Corporate Tax Essentials

Chartered Accountants
& Business Advisers

April 2011

Capital Loss on Intercompany Loans

In a recent case, the Tribunal disallowed capital losses on the forgiveness of intercompany loans between related companies. In this case, the taxpayer and another entity were wholly owned subsidiaries of the same parent company.

The taxpayer merged with the other company's business, resulting in the taxpayer acquiring the assets and liabilities of the other company at their book values as recorded in that company's accounts. The liabilities exceeded the values of the assets.

The other company owed the taxpayer a pre-existing intercompany balance for expenses and outgoings paid by the taxpayer on the other company's behalf. In addition, a transfer debt reflecting the amount by which the liabilities assumed by the taxpayer exceeded the book value of the assets transferred.

The transfer was not completed along the lines that might be expected between independent parties. This included the assets having been transferred at book value, rather than by formal valuation, the lack of transfer documentation and the absence of directors' minutes for the transfer.

The taxpayer subsequently released the debts and years later that company was deregistered without the loans being repaid. The taxpayer claimed a capital loss of $2,651,673 reflecting the value of the loans.

It was held the transfer debt came into existence upon the transfer of the assets and liabilities to the taxpayer. As the definition of a CGT asset includes any kind of property *and a legal or equitable right that is not property*, the Tribunal found the intercompany balance and transfer debts met the CGT asset definition.

The Tribunal found the companies did not maintain an arm's length relationship in relation to the transfers. Not only did the conduct of the transfer indicate this, but the Tribunal also commented that an arm's length party would not have lent money to the other company in its circumstances.

It therefore followed the market value substitution rule applied to the loans. The Tribunal considered the other company was not capable of repaying the debts when they arose, and therefore they had no value. On this basis, the cost base of the debts was nil, and no capital loss arose when the debts were released.

The Tribunal reached this conclusion by considering that, in return for assuming the liabilities, the taxpayer received assets (including goodwill) of lower value than the debts. In addition , the taxpayer acquired a debt payable to it by the other company when that other company no longer held assets and had no immediate capacity to repay the debts.

PKF Comment

This case highlights the need to identify arm's length values when forgiving debts between related entities. In making this finding, the Tribunal also made the comment that parties who do not have an arm's length relationship can deal with each other at arm's length on a transaction, especially in relation to CGT assets and intercompany debts.

In the context of intercompany loans, it would be possible for related parties to establish a value for their intercompany loans. Where the borrower is solvent, has positive assets and a capacity to repay, the loan should have a face value cost base.

However, it may also be possible to show that a loan has been made at arm's length by showing the loan is on the same terms as an arm's length party would make. This would include the term of the loan, the interest rate, the security over the loan, and most importantly, the quantum of the loan. Please note, there is an expectation that non-arm's length parties would advance greater sums than an arm's length party.

Ref: QFL Photographics and Commissioner of Taxation

Green Buildings

The Federal Government has released a consultation paper on a proposal to provide a 50% bonus deduction for taxpayers who incur costs in improving the energy efficiency of their existing buildings over a four year period from 1 July 2011.

Buildings that would qualify for this bonus deduction are:

- Office buildings;
- Hotels; and
- Shopping centres.

Some of the issues in the Consultation Paper include:

- The deduction is only available for expenditure on the retro-fitting of existing buildings. Costs of constructing new buildings will not qualify.
- The increase in energy efficiency has to be assessed by assessors accredited under the National Australian Built Environment Rating System (NABERS). This must be made before the project starts and after it is completed.
- Qualifying expenditure is capital expenditure and certain other expenditure resulting in the energy efficiency rating of the building improving from 2 star or less to 4 star or greater (NABERS energy efficiency rating).
- Qualifying expenditure can only be incurred (contracts entered into) after the taxpayer's application has been assessed by a NABERS assessor and notification of approval has been given to the applicant.
- The expenditure must be incurred by the completion time initially proposed in the application, but no later than 30 June 2015. A grace period of up to six months may apply if the delay is caused by factors outside the applicant's control.
- The 50% bonus deduction will be provided only when the project has been completed and the Department of Climate Change has issued a certificate of entitlement to the deduction.
- The total cost of this initiative will be capped at $1 billion - allocations will either be made on a first come first served basis or a competitive approach to approving applications. Under the competitive approach, an assessment of each application based on criteria to identify those projects with a greater improvement in energy efficiency will be given priority.
- There may be caps on expenditure per project (such as a per room cost limit for hotels) or a set maximum per $/m^2 floorspace.
- There will be a compliance regime to ensure a fair and accurate assessment and certification process as well as to prevent inappropriate and fraudulent claims.

Private Equity Determinations

The Tax Office has issued several draft determinations targeting the profits made by non-resident private equity investors on realising their investment in Australia.

Source of Income

This draft states Australian source is not dependent solely on where the sale and purchase contracts are executed. Instead, source is determined by having regard to all the facts of the particular case.

Source of the Profits

The draft states all the facts of the particular case must be taken into account in determining the source - the relative weight to be given to each element will be a question of fact in every case. However, the key factors increasing or impacting on the profit are:

- The business ability in assessing suitable target enterprises;
- Making operational improvements; and
- The steps involved in the acquisition of the business (such as arranging finance).

Where these activities are undertaken in Australia, the source of the profits will be Australia. The execution of the contracts are simply the acts which crystallise the return and do not affect the return on investment.

Part IVA

In some cases, taxpayers may plan to ensure profits arising from the sale of private equity investments are not sourced in Australia. If the taxpayer has structured the arrangements in such a way, the Commissioner will consider whether the Part IVA may apply.

Draft Taxation Determination TD 2010/D7

Business Profits Article

This draft states that the business profits article of Australia's tax treaties will apply to Australian sourced business profits of a foreign limited liability partnership (LLP) where the partners are residents of a treaty country and where the LLP is treated as fiscally transparent in the country of residence.

The business profits article provides that Australia may impose tax on the profits of an enterprise of another country only where those profits are attributable to a permanent establishment in Australia.

In the case of LLP investors, an issue may arise where it is the partners who are taxed on the profits rather than the LLP itself - this may occur where the foreign jurisdiction treats the LLP as fiscally transparent so that the partners are liable to be taxed on the income in their own hands.

The Tax Office considers that profits of an enterprise, that have flowed through a transparent partnership to its partners, are to be treated as income of the partners and not income of the partnership.

Thus, to the extent the business profits of the LLP are liable to tax in the hands of the partners in their country of residence, the Tax Office will provide treaty benefits to each of the partners of the LLP where the Tax Office is satisfied each of the partners of the LLP is a resident of a country with which Australia has a tax treaty.

This will also be the case where the LLP is organised in a non-treaty country, the LLP is treated as fiscally transparent in, and the partners themselves reside in, a treaty country with which we have a tax treaty.

Where it is not possible to establish the residence of the partners to the satisfaction of the Tax Office, the income derived by the LLP will be assessable in Australia in the hands of the LLP itself.

Ref: Draft Taxation Determination TD 2010/D8

Application of Part IVA to Treaty Shopping

In this determination, the Tax Office considers Part IVA can apply to schemes designed to alter the effect of Australia's tax treaty network.

Limited Liability Partnerships

The determination addresses LLPs located in countries where the relevant treaty designates the partnership as fiscally transparent.

Where the partners are residents of a treaty country which treats the partnership as fiscally transparent, treaty benefits will be afforded to partners where their residence can be verified and where they are eligible for treaty benefits.

Where the entity that acquires the Australian target company has a complex structure interposed between it and the Australian investment, for example an entity in the Cayman Islands, this may breach Part IVA as there is no commercial reason for using intermediaries. The insertion of interposed entities into the holding structure can only be explained by reason of the tax benefits that flow from the structure.

Ref: Taxation Determination TD 2010/20

Profit from Share Sale - Leveraged Buyout

This determination states profits from the disposal of shares acquired in a leveraged buyout (LBO) may be included in the assessable income of the vendor as ordinary income under Section 6-5 of the 1997 Act.

Where the private equity fund is resident in a treaty country, the business profits article will determine which country has the right to tax the income where it is ordinary income - this will generally be the country of residence of the private equity fund.

Accordingly, private equity funds resident in treaty countries will not generally be subject to Australian income tax on their Australian sourced business profits, subject to the position of the Tax Office in TD 2010/20, unless the profit is derived through a PE in Australia.

Private equity funds resident in non-treaty countries may be subject to Australian tax where the shares were acquired with the purpose of profit-making by sale (ordinary income for the purposes of Section 6-5).

If the profit is a capital gain, it is generally disregarded for Australian tax purposes if made by a non-resident.

The result may be different if the investing entity is a LLP. In these circumstances, the treatment may be determined according to the Tax Office's position in TD 2010/D8.

Ref: Taxation Determination TD 2010/21

CFC Exposure Draft

Treasury has released an exposure draft of the proposed changes to the CFC accruals taxation rules. These reforms were announced in the 2009-10 Budget as part of wider reforms to Australia's foreign source income anti-tax deferral attribution rules.

The changes are designed to reduce CFC compliance costs, encourage foreign-based companies to establish regional headquarters in Australia, and make Australian businesses with foreign operations more competitive.

However, the amendments still need to be finailsed and currently there is no start date for the both the CFC and Foreign Accumulation Fund (FAF) rules.

Changes to CFC rules so far

The proposed changes introduced by the draft CFC legislation include:

- Updating the definitions of active and passive income.
- The 5% de minimus ‘active income test’ will be retained.
- All sales and service income will be exempt from attribution (subject to an anti avoidance rule for passive income received from Australian associates).
- Only the controller, and their associates, of a CFC will be subject to the rules.
- Intra CFC group transactions will generally be exempt from attributable.
- Rental income will no longer be attributable.
- Royalties not originated from Australia will be treated as active.
- Base company income rules will be removed.
- Existing ‘listed country’ and ‘AFI subsidiary’ exemptions will be retained.
- Complying super fund and life insurance companies will be exempt from the CFC rules.
- Access to dividend exemptions will be increased and double taxation of previously attributed income will be prevented.
- Dividend exemptions will be denied where they are paid in respect of debt interests.
- A new FAF rule will apply to resident investors that hold an interest in a FAF at the end of the FAF’s accounting year.
- A choice of attribution methods will apply.

Mining Tax

The Federal Government announced it has accepted all of the recommendations of the Committee which reviewed the proposed Mining Resources Rent Tax (MRRT)

Overall, the Committee made 94 recommendations - 67 relating to the MRRT and 27 relating to the extension of the Petroleum Resources Rent Tax (PRRT) to the North West shelf projects and to coal seam gas producers.

The report of the Committee managed to avoid the radar of many practitioners, having been released on 21 December 2010. However, the recommendations essentially give effect to many of the concerns of the mining community.

The key recommendations in the report include:

- All state and territory mining royalties (both current and future) may be credited against the mining taxes payable by the miner - it was further recommended that state and territory governments be pressured not to increase their royalties.
- The threshold for qualifying miners has been confirmed at $50 million of qualifying profits, with a phase in of the tax payable on profits between $50 million and $100 million.
- There were a significant number of recommendations relating to the administration of the new system. One of the key recommendations was that smaller producers not liable to the tax, because they are under the $50 million threshold, be given a simplified compliance scheme until they become liable to pay the tax.
- There were recommendations for determining an alternative taxing point, dependent upon the mode of sale - after leaving the ROM stockpile, the first point after extraction or sale to a third party.
- There were also recommendations on determining the taxable value of minerals extracted, including a safe harbour determination for non-arm's length supplies.
- There were extended definitions of "project", including scope of linking associated projects, and scope for consolidating companies that are members of a consolidated income tax group.

Should you require assistance or 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

PKF Australia Limited is a national network of legally independent member firms that trade as PKF. Member Firms of PKF Australia Limited have offices in ACT, NSW, QLD, SA, TAS, VIC and WA.

Member Firms of PKF Australia Limited, are also Member Firms of the PKF International Limited network of legally independent firms. Neither PKF Australia Limited nor its member firms accept responsibility or liability for the actions or inactions on the part of any member firm or firms of PKF Australia Limited or of PKF International Limited.

Disclaimer: The material contained in this publication is in the nature of general comment and information only and neither purports, nor is intended, to be advice on any particular matter. Readers should not act or rely upon any matter or information contained in or implied by this publication without taking appropriate professional advice. All financial figures are quoted in Australian Dollars unless otherwise indicated.