

## Carry-forward Losses and The Same Business Test

In general, winding down of a business, or holding a business in suspense would not cause the taxpayer to fail the Same Business Test. However, in a recent case, the Court held that a mining company who were winding down their affairs after they sold their joint venture business did not satisfy the Same Business Test, therefore, could not access the carry-forward losses.

### When does a business cease to exist?

In this case, the taxpayer was a mining company which owned an interest in a mining joint venture. The company had previously breached the Continuity of Ownership Test, and was relying on the Same Business Test to enable it to access carried forward income tax losses. In the year in question, the company sold its interest in the joint venture and devoted the rest of the year to paying off its debts.

The Court held, in this instance, the company had ceased business by way of sale. There was no organic winding down period. The act of the sale of the entire business meant the company was no longer in business. The company therefore failed the Same Business Test.

Reference: Re Coal Development Pty Ltd V FTC

## Tax Consolidation - Making the Right Accounting Decisions

The first Tax Case dealing with Tax Consolidation has recently been heard. The case dealt with how the accounting standards used by a company can affect the Allocable Cost Amount (ACA) calculations for tax consolidation.

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### Allocable Cost Amount (ACA) Calculations

ACA calculations are required either at formation of a tax consolidated group or when a subsidiary joins a consolidated group. In this case, the Court considered a particular step of the ACA calculation which relied on the company's financial statements at joining time. The particular issue was whether a company could retrospectively apply a different accounting standard after it had elected another for producing its financial statements at joining time. The conclusion of the Court was that the company was not permitted to alter its choice of the accounting standard for the purpose of the ACA calculation, notwithstanding it would have produced a much better result in terms of the overall allocable cost.

The Court ruled that the *Tax Act* does not allow companies to cherry pick which accounting standard to use for the purpose of ACA calculations. Once a standard is chosen for the company's accounts, it cannot be altered for tax purposes.

The Court's decision is a caution to companies that have or are planning to consolidate. It highlights the importance of making the right decisions in accounting as they may affect tax consolidation opportunities.

Reference: Re Envestra Limited V FCT

## Deductibility of Interest Expense

Interest is generally deductible because, usually, it is a recurrent expense for securing a loan used by the borrower for the purpose of deriving assessable income. Nevertheless, in a recent tax case the Federal Court held that interest payments on a debenture from a conduit set up for capital raising purposes were not deductible.

### Substance over Form

In this case, the taxpayer was the St. George bank (SGB). In order to satisfy the capital requirements set by the Reserve Bank of Australia (RBA), SGB established a company (LLC) and raised substantial capital through LLC. The capital raised was subsequently deployed to SGB in the form of a debenture on which SGB paid interest and sought to claim a deduction for the interest payments.

The Court held that the payments on the debenture by SGB to LLC were, in substance, part of an overall arrangement for capital raising and they were intended commercially only to fund LLC's dividends to its capital securities holders. In this instance, LLC was used as a special purpose vehicle for raising and maintaining the capital base for SGB and its group.

On this basis, the Court held the interest payments were of a capital nature and therefore not deductible.

Reference: Re St. George Bank Ltd V FCT

## Corporate Limited Partnership must carry on business

The Australian Tax Office (ATO) considers, in a draft ruling that in order for a limited partnership to be treated as a corporate limited partnership the partnership must be carrying on business. If the partnership is only a passive investor, the

ATO considers that it cannot be a corporate limited partnership.

Corporate limited partnerships have become an important structuring vehicle. Some of the issues that will be relevant if the ATO's position is sustained include:

- Net income of the limited partnership will be assessed directly to the partners;
- The partnership will be ineligible to be the head company of a consolidated group;
- The partnership will not receive exemption on foreign dividends or exemption on foreign branch income;
- Loans made to the partnership by a private company may be subject to Division 7A deemed dividend rules.

Reference: TD 2008/D1

## Tax consequences for issuing shares for assets

A relatively straightforward transaction involving issuing shares for the purchase of business assets has been complicated by the ATO's views expressed in a draft ruling.

The draft ruling gives examples of two ways to conduct such a purchase. One is by issuing shares as straight consideration for the assets. The other is by issuing shares to set-off the liability arising from the purchase of the assets. Depending on which way the company chooses to conduct the purchase, the tax costs for the assets can vary.

### Two Ways to Skin the Cat

The tax costs of revenue assets acquired are critical in determining deductions for tax depreciation and cost of goods sold. The tax cost of a CGT asset will determine the cost base of the asset. Hence, before embarking on a purchase of assets by issuing shares, it would be prudent for the company to consider the tax consequences on such purchase as there are two ways to "skin the cat".

Reference: TR 2008/D1

## Selecting Transfer Pricing Methodologies in the absence of a free market

Companies that transact with international related parties often face the challenge of adopting appropriate transfer pricing methodologies. The selection of an appropriate methodology is even more difficult when there is no free market for the products or services concerned.

In a unique case before the Administrative Appeals Tribunal (the Tribunal), the taxpayer, an international pharmaceutical company (Roche), argued that the tax assessments by the Commissioner resulting from the transfer pricing adjustments were excessive. The Tribunal, in assessing this case, was confronted by a rather difficult situation where there was no free market for Roche's products and services.

This problem is typical to the pharmaceutical industry as pharmaceutical companies rarely sell their products through third parties. This means, there is generally no free market for pharmaceutical products, not even comparable products. This poses immense difficulties in establishing a benchmark for arm's length sales for the purpose of transfer pricing.

### Substantiation is the Key

Despite the inherent difficulties in selecting appropriate transfer pricing methodologies, Roche was able to persuade the Tribunal to prefer their methodologies to those adopted by the ATO. In particular, Roche was able to prove that losses incurred in one particular division were caused by economic conditions not by transfer pricing arrangements. To substantiate the methodologies employed, Roche produced strong evidence including historical third party sales.

The result of this case has further reinforced the importance of retention of documentation and records that substantiate the selection of transfer pricing methodologies.

Reference: Re Roche Products AATA 261

## Transfer Pricing and Subscription of Securities

When subscribing to securities issued by a non-resident related company, care must be taken to ensure the parties are dealing with each other at arm's length, particularly, in deciding the interest return on the securities. If the interest return is decided on a non-arm's length basis, the Commissioner can adjust the interest income of the Australian taxpayer by increasing it to the level that reflects an arm's length transaction.

In a recent draft ruling, the ATO asserts its view that the Commissioner has the power to adjust interest income even when the securities subscribed by the Australian taxpayer are categorised as "equity" rather than "debt" under the tax "debt/equity rules".

An alternative view on this issue is that if the securities subscribed are in fact an equity interest, the return on the securities will be a dividend and not interest income. Following this logic, the Commissioner's discretion to adjust interest income would be inappropriate in this situation.

The above view is rejected by the ATO. However, further comments are invited.

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Reference: TD 2008/D3

## Federal Budget Announcements

### Tax Consolidation

In the recent Federal Budget the Government has listed numerous tax consolidation amendments that it has agreed to enact, some of which are listed below:

- ensure that, if an entity joins a consolidated group with a nil available fraction and transfers losses to the group, the capital gain that arises under CGT event L5 when the entity leaves the group is reduced in certain circumstances;
- ensure that, subject to certain integrity rules, consolidated groups can convert to multiple entry consolidated groups (MEC groups), and vice versa, with minimal tax consequences;
- change the tax cost setting rules so that units held in a cash management trust that have a market value equal to their face value are retained cost base assets;
- for the period between 1 July 2002 and 8 May 2007, ensure CGT event L7 will not apply to amounts that are recognised under another provision of the income tax law and, with effect from 8 May 2007, repeal CGT event L7;
- allow the head company of a consolidated group to reduce a capital gain arising under CGT event L3 by the value of doubtful debts held by a joining entity at the joining time - this change will apply from 8 May 2007;
- extend the single entity rule to shareholders who dispose of shares in the head company of a consolidated group, for the purposes of the CGT discount rules and CGT event K6 - this change will apply from 8 May 2007.

### Scrip for Scrip Roll-Over for Corporate Restructures

The scrip for scrip CGT roll-over provisions will be modified to ensure that, for corporate restructures, an acquiring entity's CGT cost base of shares in a target entity reflects the tax cost of the target entity's net assets. This will apply with effect for arrangements entered into after 7.30pm EST on 13 May 2008.

This cost base will also be used in order to establish the tax cost setting amounts of the target entity's assets if the target

entity subsequently joins the acquiring entity's tax consolidated group.

Under the current regime, the acquiring entity obtains a market value cost base for the shares that it acquires in the target entity. The Government is concerned that this can result in significant unintended tax benefits arising if the target entity subsequently joins the acquiring entity's consolidated group.

## Depreciation of Computer Software

The statutory effective life of in-house computer software for tax depreciation purposes will be increased from two and a half to four years for expenditure incurred on or after 7.30pm EST on 13 May 2008. This means a depreciation rate of 25% on a straight line basis rather than the previous 40% rate.

In-house software is computer software, or the right to use computer software, that is acquired, developed internally or developed by someone else, and is mainly used by the taxpayer in performing the functions for which the software was developed i.e. used as a business tool rather than developed for sale.

## Cancellation of Interests in Widely Held Entities

With effect from the 2006-2007 income year, taxpayers will be permitted to calculate their capital gains or losses using the actual proceeds received when shares or units in widely held entities are cancelled or surrendered.

Under the current tax law, when shares or units in widely held entities are cancelled, surrendered or similarly brought to an end, a taxpayer is required to calculate any capital gains tax liability using the shares' or units' market value just before the event, rather than the proceeds they actually receive.

## Taxation of Financial Arrangements

The Government has confirmed that they will introduce draft legislation for the 3rd and 4th stages of the Taxation of Financial Arrangements (TOFA) amendments. These proposed amendments significantly change the way in which many financial arrangements would be taxed, including allowing taxpayers to apply the relevant accounting standards to measure gains and losses on a variety of securities.

The TOFA amendments will have effect from 1 July 2009, with an elective commencement date of 1 July 2008.

## Distributions from Managed Funds

The Government announced changes to the withholding tax rates applicable to distributions, other than dividends, interest and royalties, from managed investment funds to non-residents.

The current rate of withholding on these distributions is 30%. This is a non-final tax so the taxpayer can also lodge a tax return to claim deductions for relevant expenses.

For residents of countries which have effective exchange of information arrangements with Australia on tax matters, the changes to the withholding tax will be brought in over three years from the year after the amendments receive Royal Assent. In the first year of the new scheme the rate will be reduced to 22.5% non-final withholding tax (can claim expenses by lodging a tax return). In the second year the rate will reduce to 15% but it will become a final withholding tax i.e. no ability to claim expenses. In the third year the rate will further reduce to 7.5% final withholding tax.

For residents of countries that do not have effective exchange of information arrangements with Australia on tax matters, withholding tax payable on those distributions will continue at the rate of 30% but it will become a final withholding tax. This will become effect from the first year after the amendments gain Royal Assent.

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

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