

Corporate Tax Essentials

PKF

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What is a non-recourse loan?

The saga of bad debt deductions on intercompany loans involving BHP has ended in the High Court. In the lower courts, the Tax Office sought to deny bad debt deductions on loans made by the group's internal financier to special purpose companies.

The special purpose companies invested the borrowed amounts in projects which subsequently failed and were only able to repay (on the loan) the salvage value of the respective projects. In each instance, the court agreed that the financier was entitled to claim a bad debt deduction on the amounts lost.

In the High Court, the Tax Office sought to deny capital allowances on plant constructed using money financed by the loans on the basis of Division 243. This division operates to reduce capital allowances on plant funded by limited recourse debt that is not fully repaid.

The definition of limited recourse debt in Division 243 is extensive and it essentially operates to treat any borrowing as limited recourse debt:

- where the rights of the creditor in default are limited to the value of assets purchased by the borrowing (or the product of those assets); or
- where it is reasonable to conclude the rights of the creditor in default will be limited having regard to (among other things) the non-arm's length nature of the debtor and creditor.

The court was concerned with determining whether the rights of the creditor were capable of being limited.

While this is achieved in the loan agreement, the Tax Office argued limited recourse loans may arise where the borrower owns no other assets (other than those pledged for the loan). The loans in the case of BHP were limited recourse because the lender had recourse only to the assets purchased using the loans. As the value of the assets did not cover the loans, the creditor had no other recourse to collect the balance.

The taxpayers countered with the argument that the loan should be assessed at the time it is made, and not later when the rights of the creditor may be limited by the success or failure of the borrower.

The court accepted the taxpayers' arguments, stating the non-recourse nature of the loan is assessed at the inception of the loan. In the case of BHP, there was no effective limitation on the ability of the creditor to make a claim under the loan at its inception.

Ref: Commissioner of Taxation v BHP Billiton [2011] HC 17

Reform of car fringe benefits rules

The government has introduced a bill to amend the fringe benefits tax (FBT) legislation to reform the statutory formula method for determining the taxable value of car fringe benefits by replacing the current statutory rates with a single rate of 20%, regardless of kilometres travelled.

Application date

The change applies to car benefits after 10 May 2011, except where an employee, employer or their associate has committed to the acquisition of the car that will be the subject of a car benefit (for a specified period of time) prior to 10 May 2011.

Changes for new contracts will be phased in over four years unless an employer elects to skip the transitional arrangements. The general intent of the transitional arrangements is to leave employers and employees who have pre-existing contracts under the old arrangements.

All benefits will be covered by the new rules unless it can be proved that an agreement committing to the transaction was in place prior to 10 May 2011. The car does not need to have been delivered by 10 May 2011, but the arrangement needs to be financially binding.

Changes made to pre-existing commitments, such as re-financing, altering the length of an existing contract or changing employers, are new commitments and will be subject to the new arrangements.

If the new rules begin to apply part way through a year (a change in commitment), the law changes will commence from the beginning of the next FBT year.

Employers and employees who seek to end existing contracts early and immediately enter into new contracts to get the benefit of new arrangements may be caught by the general anti-avoidance provisions.

	Existing Cars	New cars purchased After 10 May 2011			
		From 10 May 2011	From 1 April 2012	From 1 April 2013	From 1 April 2014
0 - 15,000 km	0.26	0.20	0.20	0.20	0.20
15,001 - 25,000 km	0.20	0.20	0.20	0.20	0.20
25,001 - 40,000 km	0.11	0.14	0.17	0.20	0.20
More than 40,000 km	0.07	0.10	0.13	0.17	0.20

Ref: Tax Laws Amendment (2011 Measures No. 5) Bill 2011

The carbon tax

The Federal Government has introduced legislation for the carbon tax. It will take effect from 1 July 2012, levied on Australia's top 500 polluters, which will be required to purchase permits from the government. The government will cap the number of permits it will issue each year. Some will be provided free with the balance sold at auction. These will be transferable and may be sold.

The price is fixed at \$23 per tonne, increased to \$24.15 on 1 July 2013, and \$25.40 on 1 July 2014. The tax reverts to a floating price from 1 July 2015. A price ceiling and floor will manage price volatility. There will be compensation and assistance provided to low income households and selected affected industries.

We have released a *Tax Flash* which considers these issues in greater detail. You can access a copy of our July *Tax Flash* entitled A Carbon Tax - Looming on the Horizon on our website.

Non-compliance with PAYG and SGC

The government is proposing to tighten the rules which make company directors liable to pay the company's unpaid pay as you go (PAYG) withholding liability by:

- extending the director penalty regime beyond its current application to PAYG withholding to make directors personally liable for their company's unpaid superannuation guarantee amounts;
- allowing the Tax Office to immediately commence recovery of all director penalties when the company's unpaid liability remains unpaid and unreported three months after the due day; and
- providing the Commissioner with the discretion to prevent directors and, in some instances their associates, from obtaining PAYG withholding credits

where the company has failed to pay amounts withheld to the Commissioner.

These represent a significant extension of the director's personal liability. Company directors must be vigilant to ensure their company's PAYG withholding and superannuation guarantee charge (SGC) liabilities have been paid in a timely manner.

Ref: Tax Laws Amendment (2011 Measures No. 7) Bill 2011

Franking and new corporations law dividend rules

Under amendments to the Corporations Law, dividends can be paid out of amounts other than profits where the company's assets exceed its liabilities and the payment is fair and reasonable to the shareholders and does not prejudice the company's ability to pay its debts.

For income tax purposes, Section 44 was amended to provide amounts paid out of amounts other than profits are taken to be a dividend paid out of profits. However, a payment sourced against the share capital account falls outside of the definition of dividend.

Where the journal to give effect to the dividend involves a debit against the share capital account, the payment will not be a dividend to the extent it reflects that debit. Debits against current and retained profits and asset revaluation reserves are acceptable.

The Tax Office then considers the result of debits going against accounts other than profits, retained profits or revaluation reserves. They consider that where the debit is against other accounts, and these effectively result in a reduction of share capital, the payment would be sourced indirectly from share capital and the payment would not be a dividend.

There are a number of examples in the factsheets, and you should refer to these where you are intending to use the new dividend rules. The factsheets can be accessed through the Tax Office website.

Example (taken from Tax Office Factsheet)

Company D has the following balance sheet:

<i>Assets and Liabilities</i>	<i>Equity</i>
Cash 30	Share capital 150
Property 120	Retained earnings 0
Net assets 150	Total equity 150

The company declares a dividend of \$100 pursuant to section 254T of the *Corporations Act 2001*.

To effect the dividend payment Company D:

Dr Retained profits (accumulated losses) 100
Cr Cash 100

In essence, the only 'source' of the dividend payment is the share capital account. The balance sheet post dividend distribution will be as follows:

<i>Assets and Liabilities</i>	<i>Equity</i>
Cash (70)	Share capital 150
Property 120	Accum. Losses (100)
Net assets 50	Total equity 50

Company D can only source its dividend payment from the share capital account, irrespective of where the debit arose. Even where companies argue that there is no requirement to 'net off' equity accounts, the principles provide that the source of the distribution is the share capital account, irrespective of the form.

Taxation of financial arrangements (TOFA)

Extension to TOFA Transitional Elections

The government intends to provide a limited discretion to extend the time to notify the Commissioner of the making of a transitional election to apply Division 230 to existing financial arrangements. This will extend the time (maximum of three months) for the notification of making of a transitional election where:

- the taxpayer is unable to notify the Commissioner by the due date because of circumstances beyond their control and they have taken reasonable steps to mitigate the effects of those circumstances; or
- the taxpayer does not notify the Commissioner by the due date because of their (or their agent's) honest mistake or inadvertent omission.

PAYG Instalments

The government also proposes to amend the PAYG instalment provisions by extending the definition of instalment income in Section 45-120 to include gains (net of the losses) from Division 230 arrangements.

For TOFA entities (excluding individuals or entities that only have qualifying securities), instalment income from Division 230 financial arrangements can be worked out on a consistent basis (i.e. net basis) as gains or losses worked out under the TOFA provisions.

Ref: Tax Laws Amendment (2011 Measures No. 7) Bill 2011

Investment management regime

The government has released draft legislation for the Investment Manager Regime (IMR). The amendments were announced in the 2011 Federal Budget to assist foreign investment funds comply with FIN 48.

The amendments

The first amendment will prevent the Tax Office from raising assessments for the 2010/2011 and previous years for certain foreign investment funds and investors in these funds. It is designed to assist funds satisfy their FIN 48 requirements for their US reporting.

The second amendment will apply for the 2010/2011 and subsequent years. It will introduce the IMR, which will provide certain foreign investment funds with an exemption from Australian income tax where the funds would have been assessable in Australia only because they used an Australian resident intermediary.

We have prepared a *Tax Flash* which considers these amendments in greater detail. You may access the *October Tax Flash* entitled Investment Manager Regime on our website.

The FIN 48 amendments

These allow certain foreign complying funds to satisfy their US FIN 48 reporting requirements by providing them with an exemption from tax on qualifying investment income (refer to the *October Tax Flash* for further details). The exemption will apply for the 2010/2011 year and previous years.

A qualifying fund is one that:

- is not an Australian resident for tax purposes;
- is recognised under a foreign law as a collective investment vehicle;
- does not have its day-to-day control reside in the members of the fund;
- does not carry on a trading business in Australia - all of its income is passive investment income; and
- is widely held and is not closely held.

In addition, the fund must not have:

- lodged a tax return in relation to any year;
- received an income tax assessment (or had its beneficiaries assessed if the fund was a trust) prior to 18 December 2010; and
- been notified of an intention for the fund to be audited (prior to 18 December 2010).

Despite the fact the amendment is designed to assist funds to satisfy the requirements of FIN 48, there does not appear to be a requirement that the fund has to be subject to FIN 48.

The IMR provisions

These provisions will operate to exempt from Australian income tax all IMR income and losses including capital gains and losses (refer to the *October Tax Flash* for more details) where the fund does not have a place of business in Australia, but is treated as having an Australian permanent establishment solely as a result of engaging an Australian investment manager who habitually exercises a general authority to negotiate and conclude contracts on behalf of the fund.

These exemptions are restricted to funds deemed to have a permanent establishment in Australia because of the Australian based fund manager. They do not extend to all funds covered by the FIN 48 amendments. A further announcement on other funds is expected.

Part IVA and corporate reconstruction

There have been two interesting decisions in the courts regarding the application of Part IVA to corporate reconstructions. In both cases, the court rejected the Tax Office's attempts to apply Part IVA.

The first case (RCI) involved a restructure of the US assets of James Hardie. The group wanted to move US assets and a dividend (equal to the increase in value of the assets reflected in the asset revaluation reserve) was paid. This was non-assessable non-exempt income in Australia.

This resulted in a significant reduction in the value of the assets, thereby reducing the capital gain realised on the transaction.

The Tax Office argued Part IVA applied because an assessable gain was converted to a non-assessable amount.

At first instance, the court agreed with the Tax Office, but on appeal, the taxpayer prevailed. The court found that while the Tax Office had succeeded in presenting an alternative form of the transaction that would have resulted in a higher tax liability (as it is required to do under Part IVA in identifying the tax benefit), the court rejected that alternative as non-commercial.

The court considered the contemporaneous evidence produced by the company during the course of the restructure and made the following conclusions:

- Had the company not entered the transaction in the form it had, it would not have proceeded with the transaction, or it would have not sold the shares and pursued a lesser alternative.
- The alternative advanced by the Tax Office was completely impractical as the transaction costs of that structure meant the transaction would not have proceeded at all.
- As the transaction required the approval of shareholders, on the basis of the transaction costs of the Tax Office's alternative, it was reasonable to expect the shareholders would not have approved the transaction.
- It is for the court to decide whether there was a tax benefit - the court should do this by considering, based on the evidence, what the company might reasonably have been expected to do without the scheme - it is not sufficient for the Tax Office to simply come up with an alternative plan.
- On this basis, the court considered that it could not reasonably be expected that the company would have undertaken the transaction, given the transaction costs, other than in the form in which it was undertaken.

It therefore follows that not only must the Tax Office identify an alternative transaction, that alternative must be commercially viable and have a reasonable chance of being accepted by shareholders given the income tax liability associated with that alternative.

In the second decision, Macquarie Bank approached a US based private equity group with a proposal for the private equity group to sell certain Australian assets. Macquarie was motivated by the fees they would receive for facilitating the transaction.

The assets were owned by an Australian company that was a subsidiary of a US company. In the structure proposed by Macquarie, the unrealised increase in value of the Australian assets was paid by the US company to the ultimate parent as a dividend (not assessable in Australia as paid outside Australia to a non-resident) using funds advanced from Macquarie.

Macquarie purchased the US company, thereby also acquiring the Australian company and the assets that were identified for sale. Directors of both companies were then replaced with Australian based Macquarie staff, making the companies Australian residents.

A consolidated group was formed, comprising the US and Australian companies and the Macquarie parent company that acquired them (and provided the loan to facilitate the dividend). Under the costing setting rules, Macquarie could to push down value to the Australian assets identified for sale. This had the effect of eliminating the capital gain that would otherwise have been realised on the sale of those assets.

The Tax Office applied Part IVA to the transaction, arguing the parties deliberately consolidated to obtain the tax benefit, which was the reduction in the gain.

In making the Part IVA determination, the Tax Office issued assessments to the Australian subsidiary. This failed to take account of the single entity rule. The court noted the notices issued to the subsidiary were ineffective, as the head company is the only tax entity

under consolidations. The court also noted that once a group had consolidated, the Tax Office could not take action to deconsolidate the group.

Notwithstanding this position, the court considered the application of Part IVA, even though it was not required to do so. The court considered there was a tax benefit equal to the gain not realised, but not all the parties to the scheme had that tax benefit as their dominant purpose. Some of the parties to the scheme had other purposes for structuring the transaction as they did.

As not all parties had the same dominant purpose, the court concluded Part IVA could not apply.

The court also commented on the decision to form a consolidated group. The court accepted the taxpayers' argument that it was an inevitable consequence and a design feature of the legislation that the cost base of an asset to the head company will commonly be greater than its cost to the subsidiary.

However, it noted the Commissioner's real problem was that he wanted to use Part IVA to cancel tax consequences intended by parliament to be conferred on a company joining a consolidated group irrespective of whether it, or other persons, had as their purpose in joining, taking advantage of those consequences.

Ref: RCI Pty Ltd v Commissioner of Taxation [2011] FCAFC 104
Ref: Macquarie Bank v Comm. of Taxation [2011] FCA 1076

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

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