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TAX UPDATE

November 2010

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- › Tax Liability is a Present Legal Obligation - Commissioner of Taxation v H, Federal Court
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Deductions Allowed Against Youth Allowance – Commissioner of Taxation v Anstis, High Court

The High Court has upheld the Full Federal Court's decision and allowed a university student to claim a tax deduction for the self education expenses incurred in completing her university degree for which she received Youth Allowance.

In order to receive Youth Allowance a student must satisfy certain requirements which include a level of study that is at least equivalent to 3/4s of full time study. If a student fails to maintain the minimum level of study, their Youth Allowance can be suspended.

The Court held that the Youth Allowance, being assessable as ordinary income, was gained as a result of the taxpayer being eligible under the *Social Security Act 1991*. In order for an expense to be tax deductible it is necessary that the occasion or reason for the expense should be found in whatever is productive of the taxpayer's assessable income. The Court held that the self education expenses were found to be incurred by reason of completing her full time university study, which was what the taxpayer did to qualify and retain her entitlement to the Youth Allowance. The Commissioner contended that the expenses were private or domestic in nature thereby precluding a tax deduction. The Court held that the outgoings did not lose their connection with the "position" she held as a recipient of Youth Allowance simply because she might have been studying for reasons other than enjoying an entitlement to Youth Allowance.

This outcome goes against past Tax Office practice and it is currently considering the impact of the decision.

Tax Liability is a Present Legal Obligation - Commissioner of Taxation v H, Federal Court

The Commissioner has lost an appeal from the Administrative Appeals Tribunal (AAT) to the Federal Court concerning whether the income tax liability for a particular income year is a present legal obligation for the purposes of Division 7A.

A private company owned by the taxpayer received amended assessments issued in 2007 concerning a number of earlier years which increased the company's liability to income tax. General interest (GIC) was applied to the tax shortfall. Under Division 7A the amount of a deemed dividend which can arise is limited to the private company's distributable surplus. The formula for distributable surplus includes the company's net assets, which is arrived at after subtracting any present legal obligations existing at 30 June each year.

The Federal Court confirmed that the obligation to pay tax arises at the end of each income year as a result of the operation of the Income Tax legislation. At worst the liability is a contingent liability, being contingent on an assessment being made, but that does not prevent the tax being a present legal obligation at 30 June. On a similar vein the liability to interest on unpaid tax, commences on the date the original assessment is issued. Therefore the GIC in relation to a particular year of tax is a present legal obligation at the time of the original assessment, which falls in the following income year.

As a result the company's distributable surplus in each subsequent year was reduced by its tax liability and GIC; this will have a follow on effect by reducing the individual taxpayer's deemed dividend income under Division 7A.

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Trust Unpaid Present Entitlements and Division 7A

On 14 October the Tax Office released a Practice Statement providing guidance on the Commissioner's opinion set out in Tax Ruling TR 2010/3 as to when an unpaid present entitlement (UPE) will constitute a loan under Division 7A. Division 7A regulates the making of loans by a private company to its shareholders or associates. Refer to October's Special Edition Tax Update.

In response to the finalisation of this controversial Tax Office opinion, the four main tax and accounting bodies have jointly called for an urgent test case to be run to challenge the Commissioner's interpretation of the law. The professional bodies contend that the technical interpretation made by the Commissioner is not supportable under the law and is at odds with the original policy intent. The Commissioner agrees that a test case is appropriate.

Valid Declaration of Trust – Saunders v Deputy Commissioner of Taxation, Supreme Court W.A

In this case the taxpayer had acquired a property in 1990. In 2006 a portion of the subdivided property was sold for a significant capital gain. The taxpayer contended that the capital gain was not made in his own name but in the hands of his family trust as the taxpayer had transferred all beneficial ownership in the property by way of a declaration of trust in 1995. The family trust itself had been in existence since 1980.

The Commissioner contended that the one page declaration was not effective in transferring the property to the trust. The declaration, which was not professionally drafted, referred to the house and not the property and incorrectly named the taxpayer as the trustee of the family trust.

The Court stated that in order for there to be a valid creation of trust there must be certainty of intention, subject matter and beneficiary. The Court concluded that the taxpayer did intend the object property to be held on trust for the benefit of the family trust's beneficiaries and that as the declaration was not professionally drafted, the existence of technical errors was not surprising. The bona-fide intention to put the property under trust was supported by the fact that the sale proceeds were deposited into a bank account held by the trust. As a result the liability to capital gains tax rests with the family trust (and its beneficiaries) which has carry forward losses to apply against the gain.

Revised Regime for Taxation of MITs – Discussion Paper

Treasury has released a discussion paper on the design of the Government's proposed new tax system for Managed Investment Trusts (MITs), originally announced in the 2010-11 Federal Budget. The changes are proposed to apply from 1 July 2011. Key measures include:

- › Where the beneficiaries of the MIT have clearly defined rights or entitlements, the MIT may elect an 'attribution' system of tax
- › MITs will be able to deal with 'under' or 'over' distributions within a 5% cap so that they are not required to reissue distribution statements and investors are not required to revisit their tax returns

Taxpayer Alerts - Using an Unrelated Trust to Circumvent Division 7A or Superannuation Lending Restrictions, TA 2010/6 & TA 2010/5

These taxpayer alerts apply to two different aspects of legislation but involve the same basic features.

In TA 2010/6 the Tax Office is warning private companies who provide loans to shareholders whilst attempting to evade Division 7A.

The arrangement involves a private company investing in an unrelated trust set up by a scheme promoter. The trust then sources borrowers which may be shareholders in the investing company who borrow from the trust a similar amount to that which the private company invested in the trust. The borrowers make interest only repayments and the unrelated trust returns investment income to the company. Effectively the shareholder is borrowing from the private company via the unrelated trust.

Amongst the ATO's concerns include whether any borrowing or investment costs would be deductible and whether the arrangement is caught by Division 7A.

In TA 2010/5 the above transactions are the same but the parties involved are a self managed superannuation fund (SMSF) making loans to its members via the unrelated trust. The ATO's concerns include whether the SMSF breaches the Superannuation Industry (Supervision) Act 1993 for lending funds to its members or investing on non-arms length terms. The SMSF may be deriving non-arms length income which should be subject to a higher tax rate. Both schemes could be subject to Part IVA tax avoidance.

Non-resident Assessed as Trustee on Behalf of Non-resident Beneficiaries – Leighton v Commissioner of Taxation – Federal Court

In this case, a non-resident individual was engaged under contract to trade in Australian shares on behalf of 2 non-resident companies. Whilst an Australian bank account was opened in the individual's own name, the funds were ultimately paid to the non-resident companies under a custodian arrangement. The share trading from 2002 to 2004 generated substantial Australian sourced income. Neither the companies nor the individual lodged Australian tax returns.

The Commissioner assessed the non-resident individual for the Australian sourced income on the basis that the individual was a trustee in respect of income to which non-resident companies were beneficially entitled. The individual contended that the share trading was undertaken by the non-resident companies themselves, and therefore he was not liable to tax.

The Court found in favour of the Commissioner, holding that the individual was indeed a trustee. The individual was conducting the transactions at the direction of the companies and the funds were to be accounted for separately from his personal moneys which is consistent with a typical fiduciary obligation.

The Court did not reduce the penalties levied by the Commissioner due to, among other things, the individual's failure to provide information within a reasonable time frame as requested by the Tax Office during their audit.