through situations where the rules and regulations are absent, or do not seem to give the guidance required in producing a wise response. Ethics involves more than decisions about right or wrong. One of the most basic ethical issues concerns the choice between multiple alternatives that are all right but are in conflict.

This unit looks at tax planning, its boundaries and the consequences of going too far.

It also looks at how to keep up to date with taxation legislation that is continually changing both prospectively and retrospectively. The information contained in the TAXAU module is correct at the time of writing. However, given the continuous changes in the tax legislation and its interpretation, in practice you must refer to the latest available sources.

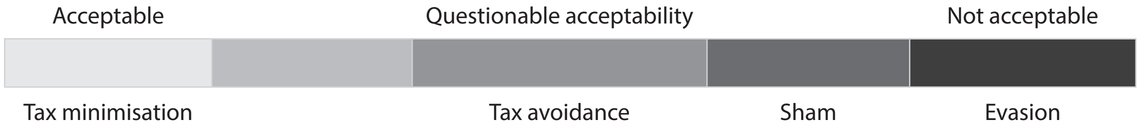
Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

Tax planning and control

Tax planning, avoidance and evasion

Tax is a cost of doing business. Taxpayers are therefore motivated to minimise the amount of tax that is payable. However, the degrees of acceptability in tax planning can be illustrated as follows:



Most tax advisors do not consciously stray into the evasion territory. However the boundary between tax minimisation and tax avoidance is harder to recognise. At the core, there is a conflict between the interest of the immediate taxpayer and the interest of the community in which the taxpayer is part. Most tax advisors use the 'reasonably arguable position' as a rule of thumb to see if they have strayed too far into the tax avoidance territory.

You would have no doubt seen or heard reports in the media about tax planning and tax avoidance. Internationally, there has been a concerted effort to deal with tax avoidance. For example, the OECD Base Erosion and Profit-Shifting (BEPS) project. In 2014, the Group of 20 largest economies (G20) agreed to automatically share information with each other and require multinationals to do a 'country-by-country' reporting that discloses the tax paid in each country in which they operate.

These developments suggest that the community's attitude on planning is shifting further along into the left hand side of the spectrum. Similarly, there is starting to be an expectation that companies pay their fair share of tax and have governance structures and processes that manage tax risks (as discussed below).

Tax planning

Tax planning (sometimes called tax minimisation) involves organising one's tax affairs in such a way that the minimum tax liability is achieved while acting within both the letter and spirit of the tax law. For example, the law contains many features which provide quite legitimate avenues to reduce tax:

- Renting a business premises may be financially more attractive than buying the premises, partly because of the deduction available for rent payments.
- The dividend imputation system provides resident shareholders with a tax offset if they invest in Australian companies that pay franked dividends, rather than investing in an offshore company.

However, the view that 'every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Acts is less than it otherwise would be' (Lord Tomlin in *Inland Revenue Commissioners v. Duke of Westminster*) is necessarily subject to legal constraints. Tax avoidance threatens government revenue, creates resentment among honest taxpayers and results in a heavier tax burden on the rest of the community. The recent clamp down on tax avoidance by multinational companies is a good example of this.

Tax avoidance

Tax avoidance involves arrangements that appear to comply with the letter of the law but not its intent. A report to the Federal Government, *Tax System Redesigned* (1999), described tax avoidance thus:

> [Tax avoidance] is often driven by the exploitation of structured loopholes in the law to achieve tax outcomes that were not intended by Parliament but also includes manipulation of the law and a focus on form and legal effect rather than substance. The way things are done in order to take advantage of structural loopholes, or dress up or characterise something to satisfy form but not substance can also stamp an arrangement as avoidance. (p. 243)

The tax law targets tax avoidance using both specific and general anti-avoidance provisions, which are designed to be 'catch all provisions of last resort'. These are considered in detail later in this unit.

Attempts to avoid tax can also be attacked by the Commissioner if they involve 'sham' transactions. A sham transaction is typically an attempt to use legal form to mask the true substance of the transaction.

> 'Sham' refers to steps which take the form of a legally effective transaction but which the parties intend should not have the apparent, or any, legal consequences. (*Equuscorp v. Glengallan Investments Pty Ltd*)

Sham transactions are ineffective and the Commissioner does not need to rely on any legislation to nullify them (*Jaques v. FCT*). Where sham is proven, the tax law applies as if the transaction did not take the form that it did.

Tax evasion

Fraud or evasion is dealt with severely under the tax law. Drummond J in *Kajewski & Ors v. FCT* stated that:

> Fraud within s. 170(2)(a) [ITAA 1936] involves something in the nature of fraud at common law, that is, the making of a statement to the Commissioner relevant to the taxpayer's liability to tax which the maker believes to be false or is recklessly careless whether it be true or false. (p. 4400)

According to Dixon J in *Denver Chemical Manufacturing Co. v. C of T* (NSW), evasion involves:

> … some blameworthy act or omission on the part of the taxpayer. An intention to withhold information lest the Commissioner should concede the taxpayer liable to a greater extent than the taxpayer is prepared to concede. (p. 313)

If fraud or evasion is proven, the consequences for the taxpayer include:

Consequences of fraud or evasion	
Under tax legislation	**Other legislation**
Unlimited time for the Commissioner to amend an income tax assessment (s. 170(1) ITAA 1936)	*Crimes (Taxation Offences) Act 1980* – conviction and up to 10 years in jail, a fine of 1,000 penalty units (i.e. 1,000 × $210 = $210,000), or both
A penalty of up to 75% of the tax shortfall (see Unit 1 on Australian tax fundamentals)	*Crimes Act 1914 and Criminal Code (*contained in the *Criminal Code Act 1995)* – conviction for various offences such as defrauding the Commonwealth, attracting possible jail sentences and fines

Tax governance and tax risk management

Background

Historically, the ATO has selected taxpayers to audit based on perceived risks and the taxpayer's risk rating. However, there is now an increasing shift by the ATO towards real time compliance, with measures such as annual compliance arrangements, pre-lodgement compliance reviews, and the introduction of the reportable tax position schedule which requires disclosures in respect of uncertain tax positions. To achieve this shift, the ATO's compliance focus areas now include the taxpayer's corporate governance and tax risk management framework.

There has also been a growing emphasis on managing tax risk, resulting from the increasing globalisation of business and the increased vigilance of the ATO (and other revenue authorities) in monitoring these businesses for tax avoidance.

Expectations for in-house tax departments are therefore expanding to include robust tax governance and risk management frameworks, and handling the increasing compliance burden resulting from real time compliance. This is in addition to handling increasing complexity in tax laws and working within budget restraints.

Tax governance

Corporate governance is about:

- How organisations are directed and controlled.
- How those who direct and control an organisation are monitored and supervised to ensure they are accountable.

An essential element of strong corporate governance in respect of taxation (i.e. tax governance) is effective tax risk management. Companies can improve their tax governance by developing tax risk frameworks across people, processes and technology, and improving engagement with the board of directors and other stakeholders.

The ATO has identified the following as key principles of effective tax governance for privately owned entities:

- Accountable management and oversight – Roles and responsibilities are clearly defined and understood in terms of accountability for tax administration and decision-making
- Recognising tax risks –Appropriate controls and processes are in place to support compliance with tax obligations and identify, assess and mitigate commercial and tax risks.
- Seeking advice – Clearly defined arrangements are in place for escalating tax issues and seeking tax advice.
- Integrity in reporting – Systems and controls are in place to ensure accurate reporting, and these controls are reviewed periodically to ensure they remain effective.
- Professional and productive working relationship – The taxpayer has an open, transparent, respectful and professional working relationship with the ATO.
- Timely lodgments and payments – Tax liabilities are well managed and paid on time.
- Ethical and responsible behaviour – Acting ethically and responsibly – with honesty, integrity and in a way consistent with the reasonable expectations of the broader community and the taxpayers' charter.

For a board of directors to satisfy their corporate responsibilities, the tax risk frameworks and processes must ensure they are fully informed on both the outcomes of the company's tax compliance processes and on the tax aspects of major transactions.

Tax risk management

The decisions, activities and operations undertaken by an organisation give rise to various areas of uncertainty, which are business risks. Some of these uncertainties will be in respect of tax uncertainties. Tax uncertainty may relate to the application of the tax law to the facts themselves, or uncertainty as to how well business systems (e.g. the accounting function) operate to arrive at the tax results of the business activities and operations. All these uncertainties give rise to tax risk.

Managing tax risk is, therefore, about managing these uncertainties. Due to the very nature of the uncertainties, there is often no one right answer. Many tax advisors often refer to a 'reasonably arguable' position when they take a stance on a tax issue that is arguable in light of the facts and the spirit of the law. Tax risk management is about understanding when these risks arise and making judgement calls as to how they are dealt with.

Managing tax risk is particularly important if an organisation is operating in international markets. The structure of an organisation and the taxation of the organisation (and/or its investments) are areas that provide both opportunities and risks to the organisation and its owners. Therefore, when developing their business or investment strategies organisations must make judgements that mitigate risks and make the most of opportunities.

An organisation needs to ensure that management is aware of transactions and activities on which tax might be levied. A tax risk management policy may provide checklists and guidance on possible areas of taxation. For example, how taxes are levied on assets (see Units 4 and 5), debt and equity financing (see Units 8 and 13), different entity structures (see Units 8 to 11), and cross border transactions (see Unit 14).

Additional risks can arise where an entity has been acquired, as the purchaser will inherit the acquired entity's tax history. The purchaser will need to conduct a review of the tax history as part of its due diligence investigations for the acquisition.

Strategies

Strategies to manage the potential risk in taxation issues should be approached in the same manner as managing any other risks that the entity is exposed to.

- An assessment by management of the information available is required to determine whether a taxation risk exists, and if so, what actions need to be undertaken to mitigate the risk. The corporate governance structure of the organisation needs to identify those responsible for managing the tax risk, provide guidance and reporting systems to ensure that those risks are communicated and considered, and record the decisions made in relation to the identified risks (Hall, 2006).
- In planning an entity's structure, or the structure of a transaction, opportunities arise to shape it in order to minimise the amount of tax required to be paid on the income generated or to maximise the ability to claim a tax incentive. This includes making use of local and/or international laws and treaties to the best advantage of the entity.
- Ensuring a company employs staff in the taxation area who have the best technical knowledge and practical experience is a sound strategy to reduce and manage risk in this complex area. However, because taxation is such a broad area and differs across jurisdictions, sometimes even internal tax specialists need additional external guidance.
- Tax audit insurance is also widely available and covers preparers of taxation documents against the costs incurred as a result of any adverse findings of an official inquiry, review, investigation or audit of returns lodged with the relevant taxation authority, agency or body. These costs include professional fees up to a prescribed limit.
- Communication throughout a company about its tax approach will help ensure that staff are aware of the approach, be it aggressive or conservative, that the company wishes to take. Policies relating to the company's tax approach and tax risk management need to be communicated clearly to eliminate the risk that divisions within the company take different approaches to tax and tax risk management.

- An internal audit committee that includes members with taxation skills may also help mitigate tax risks that the company may have overlooked or to which the company's response may not have been executed correctly.

Tax manager responsibilities

Depending on the size and complexity of an organisation, the tax manager may be a member of the board of directors, the CFO, or a specialist person (or team) appointed within the organisation. The tax manager may be assisted by external advisors, such as tax consultants from within the accounting or legal professions, registered tax agents, and the taxation authorities.

Tax managers can be seen as the internal tax compliance monitors for an organisation. They have responsibility for the operational aspects of taxation compliance, as well as providing advice and support in relation to strategic aspects.

The ATO has identified the following as key managerial-level responsibilities for large corporates:

- Ensuring sufficient capacity and capability.
- Ensuring information technology controls are in place.
- Assuring the flow of information from accounting records.
- Dealing with law and administrative updates.

Controls over transaction reporting for accounting functions can assist in compliance with taxation laws. Accurate record-keeping is imperative for both financial and taxation reporting purposes. The ability to capture a complete record of transactions for both purposes at the same time minimises costs and mitigates the risk of misstatement for each purpose and provides evidence should the matter be investigated by the ATO. Ensuring that those charged with taxation compliance are informed of new or changed transactions before they occur provides an opportunity to assess the impact and allows for tax considerations to be adequately planned or provided for.

Once a transaction has occurred, it should be reviewed to ensure that it was implemented as planned and to confirm the tax position is as anticipated. Depending on the expertise of the tax management personnel and the complexity of the transaction being contemplated or undertaken, external advisors are often consulted to provide expert advice or opinions on how a transaction will be treated under the taxation law.

Director responsibilities

The ATO has identified the following as key board-level (i.e. director-level) responsibilities for large corporates:

- Establishing a framework to identify and manage tax risk.
- Ensuring policies and controls are regularly assessed.

Taxpayers are ultimately responsible for the content of the income tax returns that they file with the relevant taxation authorities. Under s. 252 ITAA 1936, every corporate entity must appoint a public officer who bears the ultimate responsibility for filing the returns. Generally, the CFO or tax manager is appointed to be the public officer. However, decisions on the treatment of taxation issues arising from complex or new transactions, investments or businesses should be reviewed and determined by appropriate personnel, which should include the board of directors.

The ATO expects that the board of directors will have undertaken the necessary steps to identify the tax risks of the entity, sought relevant information and advice, either internally or externally, on each area determined to be a risk to the entity, and documented its consideration of the issues and the decisions made. Notwithstanding the areas of expertise of individual board members, each director is expected to have made relevant enquiries in order to satisfy themselves that the decision fits with the entity's tax risk management strategy, and is in accordance with the spirit and intent of the law.

For further guidance on tax risk management refer to the ATO publications *Tax risk management and governance review guide* and *Tax governance for privately owned groups*.

Professional conduct

Professional and ethical requirements

Chartered Accountants Australia and New Zealand (CAANZ) has codes and Standards that **all Chartered Accountants** must follow. Those applicable to members providing taxation services include:

- **APES 110** *Code of Ethics for Professional Accountants (including Independence Standards) – issued November 2018* (APES 110)

  The code adopts a conceptual framework approach to ethics. It is based on fundamental principles that express the basic tenets of ethical and professional behaviour and conduct. Observing these fundamental principles is central to the **public interest** and all members must abide by them **at all times**. Members should be guided, not merely by the terms, but also by the spirit of the code and should be prepared to justify, if called upon, any apparent departure from any of the provisions or spirit of the code.

  Under APES 110, a member shall comply with the following fundamental principles:

  - **Integrity –** to be straightforward and honest in all professional and business relationships.
  - **Objectivity –** not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.
  - **Professional competence and due care –** to:

    (i) attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation, and

    (ii) act diligently and in accordance with applicable technical and professional standards.
  - **Confidentiality –** to respect the confidentiality of information acquired as a result of professional and business relationships.
  - **Professional behaviour –** to comply with relevant laws and regulations and avoid any conduct that the professional accountant knows or should know might discredit the profession.

  Note: The revised APES 110 is effective from 1 January 2020 with early adoption permitted.

- **APES 220** *Taxation Services - issued July 2018* (APES 220)

  This Standard relates specifically to the provision of taxation services and applies to members in business (if they supply taxation services to employers), as well as members in public practice. It contains the professional and ethical standards for members.

  Under APES 220, a member shall at all times safeguard the interests of their client or employer provided that such services are delivered in accordance with APES 110 and relevant law, including applicable taxation law. In doing this, a member shall comply with the following fundamental responsibilities:

  - **Public interest –** in accordance with APES 110, to observe and comply with their public interest obligations.
  - **Integrity and professional behaviour –** in accordance with APES 110, to ensure that their own professional tax obligations and those of any associated entities for which the member is responsible are properly discharged.
  - **Objectivity –** in accordance with APES 110, to maintain an impartial attitude and recommend options that meet the client's or employer's interests, consistent with the requirements of the law. Objectivity is also required if a conflict of interest arises due to the member being asked to act as an advocate for a client or employer before a court or tribunal in respect of professional activities the member provided.

- **Independence obligations** – in accordance with APES 110, when a member in public practice is providing taxation services to a client and the member's firm is also engaged to conduct an assurance engagement for the same client.
- **Confidentiality** – in accordance with APES 110, unless the Member has a legal obligation of disclosure, a member shall not:
  - Convey any information relating to a client's or employer's affairs to a third party without the client's or employer's permission.
  - Furnish to the revenue authorities any opinions or written advice of a third party who is acting in a specialist capacity on specific aspects of the engagement, without the prior knowledge and express consent of that third party.
- **Professional competence and due care** – in accordance with APES 110:

  A member must maintain open, frank and effective communications with a client or employer, in particular with regard to rights, obligations, options, penalties and other legal consequences.

  A member in public practice has additional obligations to communicate in writing with a client, in particular, in regard to responsibilities, basis of advice and the self-assessment system.

  Where the application of the taxation law is not certain, a member shall not represent to a client or employer that the results of a taxation service (such as the tax or other revenue returns which the member prepares or assists in preparing, or the tax advice the member offers) are beyond challenge.

Under APES 220, where applicable, a member shall prepare and/or lodge returns and other relevant documents required to be lodged with a revenue authority in accordance with the information provided by a client or employer, their instructions, and the relevant taxation law.

Under APES 220, members also have professional and ethical obligations in respect of the association with tax schemes and arrangements, the use of estimates, false and misleading information, professional engagement matters, Client monies, professional fees and documentation.

Note: The revised APES 220 is effective from 1 October 2018 with early adoption permitted.

- **Guidance Note N6** *Reporting of Fraud and Other Illegal Acts* - This may also be relevant in extreme cases where clients are actively proposing the avoidance of tax.

Criminal legislation

The *Crimes (Taxation Offences) Act 1980*, *Crimes Act 1914* and *Criminal Code* apply to those who have aided, abetted or conspired with another to commit the relevant offence. For example, s. 6(1)(a) of the *Crimes (Taxation Offences) Act 1980* talks about a person who 'directly or indirectly, aids, abets, counsels or procures another person (including a company) to enter into an arrangement or transaction'. This legislation may be applied, for example, if a taxpayer winds up a company knowing that the company has a pending tax liability.

Common law duty of care

Professional tax advisors have a common law duty towards their client to exercise proper care and skill and can be held liable if they are negligent in providing (or failing to provide) advice which causes their client damage, injury or loss. The standard of care required is typically determined by looking at what a reasonable person would have done (or not done) in the same circumstances.

Required reading

- APES 110.
- APES 220.

Tax agent conduct

Tax agents play an important role in the tax system, preparing the vast majority of income tax returns lodged by taxpayers and advising clients on how to comply with the tax law in a self-assessment environment.

Concessions

Tax agents enjoy a privileged position under the tax law. For example, expenditure incurred in seeking tax advice is deductible under s. 25-5 only if the advice is provided by a 'recognised tax adviser', defined in s. 995-1(1) as a registered tax agent, business activity statements (BAS) agent or a legal practitioner.

A taxpayer who uses a registered tax agent also benefits from a 'safe harbour' from certain administrative penalties in circumstances where:

- A false or misleading statement is made carelessly, provided the taxpayer has taken reasonable care to comply with their tax obligations by giving their tax agent or BAS agent the information necessary to make the statement.
- A document (such as a return, notice or statement) is not lodged on time in the approved form due to the tax agent's or BAS agent's carelessness, provided the taxpayer gave the agent the necessary information in sufficient time, to lodge the document on time and in the approved form. If the agent was reckless or has intentionally disregarded the law, the safe harbour is not available.

Due to secrecy provisions in the tax law, the ATO will discuss a taxpayer's affairs only with the taxpayer or the tax agent who has been appointed to act on behalf of the taxpayer.

Finally, the ATO also allows tax agents to spread their workload beyond the standard 31 October tax return lodgement date and provides tax agents with electronic access to client data and dedicated enquiry lines.

It is not surprising therefore that tax agents are subject to regulatory requirements which aim to ensure that they are competent and act with integrity.

Regulations

Tax agents

The provision of tax agent services is regulated by the *Tax Agent Services Act 2009* (TASA) and *Tax Agent Services Regulations 2009* (TASR). This legislative regime covers both tax agents and those who prepare business activity statements (BAS agents). The discussion below is confined to tax agents.

The TASA legislation is administered by the Tax Practitioners Board (TPB). If an individual is not registered as a tax agent, they cannot provide tax agent services (ss 50-5 and 90-5 TASA), advertise themselves as a tax agent (s. 50-10 TASA) or hold themselves out as a registered tax agent (s. 50-15 TASA). Breach of these requirements will attract civil penalties.

An individual can be registered as a tax agent if (s. 20-5 TASA):

- The person is a fit and proper person having regard to the criteria in s. 20-15 TASA.
- The person is suitably qualified and has the relevant work experience as a tax agent (see Regulations 7 and 8, and Schedule 2 of TASR).

An individual can also be registered if they are a member of a professional association accredited by the TPB and have the required number of years' experience. Chartered Accountants Australia and New Zealand (CA ANZ) is an accredited professional association.

Registered tax agents are subject to the statutory Code of Professional Conduct under s. 30-10 TASA. There are 14 codes of conduct, that are organised around five principles, as follows:

- Honesty and integrity – a registered tax agent must:
  - act honestly and with integrity
  - comply with the taxation laws in the conduct of their personal affairs
  - account to their client for money or other property that the agent receives or holds on their client's behalf.
- Independence – a registered tax agent must:
  - act lawfully in the best interests of their client
  - have in place adequate arrangements for the management of conflicts of interest.
- Confidentiality
  - Unless a registered tax agent has a legal duty to do so, they must not disclose any information relating to a client's affairs to a third party without their client's permission.
- Competence – a registered tax agent must:
  - ensure that their service is provided competently
  - maintain knowledge and skills relevant to the services they provide
  - take reasonable care to ensure that taxation laws are applied correctly to the circumstances in relation to which they are providing advice to a client.
- Other responsibilities – a registered tax agent must:
  - not knowingly obstruct the proper administration of the taxation law
  - advise their client of the client's rights and obligations under the taxation laws that are materially related to the services the tax agent provides
  - maintain professional indemnity insurance that meets the TPB's requirements.

Failure to adhere to the code of conduct may cause the TPB to either:

- Caution the agent (s. 30-15(2)(a) TASA).
- Require the agent to undertake further training (ss 30-15 and 30-20 TASA).
- Impose restrictions on the agent's practice (ss 30-15 and 30-20 TASA).
- Suspend the agent's registration (ss 30-15 and 30-25 TASA).
- Terminate the agent's registration (ss 30-15 and 30-30 TASA).

Further guidance is available on the Tax Practitioners Board website: www.tpb.gov.au.

Note: The TPB code of conduct does not replace or mitigate the more stringent professional and ethical obligations of a Chartered Accountant (as discussed earlier in this unit). You may be subject to disciplinary action by CAANZ even where you adhere to the TPB code of conduct.

Financial advisers

Previously, financial advisers who provided taxation advice (and who were not registered as tax or BAS agents under TASA), were exempted from the TASA regulatory regime. The TASA was amended to introduce a new regulatory regime for tax (financial) advisers to bring entities who give tax advice (in the course of giving advice that is usually provided by financial services licensees) within the regulatory regime administered by the TPB. The new regime commenced on 1 July 2014 with a three-year transitional period before commencing in full on 1 July 2017.

Required reading

Sections 30-10 to 30-30, 50-5 to 50-15, 90-5 of *Tax Agent Services Act 2009*.

Promoter penalties regime

The anti-avoidance mechanisms of the ITAA 1936 and ITAA 1997 usually apply against the taxpayer who benefits from a tax scheme, not those who promote tax schemes. Unfortunately, some people saw the exploitation of tax laws as a business opportunity and developed tax schemes to sell to others. The schemes typically promised large, upfront deductions or the deferral of assessable income, sometimes using the 'round-robin' movement of funds designed to give the appearance, rather than the reality, of legitimate business activity. The promoter penalties regime in Division 290 Schedule 1 TAA 1953 was therefore introduced in 2006 to deter the promotion of tax avoidance schemes. The promoter penalties regime applies if a promoter promotes a tax exploitation scheme.

Promoter

A promoter is any entity who has a substantial role in promoting a tax exploitation scheme for consideration (s. 290-60(1) Schedule 1 TAA 1953). Note that a practitioner who provides independent and objective tax advice (including tax planning advice) is not a promoter.

Tax exploitation scheme

A tax exploitation scheme is defined in s. 290-65 Schedule 1 TAA 1953 as a scheme in which:

- The entity enters into with the sole or dominant purpose of obtaining a lower tax liability (or higher tax credit or refund) for itself or others.
- The benefit sought is not reasonably arguable at law.

Penalties

If the promoter penalty regime applies, the Commissioner can:

- Apply to the Federal Court to impose substantial fines against promoters (Subdivision 290-B Schedule 1 TAA 1953).
- Seek an injunction to stop the promotion of a scheme or implementation of a scheme (Subdivision 290-C Schedule 1 TAA 1953).
- Enter into voluntary undertakings with the promoter about how the scheme should be promoted or implemented (Subdivision 290-D Schedule 1 TAA 1953).

Product rulings

The promoter penalties legislation has led to an increase in the number of product rulings sought from the ATO prior to the launch of investment products that offer tax savings. Product rulings provide investors with certainty about the tax consequences of the investment.

It is important to note that the promoter penalty laws also apply to deter schemes, promoted on the basis of conformity with a product ruling, which are implemented in a way that is materially different to that described in the product ruling.

Required reading

Schedule 1 and, 290-60 and 290-65 TAA 1953.

Keeping up to date (recent developments)

Six-month rule

As a Chartered Accountant it is important to keep up to date with changes in the tax legislation to be able to competently advise your clients or comply with taxation compliance requirements, as even seemingly small changes may have a significant impact on the taxation obligations of a taxpayer.

For the TAXAU module, candidates are expected to be up to date with the relevant legislation, cases, rulings, determinations and other guidance as they stand six months before the exam date (unless otherwise stated) that are applicable to the periods covered in the module (i.e. 30 June 2019 for income tax purposes and 31 March 2019 for FBT purposes). Any developments subsequent to this six-month period or applicable to future periods are outside the scope of the TAXAU module (i.e. are not examinable).

The relevant application dates under the six-month rule are:

- Legislation – the date the legislation receives Royal Assent.

  Note: Taxation legislation can have retrospective effect. For example, it is now common for taxation measures announced as part of the Federal Budget to have effect from that date (i.e. the date of announcement). Legislation with a retrospective effect is outside the scope of the TAXAU module where that legislation has not been finalised at the time of writing these materials.
- Cases – the date the decision is handed down.
- Rulings and determinations – the date of issue.

Recent developments that impact the TAXAU module are referred to in the applicable unit.

Sources of updates

Useful ways of keeping up-to-date with legislative and other taxation developments include:

- ATO guidance materials – The ATO regularly releases fact sheets and decision impact statements regarding significant tax cases and other guidance materials. These materials often contain simple-to-understand examples and guidance on the ATO's interpretation of the law.
- Explanatory memorandums (EMs) – The EM to amending legislation is generally released at the same time as the Bill proposing the legislative change. Tax-related EMs are available under 'Extrinsic Materials', which sits within 'Legislation and other supporting material' in the ATO's legal database (www.ato.gov.au). Bills, in respect of amendments to taxation laws, are often titled 'Tax Laws Amendment Bill (No. x) 20XX'. EMs provide a comprehensive explanation of the proposed legislative changes (including a comparison to existing legislation) and examples that are easy to understand.
- Monitoring the Treasury, Treasurer, and Parliament of Australia websites – In particular:
  - Legislation proposed and before Parliament (available at: www.aph.gov.au → Parliamentary Business → Bills and Legislation).
  - New legislation (available at: www.legislation.gov.au → What's new)
- Newsletters and update emails – Many larger Chartered Accounting firms and professional associations have publications that you can subscribe to on their websites (e.g. CAANZ Taxation News, and The Tax Institute Tax Vine).
- Update training courses – These are conducted by many providers (e.g. CAANZ Essential Tax Updates).

Much of this represents continuing professional development (CPD), which as a Chartered Accountant you will be required to complete on a regular basis.

Specific anti-avoidance rules

Overview

A policy statement from the government or an interpretative stance from the ATO will sometimes be described as an 'anti-avoidance' or integrity measure. In other words, it is aimed at an activity within the community that, while not necessarily illegal, threatens the revenue base. The government or ATO announcement will either seek to stop the particular activity, or allow the tax benefits to be obtained only if the taxpayer satisfies specific criteria.

The anti-avoidance response in the tax law takes three main forms:

1. Provisions with 'built-in' anti-avoidance mechanisms, such as s. 8-1. Where the taxpayer's subjective purpose is to avoid tax rather than derive assessable income, no s. 8-1 deduction is allowed (refer *FCT v. Ilbery*, *Ure v. FCT* and *Fletcher v. FCT*). See example below and Unit 1.

Example – 'Built-in' anti-avoidance mechanism under s. 8-1

In *Fletcher's case*, the court held that s. 8-1 should be applied with regard to the taxpayer's subjective purpose, particularly in circumstances where the deductible outlay claimed is in excess of the actual or expected assessable income.

The case involved the promotion of an annuity plan to individuals who formed a partnership that paid a large upfront amount (using mostly borrowed funds) to purchase an annuity over 15 years. The amounts receivable under the annuity were comparatively low in the initial years, resulting in a net partnership loss that was shared among the partners and claimed as a deduction in their personal tax returns. The agreement provided that the promoter would redeem the annuity upon receipt of a notice from the partnership indicating that the arrangement could be wound up before the arrangement ever produced a net profit.

2. Specific anti-avoidance legislation that deals with particular types of planning. These include (but are not limited to):
   - General value shifting rules.
   - Commercial debt forgiveness rules.
   - Personal services income rules – see Unit 7.

   The tax legislation also contains specific provisions that do not directly deal with particular types of planning (i.e. they are disclosure requirements), but which exist for anti-avoidance purposes. These include:
   - The requirement for the Commissioner (i.e. via the ATO) to publish tax information in relation to certain corporate tax entities that report total income of $100 million or more. This information includes total income, taxable income or net income, and income tax payable (s. 3C TAA 1953).
   - The requirement for Australian businesses of significant global entities to prepare and lodge general purposes financial statements for income years commencing on or after 1 July 2016 (s. 3CA TAA 1953).
3. A general anti-avoidance rule (GAAR) in Part IVA ITAA 1936, which acts as the ATO's last line of defence against anti-avoidance activity and is deliberately framed in broad terms so it can act as a backup. If a taxpayer manages to circumvent a specific anti-avoidance measure, the general anti-avoidance rules could still apply. The GAAR is discussed in detail later in this unit.

General value-shifting rules

Overview

A value shift usually occurs when something is done that results in the value of one thing (e.g. a share) decreasing and another increasing.

The legislation typically applies only to closely held entities because of the legislative requirement for a controlling stake, thereby excluding:

- Almost all interests in listed entities.
- Shareholders who are not 'affected entities' (e.g. minority shareholders (ss 725-50 and 725-55)), except where they are 'active participants' (s. 725-65)).

The general value-shifting rules aim to prevent:

- Distortion of gains and losses when equity or loan interests in companies and trusts are sold, rendered worthless or otherwise come to an end.
- Opportunities for inappropriate deferral or avoidance of tax where the value shift results in an interest decreasing or increasing in value.

The general value-shifting regime consists of both:

- Direct value-shifting rules in Divisions 723 and 725 (where value is shifted between direct interests in an entity, such as those involving shares in a company, or by creating rights over non-depreciating assets).
- Indirect value-shifting rules in Division 727 (where value is shifted using non-arm's-length dealings between assets held by different group companies).

These measures can apply without the need to show a tax avoidance purpose.

The example below illustrates the need for such rules.

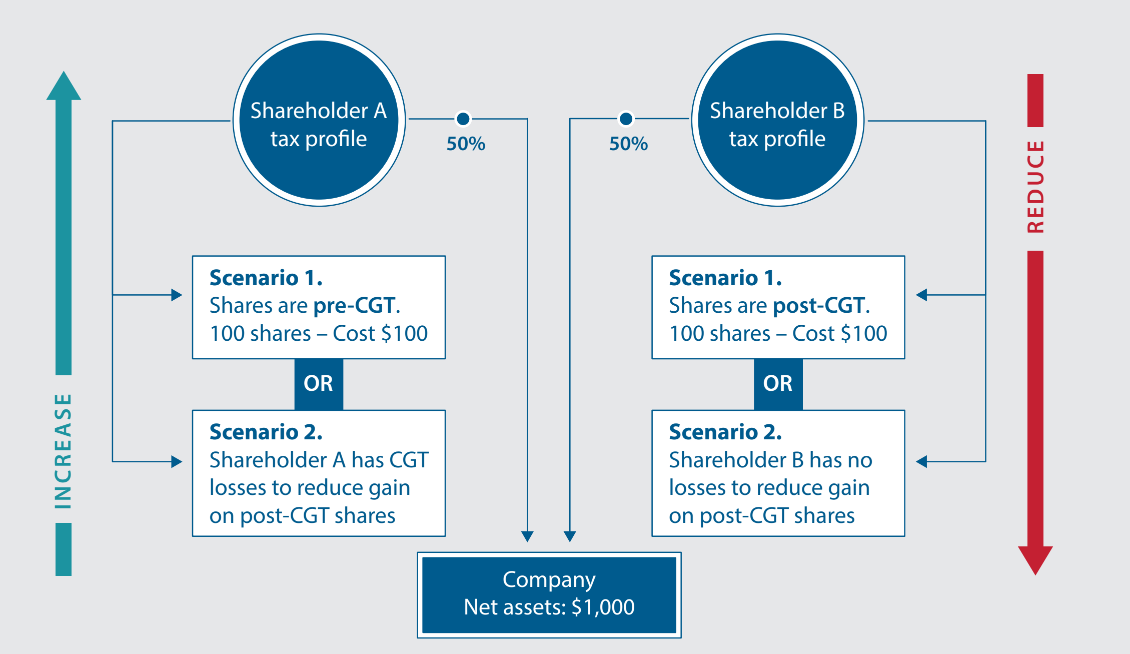
Example – Shifting value prior to sale of shares

Shareholder A and Shareholder B, who are related, each holds 50% of the shares in a company. Their different tax profiles provide an incentive to make the shares held by Shareholder B less valuable and the shares held by Shareholder A more valuable, prior to the actual sale of their shares.

In Scenario 1, both shareholders are assumed to hold their shares as long-term investments:

- If Shareholder A's pre-capital gains tax (pre-CGT) shares can be made more valuable, the gain on the eventual sale of these shares will not be subject to CGT (leaving aside the possibility that CGT event K6 might apply).
- Correspondingly, the decreased value of Shareholder B's post-CGT shares reduces the CGT exposure when these shares are sold (assuming Shareholder B has no capital losses).

In Scenario 2, if value can be shifted from Shareholder B's post-CGT shares to Shareholder A's post-CGT shares, the gain on the sale of those shares will be offset by Shareholder A's own CGT losses, whereas Shareholder B has no CGT losses to reduce the gain.



Application

A value shift can occur in a variety of ways including changing share rights, issuing shares at a discount etc., as the following examples illustrate:

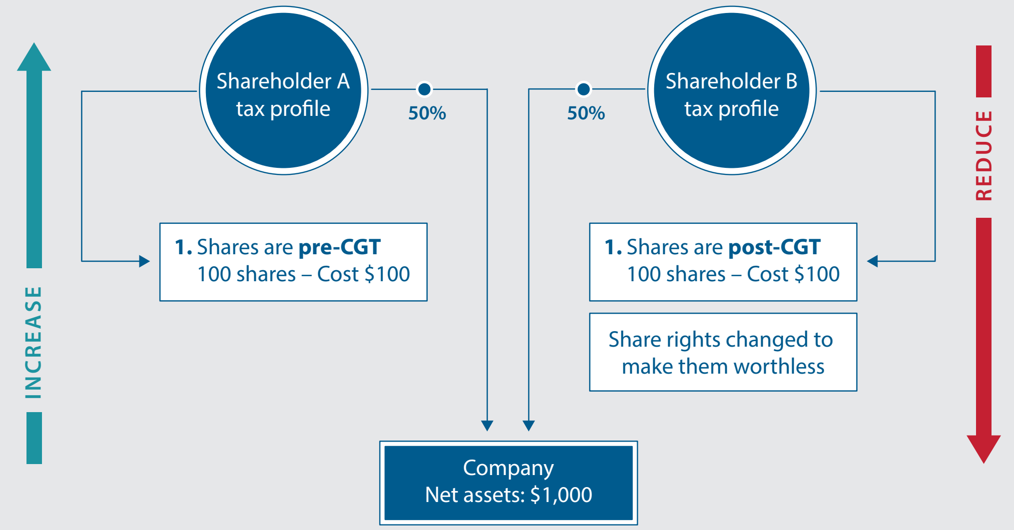
Example – Shifting value by the issue of shares or changing share rights

Value can be shifted from Shareholder B to Shareholder A by changing share rights in favour of Shareholder A who only has pre-CGT shares.

Prior to the value shift, assume that the market value of each shareholder's shares is exactly the same: $5 per share (i.e. the company's $1,000 net asset value divided by 200 shares).

Shareholder A and Shareholder B (who control the company) arrange for Shareholder B's shares to become worthless.

Shareholder A's pre-CGT shares have now increased in value from $500 to $1,000 and can be sold tax free (subject to CGT event K6). Shareholder B's post-CGT shares have fallen in value from $500 to $0.



Two other ways to shift value include:

1. Creating a right over a non-depreciating asset. This type of value shift might occur when the asset is realised at a loss, arising due to a right previously created over the asset by an associate.

Example – Shifting value by creation of a right

Value can be shifted by creating a right over a non-depreciating asset.

Family Company owns a luxury apartment with a cost base of $1 million and a market value of $1.5 million. The company leases the apartment to the daughter of the controlling shareholder, allowing her to live in the apartment at $1 a week rent for 10 years. The CGT rules do not deem market value consideration in this situation (refer s. 116-25), although the deemed dividend provisions in Division 7A may apply because an associate of the shareholder is receiving the benefit of the company's asset for less than market value (refer s. 109CA ITAA 1936 and unit 8).

The existence of the lease substantially reduces the market value of the apartment. Family Company then sells the apartment to another associated party for the diminished market value, triggering a capital loss that would not otherwise have resulted.

Division 723 in the general value-shifting rules will apply to reduce the CGT loss.

2. An indirect value shift arising between entities where they have not dealt at arm's-length in relation to an underlying transaction (e.g. the sale of an asset at less than market value between related companies) and where the values of the shares in the companies have been altered as a result of the underlying transaction (Division 727).

Value shifting thresholds

The general value-shifting regime only applies to material value shifts; that is, it does not apply to the following:

- Direct value shifts that total less than $150,000.
- Shortfalls (i.e. where the market value exceeds the tax value) of less than $50,000 when rights are created over non-depreciating assets.
- Indirect value shifts of less than $50,000.

The general value-shifting rules also **do not** apply to dealings within a tax consolidated group or to transactions that occur at market value.

Consequences

The consequences of a value shift for an owner of an affected interest depends on whether the value shift was a **direct** or **indirect** value shift and whether there was a 'pre-shift gain' or a 'pre-shift loss'. There are also some choices a taxpayer can make about when the adjustments to the cost base should be made.

Indirect value shift

An indirect value shift can result in adjustments to realised losses and gains, or adjustments to adjustable values to realign these values to market value.

Direct value shift

A direct value shift can result in:

- A deemed gain (as if the asset has been disposed of), but not a loss under CGT event K8 (s. 104-250).
- Adjustments to adjustable values and cost bases to realign the relationship of those values to the market value.

Example – Direct value shift under CGT event K8

Shuttle Pty Ltd (Shuttle), an Australian resident company, carries on a retail business. Sally owns two shares in Shuttle which she acquired for nothing (i.e. $nil issue price for the company and $nil cost base for Sally) when she incorporated the company on 13 August 2012.

On 30 June 2019, Sally gave one share in Shuttle to her sister for free (i.e. $nil sale proceeds) and then later that day, Shuttle issued one new share to Sally's brother for free (i.e. $nil issue price for the company). On 30 June 2019, Shuttle had a market value of $3,000,000.

After the gift of one share to her sister, Sally's investment in Shuttle was worth $1,500,000 (i.e. $3,000,000 ÷ 2). After the issue of the share to Sally's brother, Sally's investment in Shuttle was worth $1,000,000 (i.e. $3,000,000 ÷ 3).

The capital gains tax (CGT) implications for Sally are:

- Gift of one share – this triggers CGT event A1, disposal of a CGT asset (s. 104-10). Under s. 116-30, as Sally and her sister are not dealing at arm's-length, Sally is deemed to have disposed of the share at its market value of $1,500,000. As the share has a nil cost base, Sally makes a capital gain (before discounting) of $1,500,000 on the disposal of the share.
- Issue of one share – this triggers CGT event K8, direct value shifts affecting equity in a company (s. 104-250 and Division 725). Under s. 725-365, Sally makes a gain of $500,000 (the decrease in value of her share in the company from $1,500,000 to $1,000,000).

Note: When calculating Sally's net capital gain you need to consider the application of the general 50% CGT discount and the CGT small business concessions (see Unit 4 on CGT and Unit 6 on small business entities).

Commercial debt forgiveness rules

Overview

Division 245 deals with commercial debt forgiveness.

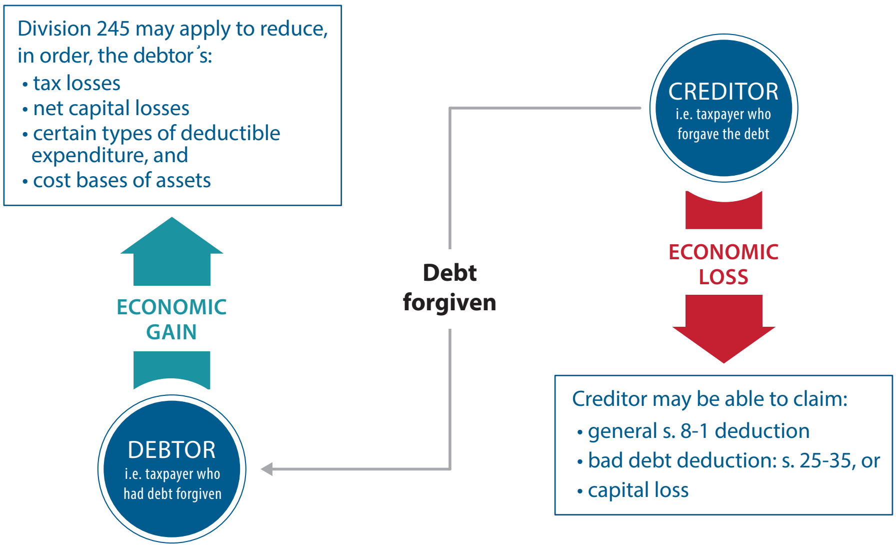
The need for this legislation is best explained by looking at the tax outcomes that would apply in the absence of Division 245. A creditor who cannot recover its loan can:

- if carrying on a business as a money lender, get a deduction either under s. 8-1 or s. 25-35 (as a bad debt), or
- trigger a capital loss on the release of the loan.

But the debtor is not required to include the benefit of not having to repay the debt, either as assessable income (except where the gain arises in the ordinary course of business, or is the product of a profit-making transaction – refer to Unit 1) or as a capital gain. Division 245 seeks to address the mismatch between the tax treatment of the creditor and the economic gain made by the debtor.

The broad effect of Division 245 is to **increase the tax liability of the taxpayer who is relieved of the obligation to repay the debt**. However, instead of including the amount of the forgiven debt in that taxpayer's assessable income, the tax benefit of the forgiven debt is clawed back through reducing tax benefits, such as tax losses and the tax base of assets (which generally provides a deferred taxing point).

The diagram below illustrates the tax outcomes that may now apply on both sides of the debt forgiveness transaction, taking into account the operation of Division 245.



Application

For the commercial debt forgiveness provisions to apply there needs to be:

- A commercial debt.
  - **Debt** takes on its ordinary meaning. That is, an obligation to pay an amount to another party.
  - A debt is a **commercial debt** if the whole or any part of the interest paid or payable in respect of the debt would be deductible to the debtor, or would have been deductible if interest had been paid (s. 245-10).
- A forgiveness. There is a **forgiveness** when:
  - Debt is released, waived or extinguished (including if the creditor can no longer sue to recover the debt) (s. 245-35).

   - Debt is assigned to an associate of the debtor, or under an arrangement between the new creditor and debtor (i.e. debt parking) (s. 245-36)
   - A debtor company does a debt for equity swap (i.e. issues shares in itself and reduces its debt by the value of those shares) (s. 245-37).

However, in accordance with s. 245-40, the commercial debt forgiveness rules **do not apply** if the debt forgiveness is:

- Included in the assessable income of the debtor (e.g. as ordinary income, see *Warner Music v. FCT*).
- A deemed dividend under Division 7A ITAA 1936 (i.e. the debt was due by a shareholder (or their associate) to a private company – see Unit 8).
- A fringe benefit (i.e. a debt waiver fringe benefit – see Unit 3).
- Effected under bankruptcy.
- Effected by will (i.e. of a deceased person).
- For reasons of natural love and affection (e.g. between family members for personal reasons).

Where commercial debts are forgiven by entities within a tax consolidated group (intra-group debts), the transaction is disregarded under the single entity rule – see Unit 12.

Consequences

Where the commercial debt forgiveness rules apply, the debtor needs to calculate the gross forgiven amount, the net forgiven amount, and apply the net forgiven amount against the debtor's tax benefits. Any net forgiven amount remaining after the tax benefit reductions is disregarded (s. 245-195). The calculation steps are set out below.

Step 1 – Calculate the gross forgiven amount (s. 245-75)

The 'gross forgiven amount' is worked out in two steps:

- Determine the value of the debt.

  The value of a debt is worked out under s. 245-55 for debts generally, under s. 245-60 for non-recourse debts, and under s. 245-61 for assigned debts. For debts generally, the value of the debt is its market value worked out on the basis that the debtor was solvent both when the debt was incurred and at the time it was forgiven.
- Offset the value of the debt by any consideration given for the forgiveness of the debt.

  The available offsets are listed in s. 245-65. For example, the value of a debt is reduced for amounts received by a banker from a debtor for releasing the debtor from the debt.

Step 2 – Calculate the net forgiven amount of the debt (s. 245-85)

The 'net forgiven amount' is the 'gross forgiven amount' reduced by any amount that is already taken into account for the debtor under the legislation because the debt was forgiven. The reductions include:

- Any amounts assessable to the debtor as a result of the forgiveness (s. 245-85(1)(a)).
- Any reduction of deductions to the debtor as a result of the forgiveness (s. 245-85(1)(b)).
- Any reduction to the cost bases of the debtor as a result of the forgiveness (s. 245-85(1)(c)).
- Where the debtor and creditor are under a common ownership, any amounts of capital loss elected by the creditor to forgo as a result of the forgiveness (s. 245-90).

Step 3 – Apply net forgiven amount to reduce tax benefits

The net forgiven amount is applied by the debtor to reduce tax benefits. Tax benefits are amounts that could otherwise reduce the debtor's taxable income in the same or a later income year.

The tax benefits must be reduced in the following order:

- Tax losses arising before the forgiveness year (s. 245-115).
- Net capital losses arising before the forgiveness year (s. 245-130).
- Specified types of deductible expenditure arising before the forgiveness year, such as expenditure giving rise to deductions for capital allowances and borrowing costs (s. 245-145).
- Cost bases of specified CGT assets (excluding pre-CGT assets, trading stock, goodwill, etc.) (s. 245-175). This includes non-appreciating assets such as trade debtors and bank accounts. So, a repayment of a trade debtor could produce a capital gain, subject to the application of the anti-overlap provision in s. 118-20 (refer ATO ID 2008/110).

Any net forgiven amount remaining after the above reductions is disregarded (s. 245-195).

Required reading

Sections 245-5 to 245-20, 245-35, 245-40, 245-55, 245-65, 245-75, 245-85 and 245-90 ITAA 1997.

Worked example 15.1: Commercial debt forgiveness

[Available online in myLearning]

General anti-avoidance rules (Part IVA)

General rules

Overview

Part IVA ITAA 1936 contains the general anti-avoidance provision which gives the Commissioner the discretion to cancel a tax benefit that would otherwise be obtained by a taxpayer as a result of a scheme.

It operates as the last line of defence and applies only if the Commissioner makes a determination under s. 177F ITAA 1936 (i.e. when the Commissioner applies it – the provision is not self-executing). Taxpayers bear the burden of proof when contesting an amended assessment resulting from a Part IVA ITAA 1936 determination. Tax practitioners need to carefully consider the possible application of Part IVA ITAA 1936 to income tax planning arrangements, including the higher penalty regime (refer to Unit 1).

Other tax laws such as *A New Tax System (Goods and Services Tax) Act 1999* (GST Act) and the *Fringe Benefits Tax Assessment Act 1986* (FBTAA 1986) also contain general anti-avoidance rules. Note that this unit focuses solely on Part IVA ITAA 1936.

Application

The three legislative elements of Part IVA are a scheme, a dominant purpose and a tax benefit.

Scheme

A scheme is defined in s. 177A ITAA 1936. It can include a single step in an arrangement (*Hart's case)* or failing to do something (*Corporate Initiatives v. FCT)*. In other words, a scheme may be as broad or as narrow as the Commissioner likes. A scheme does not have to be commercial.

Dominant purpose

The dominant purpose test in s. 177D ITAA 1936 is the key principle (i.e. the fulcrum) around which Part IVA is generally based (see later in this unit for the principal purpose test applicable to members of significant global entities).

The question is whether a person who entered into or carried out the scheme did so for the purpose of enabling a taxpayer to obtain a tax benefit. This can be the purpose of the tax advisers (*FCT v. Consolidated Press Holdings Ltd*) or the participants in their own right (*Hart's case)*.

The question is answered by considering the eight factors in s. 177D ITAA 1936. Factors 1, 2, and 3 are concerned with how the scheme was implemented, while factors 4, 5, 6, 7 and 8 are concerned with the effects of the scheme (see diagram below for details). The eight factors can be considered together and need not have equal weight (*Hart's case)*, but they all must go into the consideration mix.

Dominant purpose is determined objectively; the person's actual subjective purpose is irrelevant (*Hart's case).*

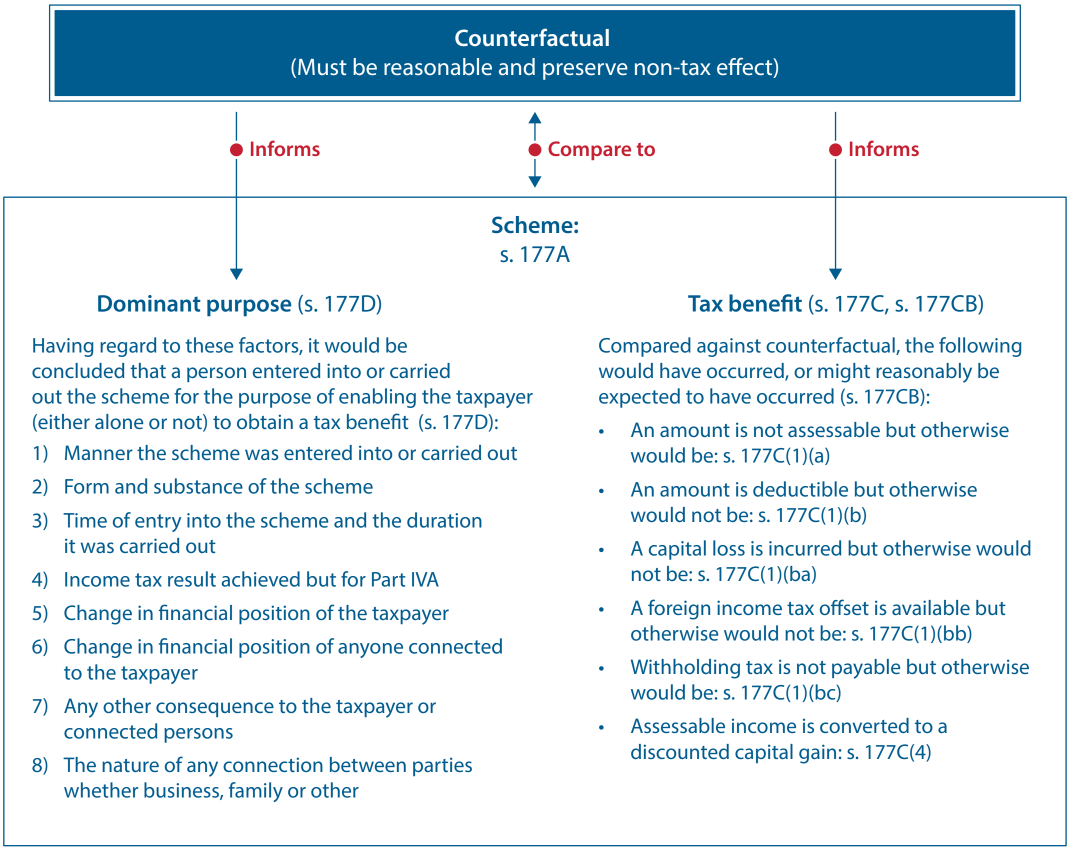
Tax benefit

'Tax benefit' is defined in s. 177C ITAA 1936. A tax benefit must arise in connection with a scheme. It does not include benefits arising from making a choice allowed by the tax legislation such as the choice to use diminishing value depreciation rates rather than prime cost or the choice to take advantage of the CGT rollover provisions (the 'choice principle') (s. 177C(2) ITAA 1936). However, s. 177C(2) ITAA 1936 does not apply if a scheme was done to create circumstances such that the choice could be made (*Macquarie v. FCT).*

Implicitly, Part IVA ITAA 1936 asks what would have happened, or might reasonably be expected to happen, if the tax scheme were not to happen (the counterfactual):

Possible counterfactual	When relevant
If scheme did not occur (annihilation) (s. 177CB(2) ITAA 1936)	When the scheme has no material non-tax effect (i.e. the scheme can only be explained by the creation of the tax benefit). For example, in the context of the making of a tax deductible prepayment, the prepayment scheme is simply ignored in working out what would have happened if the scheme had not been entered into (i.e. the counterfactual)
If scheme did not occur but something else did (annihilate and reconstruct) (s. 177CB(3) ITAA 1936)	When the scheme has a material non-tax effect, the taxpayer needs to reconstruct the arrangement to preserve the non-tax effect (s. 177CB(4) ITAA 1936) **Note:** A taxpayer cannot say that a counterfactual is unreasonable simply because of its tax effect (e.g. a taxpayer cannot say that the counterfactual was to do nothing)

In effect, the elements are considered together.



Methodology

When dealing with a Part IVA problem (for entities other than significant global entities), the following methodology may be useful.

Step 1: Identify the tax effect and the counterfactual

The summary of *Hart's case* below highlights these elements.

Example – Tax effect and counterfactual: *Hart's case*

Mr and Mrs Hart took out a loan to fund both their private home and rental property. The loan had a special feature which allowed them to direct their monthly repayments to reduce the debt on their private home and capitalise the interest relating to the investment property. As a result, the Harts got a greater deduction than if the repayments reduced both the private and investment portion respectively.

Tax effect of the arrangement: Deduction for the interest.

Counterfactual: The counterfactual must preserve all the non-tax effect of the arrangement (i.e. the borrowing itself) because the scheme has both a tax element (the deduction) and a commercial element (the borrowing). This means there must still be a loan taken out to fund the two properties when applying the counterfactual test. The counterfactual must therefore be about the special feature of the loan – that is, a loan without the special feature. Note the result is the same whether you:

(a) simply delete the special feature and have no substitute, or

(b) delete the loan with the special feature and substitute it with a loan without the special feature.

Step 2: Identify the scheme, dominant purpose, and tax benefits

The continuation of the summary of *Hart's case* below highlights these elements.

Example – Scheme, purpose, and tax benefit: *Hart's case:*

Following the discussion of the *Hart's case* above:

Scheme: The counterfactual is a loan without the special feature. The scheme therefore must include the special feature.

Dominant purpose: The Harts sought and took advantage of the special feature in the loan to obtain a tax advantage.

Tax benefit: The tax benefit is the extra interest deductions in addition to what they would have obtained if the loan had no special feature and all repayments reduced the private and investment portion respectively (see s. 177C(1)(b) ITAA 1936).

Step 3: Identify the taxpayers that obtained the tax benefit

It is important to identify the correct taxpayers that obtained the tax benefit because failure to do so may result in Part IVA being frustrated: *FCT v. Peabody; AXA Asia Pacific Holdings v. FCT*. The tax benefit may be shared between more than one taxpayer (s. 177D(1) ITAA 1936).

Example – The taxpayer: *Hart's case*

Taxpayer: The Harts were the taxpayers who obtained the tax benefit.

Consequences

Where the Commissioner determines that Part IVA ITAA 1936 applies, the consequences are:

- A tax benefit may be cancelled under s. 177F ITAA 1936 and compensating adjustments made if necessary. The Commissioner has up to four years (not the usual two for some taxpayers) to amend an assessment (s. 170(1) Item 4 ITAA 1936).
- A penalty may be imposed under s. 284-155 of Schedule 1, TAA 1953 (see Unit 1) of 50% of the scheme shortfall amount (25% if the tax position is reasonably arguable). This amount is doubled for significant global entities unless the tax position is reasonably arguable.

The ATO has released guidance in PCG 2018/7 to assist taxpayers in determining the application of Part IVA to a restructure following the introduction of the foreign hybrid mismatch integrity rules in Division 832 (see Unit 14).

Required reading

ITAA 1936, Part IVA: Sections 177A(1), 177A(3), 177C, 177CB, and 177D.

Significant global entity rules

Defining a significant global entity

Current law

Under s. 960-555 ITAA 1997, a significant global entity (SGE) includes:

- A global parent entity that either has annual global income of $1 billion or more (i.e. total annual income as shown in its audited global financial statements), or is the subject of a determination by the Commissioner.
- A member of an accounting consolidated group where the global parent entity is an SGE.

Under the current law, an entity that is a member of a group can only be an SGE where the group is headed by a public company (i.e. a listed company) or a private company that is required to prepare consolidated financial statements.

Proposed retrospective law

Note: The Government had proposed to extend the definition of an SGE from 1 July 2018. At the time of writing legislation has yet to be finalised and is therefore outside the scope of the TAXAU module.

Under this proposal, the definition of an SGE in s. 960-555 is extended to include a member of a 'notional listed company group' (NLCG). Under proposed s. 960-575, a NLCG is a group of entities that would be required to consolidate for accounting purposes if it were headed by a listed company rather than another type of entity (e.g. a trust, partnership or investment company).

General anti-avoidance – Principal purpose test

As noted above, the three legislative elements of the general anti-avoidance rules in Part IVA ITAA 1936 are a scheme, a dominant purpose and a tax benefit. When applying these elements to an SGE entity, the dominant purpose test may be replaced by the principal purpose test in s. 177DA ITAA 1936.

Section 177DA is commonly referred to as the multi-national anti-avoidance law (MAAL). It is targeted at artificial or contrived arrangements used to avoid having a taxable presence in Australia.

Section 177DA applies if, under a scheme, or in connection with a scheme:

- a foreign entity (that is an SGE) makes a supply to an Australian customer,
- an Australian entity (or permanent establishment), that is an associate of or is commercially dependent on the foreign entity, undertakes activities in Australia directly in connection with the supply,
- some or all of the income derived by the foreign entity is not attributable to an Australian permanent establishment, and
- the principal purpose, or one of the principal purposes of the scheme, was to obtain an Australian tax benefit or to obtain both an Australian and foreign tax benefit.

When applying the above requirements, supplies made by a trust or partnership to Australian customers and income received from these supplies are treated as being made or received by a foreign entity if the trust or partnership satisfies certain conditions. The trust or partnership will satisfy these conditions if it:

- has at least one foreign entity participant (broadly, a potential ultimate recipient of income of the trust or partnership that is a foreign entity), and
- is connected with the foreign entity, would be an affiliate of the foreign entity if the trust or partnership was an individual or a company, or is part of a global group that also includes the foreign entity.

The principal purpose is determined under s. 177DA(2) ITAA 1936 by considering:

- The eight factors in s. 177D ITAA 1936 (see earlier under the general anti-avoidance rules).
- The extent to which the activities are performed, and are able to be performed by the foreign entity, associated Australian entity or permanent establishment.
- The result, under a foreign tax law, that would be achieved by the scheme (ignoring the application of this provision).

For further ATO guidance on the application of the principal purposes test to significant global entities see LCR 2015/2 and TD 2018/12.

Required reading

ITAA 1936, Part IVA: Section 177DA.

Diverted profits tax

The diverted profits tax (DTP) is included in the legislation as an extension to the general anti-avoidance measures in Part IVA ITAA 1936. The purpose of the DPT is to prevent significant global entities from reducing the amount of Australian tax they pay by diverting profits offshore through contrived arrangements between related parties.

Under s. 177J ITAA 1936, the DPT is broadly applicable:

- to Australian resident entities (or permanent establishments of foreign entities) that are members of a multi-national group that is an SGE,
- where there is a scheme entered into with a foreign related party (within the meaning of associate in s. 318 ITAA 1936) for the principal purpose of obtaining a DPT tax benefit, and
- where it is reasonable to conclude that none of the following tests are satisfied:
  - $25 million income test (s. 177K ITAA 1936)

    A *de-minimis* threshold that exempts Australian subsidiaries of offshore companies with combined Australian turnover of less than $25 million, except where income is being artificially booked offshore.
  - Sufficient foreign tax test (s. 177L ITAA 1936)

    The profit is diverted to a country where the tax paid on that income equals or exceeds 80% of the tax that would have been paid in Australia.
  - Sufficient economic substance test (s. 177M ITAA 1936)

    Where it is reasonable to conclude that the arrangement was not designed to secure a tax reduction.

Under s. 177P ITAA 1936, a DPT liability will only arise when the Commissioner issues an assessment; it is **not a self-assessed tax**. If the DPT applies, the *Diverted Profits Tax Act 2017* will impose tax on the amount of the 'diverted profit' at a rate of 40%.

An example of when these rules may apply includes where there is a foreign company that engages an Australian agent to make sales to Australian entities, and therefore only a small percentage of the profit is taxed in Australia.

For ATO guidance see PCG 2018/5, LCR 2018/6 and PS LA 2017/2.

A detailed understanding of the DPT is outside the scope of the TAXAU module.

Worked example 15.2: General anti-avoidance provisions – Part IVA ITAA 1936

[Available online in myLearning]

Other key resources

'Tax takes' video resources
[Available online in myLearning]

Mind maps
[Available online in myLearning]

Quiz
[Available online in myLearning]

Unit 16: Integrated activities

Contents

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Learning outcomes

At the end of this unit you will be able to:

1. Prepare a tax reconciliation to calculate taxable income by making tax adjustments to accounting profit.
2. Integrate all learning outcomes from Units 1–15.

Introduction

The overall objective of the TAXAU module is to examine and apply relevant Australian taxation law to various tax entities. It is essential for an accounting professional to be able to analyse information provided by clients and provide accurate taxation advice.

This unit contains integrated activities that bring together the knowledge and concepts that have been covered in all previous units of the TAXAU module.

It is strongly recommended that the tax reconciliation activity in this unit is **not** attempted before completing all previous units in the TAXAU module.

Note:

- The impact of leap years is ignored for the purposes of calculations in the TAXAU module. In practice, they would need to be taken into account.
- Unless otherwise indicated, legislative references in this unit relate to the *Income Tax Assessment Act 1997* (ITAA 1997) and the *Income Tax Assessment Act 1936* (ITAA 1936).

Integrated activities

Overview

Tax reconciliation

Most businesses calculate taxable income by preparing a reconciliation from their accounting profit to taxable income. A tax reconciliation identifies the differences between what is recognised for accounting purposes and what is assessable income or an allowable deduction for tax purposes in a particular income year. All identified differences are added to, or subtracted from, accounting profit to determine taxable income.

You should be familiar with this approach and have the basic accounting skills to analyse financial information from your prior studies. The following table provides an overview of a tax reconciliation.

Tax reconciliation	
Item	**$**
Accounting profit/(loss)	xx
Add/(less): Adjustments	
Add: Expenses in P/L but not tax deductible	xx
Less: Expense not in P/L but tax deductible	(xx)
Less: Income/gains in P/L but not assessable	(xx)
Add: Income/gains not in P/L but assessable	xx
Equals: Taxable income/(loss)	xxx

Tax calculations

Not all taxable income/(loss) calculations require the preparation of a tax reconciliation. There are also a number of other circumstances in which a tax calculation will need to be prepared by adding and subtracting amounts determined under the tax legislation.

Examples of tax calculations under the income tax legislation include assessable income, allowable deductions, taxable income/(loss), cost base of a CGT asset, net capital gain/(loss), and cost of a depreciating asset.

Exam questions

When approaching an exam question for income tax, it is critical to first understand whether it requires you to undertake a tax reconciliation or a tax calculation. It is also critical to understand if you are required to calculate the taxable income (i.e. assessable income less allowable deductions) or income tax liability (i.e. applying relevant tax rates and tax offsets) of the taxpayer.

For FBT exam questions, it is critical to understand whether you are required to calculate a benefit's taxable value (i.e. before applying the gross-up and FBT rate) or FBT payable (i.e. after applying the gross-up and FBT rate).

Activity 16.1: Income tax reconciliation – company
[Available online in myLearning]

Activity 16.2: FBT, GST and income tax reconciliation – employee expenses
[Available online in myLearning]

Activity 16.3: FBT, GST and income tax calculation – various transactions
[Available online in myLearning]

Other key resources

Quick reference guides
16.1: Taxable income – Reconciliation adjustments for a business
[Available online in myLearning]

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