

Trust Streaming in Doubt

Tax Office Approach to Bamford

The ATO has issued a Practice Statement and a Decision Impact Statement indicating the approach they will take in regards to trust assessments following the High Court's Bamford decision.

Amounts Assessed to Beneficiaries

The ATO states that the amount included in a beneficiary's assessable income from the trust distribution consists of an un-dissected proportionate share of the entirety of the taxable net income.

This means, for example, if a beneficiary is entitled to receive all the interest income of a trust, which consists of 30% of the distributable income of the trust, the beneficiary will be assessed on 30% of all the different classes of income derived by the trust for tax purposes. That is, they will be assessed on 30% of the interest income, as well as 30% of any other taxable income such as dividends, capital gains etc. If this is correct, this means that streaming of different classes of income would not be tax effective (see below).

Streaming and Capital Gains

Although the status of streaming is generally uncertain, the Commissioner has said he will keep the rulings and practice statements that allow streaming in place until 30 June 2010. This gives some protection for trust distributions for the 2009/2010 tax year. In particular, the Commissioner has foreshadowed changes will be made to the following:

- ▶ **Capital gain streaming** – Effective from 1 July 2010, the Commissioner will withdraw PS LA 2005/1 (GA) which allowed the streaming of capital gains to beneficiaries. This Practice Statement will still be valid for trust capital gains prior to 1 July 2010, unless there is a dispute in which case the Commissioner will apply the ATO view of the law.
- ▶ **Franking credit streaming** – The current ruling on franking credit streaming (TR 92/13) will be withdrawn effective from 1 July 2010. Taxpayers may rely on TR 92/13 until 30 June 2010 and earlier income years.

What is Income or Capital of a Trust?

- ▶ The Commissioner now accepts 'income of the trust estate' takes its meaning from general trust law concepts. For practical purposes, this means the trust deed can define the meaning of distributable income of the trust.

Compliance Action

The Commissioner recognises some taxpayers may have incorrectly lodged returns or administered trusts in view of the final Bamford decision and has announced the following:

- ▶ There should be no compliance activity to correct such errors if taxpayers have relied on a view of Division 6 that was reasonably open prior to the Bamford litigation.
- ▶ Compliance activities will occur if there is a deliberate attempt to exploit Division 6, or for other reasons, e.g. there is a dispute about the quantum of the taxable net income requiring adjustments. In such cases, adjustments will be made on the basis of the ATO's view on Bamford.

What Action Should Be Taken Now?

The decision highlights the importance of having a relevant and up to date definition of income in the trust deed. For example, does your trust deed:

- ▶ Have a definition of income that includes taxable capital gains;
- ▶ Provides the ability for the trustee to define capital gains as income (this is particularly important for deeds drafted before CGT was introduced); or
- ▶ Defines income of the trust to be the same as net income under section 97 of the ITAA 1936?

When drafting trust distribution minutes, you should ensure they comply with the terms of the deed. For example, if the trust deed defines income to be the same as section 97 net income, the accounts of the trust and the distribution minutes should be based on the taxable income of the trust and not based on accounting principles.

There are unresolved issues for trust distributions but PKF will be involved with the ATO consultation process and we will keep you informed of developments.

Ref: Commissioner of Taxation v Bamford [2010] HCA 10; PS LA 2010/1: Approach to cases involving Division 6 of the ITAA 1936; Decision Impact Statement: FCT v Phillip Bamford & Ors; Phillip Bamford & Anor v FCT

Division 7A Amendments

The amendments to Division 7A that were announced in the 2009/2010 Federal Budget have now passed into law. The key amendment is the extension of Division 7A to tax shareholders and their associates on the private use of assets owned by their private company.

Where the shareholder or associate uses an asset, the amount included in their income is the amount they would have had to pay (market value) for that use of the asset.

Where the shareholder or associate has exclusive access to the asset, they will be taxed on the market value they would have been required to pay to use the asset for the entire exclusivity period, irrespective of whether they use the asset.

The amendments apply from 1 July 2009. Many of the other amendments are technical amendments, and they include:

- ▶ Division 7A will apply to closely held limited partnerships.
- ▶ Withholding an amount from an employee's salary and offsetting it against a loan can be a repayment of the loan.
- ▶ Any amounts that result in a payment or a forgiveness of debt are recognised in the distributable surplus.
- ▶ Amounts included in the assessable income of a shareholder in an earlier year of income are reflected in the non-commercial loans of the distributable surplus.
- ▶ Division 7A will apply to arrangements involving a non-resident private company making a payment, loan or forgiveness of debt to a resident shareholder.

Ref: Tax Laws Amendment (2010 Measures No. 2) Bill

Undeclared Offshore Income – Concessional Treatment Ceases on 30 June 2010

As reported in PKF Tax Flash of December 2009, the ATO has announced a new offshore voluntary disclosure initiative (OVDI). Under the OVDI, the Commissioner is providing taxpayers with the opportunity to make a voluntary disclosure in relation to their undeclared offshore income and pay reduced penalties and interest.

The ATO has said this OVDI is the second and last opportunity for taxpayers to “fess up and pay up” before 30 June 2010 and is available to all taxpayers until 30 June 2010. The ATO has indicated that provided the taxpayer or their advisors have notified the ATO by 30 June 2010 that the taxpayer wants to make a disclosure, the ATO will accept that the disclosure will be made by 30 June 2010, provided the details are given to the ATO within a reasonable timeframe after 30 June 2010.

Examples of unreported offshore income include:

- ▶ A taxpayer changes their country of residence to Australia and once in Australia they do not realise they are taxable on income from the country they came from, or
- ▶ A taxpayer has investments in offshore funds or bank accounts with income accumulating overseas, and they do not realise that income may be taxable in Australia.

No Names Basis Enquiries

The updated OVDI allows people to approach the ATO anonymously for an indication as to whether an investigation will be undertaken to determine whether there is any potential breach of the criminal law.

In considering whether to investigate a matter, the ATO views favourably taxpayers who make a voluntary disclosure and cooperate with them or with law enforcement agencies.

Reduced Penalties for Coming Forward

If the taxpayer takes advantage of the OVDI and comes forward to voluntarily disclose offshore income that results in additional taxable income, the reduced shortfall penalties are as follows:

- ▶ If the taxpayer's additional taxable income is \$20,000 or less in a tax year, they will not need to pay a shortfall penalty for that year, or
- ▶ If the taxpayer's additional taxable income exceeds \$20,000 in any tax year, the shortfall penalty will be remitted to 10% of the additional tax for that year.

There will also be adjustments to the general interest charge (GIC) as follows:

- ▶ GIC will be reduced to nil for the tax years up to and including the 2002 tax year,
- ▶ GIC will be reduced to the base rate for the 2003 and 2004 tax years, and
- ▶ Shortfall interest charge applies for 2005 and later years at the normal rates.

What Must Taxpayers Do To Take Advantage of the OVDI?

To qualify for this concessional treatment taxpayers need to submit a voluntary disclosure in writing on the Offshore Voluntary Disclosure Statement, which is available from the Tax Office website.

Increased Tax Office Audit Activity

The ATO is increasing audit activities in cases where people may try to conceal income and assets offshore, particularly in low tax and bank secrecy jurisdictions. It is important for people to take early advantage of OVDI, as these benefits will not be available after notification of an audit.

The ATO has announced it is working closely with AUSTRAC, banks and other overseas tax jurisdictions to identify people with undeclared income, including those with highly complex and sophisticated arrangements. Further, the ATO is constantly expanding its ability to trace fund flows around the world and its capacity to identify Australians with income and assets hidden offshore.

The Australian Government has embarked on executing 'Tax Information Exchange Agreements' with various tax havens or low tax jurisdictions. To date, Australia has entered into over 20 of these, which obligate treaty partners to put into place legal and administrative frameworks to exchange information. Notably, information exchange cannot be hampered by

restrictions such as bank secrecy laws, or limited to exchanging information which is only required for domestic tax administration.

The Tax Office may commence a tax review and/or full audit if it is established the taxpayer has not made a full and true disclosure. If additional shortfall amounts are discovered which were not originally disclosed by 30 June 2010, the Tax Office may withdraw all of the benefits and impose full base penalties and interest charges, and refer the case file for criminal prosecution. The taxpayer would already be on the 'back foot' in any possible criminal prosecution because they have made a false and misleading statement, which would not be viewed favourably by the Criminal Courts who have the power to impose a custodial sentence. Taxpayers may also expose themselves to possible charges under the Crimes Act and/or anti money laundering laws.

Henry Review – a work in progress

The Government has released the Henry Committee's report that contains 138 recommendations for changes to our Tax System. The proposals that apply to small business include:

- ▶ *Company Income Tax Rate* - the company income tax rate should be reduced to 25%. The Government has proposed the company tax rate be reduced as follows:

	Other company	Small business
2011-12	30%	30%
2012-13	30%	28%
2013-14	29%	28%
2014-15	28%	28%

- ▶ Capital Allowances
 - (a) depreciating assets costing less than \$5,000 to be immediately written-off. The Government has announced it will allow a write off for assets costing less than \$5,000 from 1 July 2012; and
 - (b) all other depreciating assets valued at \$5,000 or more (except buildings) to be pooled (the Government has accepted a single pool with a 30% DV rate from 1 July 2012).

- ▶ *Increase to Small Business Threshold* – The small business entity turnover threshold should be increased from \$2 million to \$5 million, and adjustments to the \$6 million net asset value test should be considered. The Government has not commented on this.
- ▶ *Carry back Losses* – Companies should be allowed to carry back a revenue loss to offset it against the prior year's taxable income. The Government has not commented on this.
- ▶ *Trust rules to be rewritten* – The current trust rules should be updated and rewritten to reduce complexity and uncertainty around their application. The Government has not commented on this.
- ▶ *Introduce flow through taxation for closely held companies* – A flow-through entity regime for closely held companies and fixed trusts should be considered in the future. The Government has not commented on this.
- ▶ *Amend tax arrangements for clubs* – Simple tax arrangements should be established for clubs with large trading activities in the fields of gaming, catering, entertainment and hospitality. This has been rejected by the Government.
- ▶ *Amendments to Fringe Benefits Tax* - Fringe benefits that are readily valued and attributable to individual employees should be taxed in the hands of employees through the PAYG system. Other benefits, including those incidental to an individual's employment, should remain taxed to employers at the top marginal rate.

In addition, the formula for valuing car fringe benefits should be replaced with a single statutory rate of 20%, regardless of the kilometres travelled. The Government has not commented on these recommendations.

- ▶ Rationalising and streamlining the current small business capital gains tax concessions by:
 - removing the active asset 50% reduction and 15-year exemption concessions;
 - increasing the retirement exemption by aligning it with the cap for contributions to a super fund; and
 - allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test.

The Government has not commented on these.

- ▶ Removing the pre-CGT status of assets acquired before 19 September 1985 - This has been rejected by the Government.

Payments by direction

This case involved a taxpayer and her spouse who were shareholders in a private company. The company had debtors in the US who were directed by the taxpayer to pay the amounts they owed into the individuals' private bank account.

The Court held the payments should be treated as Division 7A dividends. The Court considered a shareholder directing an amount be paid into their personal bank account was a payment from the private company for Division 7A purposes.

Ref: FCT v Rozman [2010] FCA 324

Trailer park not an active asset

This case involved a company that owned and operated a mobile home park. It made a capital gain on the sale of the park, which it reduced under the small business CGT concessions.

The argument was whether the park was an active asset. The land was used in the business; however, it could have been excluded from the concessions because the land was being used to derive rental income.

The Tribunal found that the land was being used to derive rental income. To reach this conclusion, the tenancy agreements between the company and its tenants were reviewed.

In the case of this park, the tenants were long-term residents, not short-term holiday stays. Under the terms of the agreements, the tenants had a right of exclusive occupation of their part of the land. The Tribunal found this constituted a rental agreement, thus excluding the land from the concessions.

The decision appears to turn on whether the tenant has the right of exclusive occupation. Not all agreements grant the tenant the right of exclusive occupation. In cases where this is not the case, the income derived from the land may not be rent, for example a tourist caravan park or boarding house. Where that land is used in a business, it may therefore be an active asset.

Ref: Tingari Village North Pty Ltd v Commissioner of Taxation [2010] ATAA 233

Special income of Super Funds

Under the superannuation rules, special income is taxed at the rate of 45% (rather than 15%). Special income includes income derived from related parties under an arrangement where the fund receives a preferential allocation of the income.

This was the issue considered in this case. The fund acquired an interest in a private company, which, in turn, held an interest in a listed company. The private company shares were acquired from a related party at less than 10% of their value.

The listed company paid dividends each year, which were then paid *pari passu* to each shareholder in the private company (including the super fund). The fund argued the dividend was not special income, as it had not been paid preferentially to the fund.

The Tax Office argued special income not only applies to situations where income is preferentially allocated to a super fund. It also applies to income that is the product of the preferential allocation of income producing assets to a super fund (as occurred in this case). The Tribunal accepted the Tax Office's argument that the income was special income.

Ref: Darrelen v Comm. of Taxation [2010] FCAFC 35

Accountant's concession

Under this concession, the Tax Office will generally not use their powers to access certain categories of documents, including advices prepared by external accounting advisors. However, in exceptional circumstances, the Tax Office reserves the right to access accountants' workpapers.

In a recent case, an adviser unsuccessfully tried to invoke this concession to prevent the Tax Office from

accessing their workpapers. These had come into the Tax Office's possession following activities carried out by the Australian Crime Commission under a Wickenby warrant.

The Court found the Tax Office was entitled to access the documents, especially as the concession was not a rule of law, and given that the Crime Commission was not bound by the concession. Furthermore, the Court found the concession could not operate to prevent the Tax Office discharging their public duties under the income tax legislation.

Ref: Stewart v Commissioner of Taxation [2010] FCA 402

Disability policy income

The taxpayer was a financial planner conducting business as a sole trader. In 1996, he became ill and made a claim for disability payments under his professional income protection policy. He began receiving payments from that policy to cover lost income because he was working at a reduced capacity because of his illness.

The financial planning business incurred losses for a number of years because of his reduced capacity. He sought to offset his 2004 business losses against the policy income.

The Court held the losses could not be offset against the income from the insurance policy because it was not related to the taxpayer's 2004 business activities. Instead, the policy income was received because he had been incapacitated since 1996. It was derived from his inability to conduct the full range of his business activities, not from the activity.

The losses were therefore quarantined under the non-commercial loss provisions, to be offset only against income derived from that business.

Ref: Watson v Commissioner of Taxation [2010] FCAFC 1

Should you require assistance additional information, **contact your PKF tax adviser** or:

Lance Cunningham | Director of Taxation
02 9240 9736 | lance_cunningham@pkf.com.au
Level 10, 1 Margaret Street | Sydney | New South Wales 2000 | Australia

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