client alert | explanatory memorandum

August 2015

CURRENCY:

This issue of **Client Alert** takes into account all developments up to and including 1 July 2015.

Work-related and rental property claims on ATO's watch list

During tax time 2015, the ATO will be focusing on "unusually high" work-related expense claims across all industries and occupations, a much wider approach than in previous years.

ATO Assistant Commissioner Adam Kendrick said that the ATO's ability to identify and investigate claims that differ from the "norm" is improving each year due to enhancements in technology and the use of data. "These enhancements mean that every return is scrutinised and it is becoming a lot easier to identify claims that are significantly higher than those claimed by people with similar occupations and employment income," Mr Kendrick said.

In addition to focusing on work-related expense claims that are significantly higher than expected, the ATO will also be paying particular attention to the following:

- claims that have already been reimbursed by employers; and
- claims for private expenses, such as travel from home to work.

In relation to work-related travel, the ATO has reminded taxpayers that they cannot claim a normal trip between home and work, unless:

- they use their car to carry bulky tools or equipment which they use for work and can't leave on the work premises;
- their home is a base for employment; or
- they have shifting places of employment (eg they regularly work at more than one place each day).

Rental property deductions

The ATO will also have an increased focus on rental property deductions and is encouraging rental owners to double-check their claims are correct before lodging their tax returns. In particular, the ATO is paying close attention to:

- excessive deductions claimed for holiday homes;
- husbands and wives splitting rental income and deductions inappropriately for jointly owned properties;
- claims for repairs and maintenance shortly after the property was purchased; and
- interest deductions claimed for the private proportion of loans.

In addition to paying closer attention to rental property deductions, the ATO will also be educating rental property owners about what they can and cannot claim. For example, the ATO will be writing to owners of rental property in popular holiday locations, reminding them to claim the deductions they are entitled to only for the periods the property is rented out or is genuinely available for rent.

The following are key points from the ATO to avoid mistakes in making claims:

- It is important for all property owners to keep accurate records. This helps to ensure the right amount of rental income declared, and evidence for claims made.
- Rental property owners should only claim deductions for the periods the property is rented out or is genuinely available for rent. If a property is rented at below market rate, for example to family or friends, deduction claims must be limited to the income earned while rented.
- Costs to repair damage, defects or deterioration existing on purchase, or renovation costs, can't be claimed as an immediate deduction. These costs are deductible over a number of years.

Source: ATO media release, 27 May 2015, https://www.ato.gov.au/Media-centre/Articles/ATO-warns-over-claiming-is-easier-to-detect-than-ever; ATO media release, 28 May 2015, https://www.ato.gov.au/Media-centre/Articles/ATO-increases-focus-on-rental-property-deductions.

Share-economy service providers need to assess tax implications

The ATO has released its view of the tax obligations of people providing services in the sharing economy. It said people engaged in sharing-economy activities (eg letting a room, letting a car space, doing odd jobs or other activities for payment, or driving passengers in a car for a fare) may have tax obligations.

The ATO said "the tax laws which apply to activity conducted in a conventional manner apply in the same way to activity conducted in the sharing economy". There are income tax and GST implications. "The existing tax law applies equally whether a buyer and seller come together at a bricks and mortar business or via a mobile phone app or website," said ATO Deputy Commissioner James O'Halloran.

Some key points:

- **Income tax obligations for providers** – people who are earning assessable income from the provision of sharing economy services will need to keep records of income from that activity, and any allowable deductions (which may need to be apportioned for private use).
- **GST implications for providers** – for those already registered for GST for another purpose, the activities in their sharing economy enterprise must be included with their other activities. People need to register for GST if their annual turnover from their sharing economy enterprise is $75,000 or more. However, note that people providing "taxi travel" must be registered regardless of turnover (see below).
- **Taxi travel services through ride-sourcing** – the ATO has released further guidance (available at https://www.ato.gov.au/Business/GST/In-detail/Managing-GST-in-your-business/General-guides/Providing-taxi-travel-services-through-ride-sourcing-and-your-tax-obligations) for people providing taxi travel services through ride-sourcing (also known as ride-sharing or ride-hailing). The ATO has confirmed that people who provide ride-sourcing services are providing "taxi travel" under the GST law. It said the existing tax law applies, and so drivers are required to register for GST regardless of their turnover. "Affected drivers must register for GST, charge GST on the full fare, lodge BASs and report the income in their tax returns," Mr O'Halloran said. Other key points relating to ride-sourcing include the following:
  - GST must be calculated on the full fare, not the net amount received after deducting any fees or commissions. For example, if a passenger pays $55 and the facilitator pays $44 (after deducting an $11 commission), the GST payable is $5 (not $4).
  - GST credits on business purchases can be claimed, but must be apportioned between business and private use. For example, if a new car is bought for $33,000 (including $3,000 GST) and used for 10% ride-sourcing and 90% private use, there will be a GST credit of $300.
  - Drivers must provide their passengers with a tax invoice if they ask for one for fares over $82.50 (including GST).
  - Recognising that some taxpayers may need to take some corrective actions, **the ATO is allowing drivers until 1 August 2015 to obtain an ABN and register for GST**. The ATO said it does not intend to apply compliance resources regarding GST obligations for drivers prior to 1 August 2015 – except if there is evidence of fraud, or other significant matters.
- **Renting out part, of all, of your home** – the ATO has also released further information (available at https://www.ato.gov.au/general/property/your-home/renting-out-part-or-all-of-your-home) for people renting out part, or all, of their home. The ATO said the rent money received is generally regarded as assessable income. Taxpayers must declare their rental income in their income tax returns. However, they can claim deductions for the associated expenses (such as part, or all, of the interest on their home loan). The ATO noted these people may not be entitled to the full CGT main residence exemption. The ATO also noted that GST does not apply to residential rents, which means GST credits cannot be claimed for associated costs.

Source: ATO guide, "The sharing economy and tax", 19 May 2015, https://www.ato.gov.au/Business/GST/In-detail/Managing-GST-in-your-business/General-guides/The-sharing-economy-and-tax; ATO media release, 20 May 2015, https://www.ato.gov.au/Media-centre/Media-releases/ATO-provides-advice-on-taxi-travel-services-through-ride-sourcing.

Franked-distributions funded by capital-raising under scrutiny

The ATO has issued Taxpayer Alert TA 2015/2 *Franked distributions funded by raising capital to release franking credits to shareholders*.

The ATO says it is reviewing arrangements where companies raise new capital to fund franked distributions and release accumulated franking credits to shareholders. "We consider that these arrangements are being entered into by companies with accumulated franking balances to release franking credits which they otherwise would have retained," ATO Deputy Commissioner Tim Dyce said.

In a typical case, the ATO is seeing companies issue rights to shareholders and using the funds raised to make franked distributions via special dividends or an off-market share buy-back. The ATO says these arrangements are distinct from ordinary dividend reinvestment plans involving regular dividends. "The distributions are unusually large compared to ordinary dividends and occur at a similar time, and in a similar amount, to the capital raised," Mr Dyce said. "So, a potentially large amount of franking credits is released with minimal net changes to the company's economic position. There is also minimal impact on the shareholders, except in some cases they may receive refunds of franking credits and in the case of buy-backs they may also get improved capital gains tax outcomes," he added.

The ATO considers that these arrangements may not be compliant with the tax law. The ATO is concerned that the arrangement is being used by companies for the purpose of, or for purposes which include, releasing franking credits or streaming dividends to shareholders. This may attract the operation of the anti-avoidance rule in s 177EA of the ITAA 1936 or other anti-avoidance rules. One immediate purported effect of these arrangements is the release of franking credits that may otherwise have been retained by the company, the ATO said.

The ATO says it is engaging in discussions with taxpayers and is developing its "technical position on the arrangements". The ATO has encouraged early engagement for taxpayers who have entered into, or are contemplating entering into an arrangement. It said these taxpayers can email the ATO at PGIAdvice@ato.gov.au.

The ATO also warns that penalties may apply to participants and promoters of this type of arrangement.

Description

The arrangement of concern to the ATO displays all or most of the following features:

- A company with a significant franking credit balance raises new capital from existing or new shareholders. This may occur through issuing renounceable rights to shareholders. Shareholders may include large institutional superannuation funds.
- At a similar time to the capital raising, the company makes franked distributions to its shareholders, in a similar amount to the amount of capital raised. This may occur as a special dividend or through an off-market buy-back of shares, where the dividend forms part of the purchase price of the shares.
- Overall:
  - there is minimal net cash inflow to, or outflow from, the company;
  - the net asset position of the company remains essentially unchanged (in a buy-back variant, the number of shares on issue following the transaction may be marginally reduced due to the difference between the buy-back price and the issue price of the new shares) but its franking account is significantly reduced; and
  - there is minimal impact on the shareholders, except in some cases they may receive refunds of franking credits, and in the case of buy-backs they may also get improved capital gains tax outcomes.
- The franked distributions (or franked component of buy-back consideration) may be unusually large compared to ordinary dividends previously declared and paid by the company (as distinct from a typical dividend reinvestment plan applicable to an ordinary regular dividend).
- The franked distribution may be receivable by all existing shareholders of the company, or shareholders may have a choice as to whether to participate (for example, in a buy-back scenario).

Source: ATO Taxpayer Alert TA 2015/2, 7 May 2015, http://law.ato.gov.au/atolaw/view.htm?DocID=TPA/TA20152/NAT/ATO/00001; ATO media release, 7 May 2015, www.ato.gov.au/Media-centre/Media-releases/ATO-cautions-companies-about-raising-capital-to-fund-franked-distributions.

"Contrived" dividend arrangements used by SMSFs flagged by ATO

The ATO has issued Taxpayer Alert TA 2015/1 *Dividend stripping arrangements involving the transfer of private company shares to a self-managed superannuation fund* which describes arrangements where a private company with accumulated profits channels franked dividends to an SMSF instead of to the company's original shareholders. As a result, the original shareholders escape tax on the dividends and the original shareholders (or individuals associated with the original shareholders) benefit as members of the SMSF from franking credit refunds to the SMSF.

The ATO is concerned that contrived arrangements are being entered into by individuals (typically SMSF members approaching retirement) so that dividends subsequently flow to, and are purportedly treated as exempt from income tax in, the SMSF because the relevant shares are supporting pensions. The intention is for the original shareholders of the private company and/or their associates to avoid "top-up" income tax on the dividend income, and for the SMSF to receive a refund of the unused franking credit tax offset, which is available for tax-free distribution to its members.

The ATO also warned the arrangement has features of dividend stripping. This could lead to the ATO cancelling any tax benefit for the transferring shareholder and/or denying the SMSF the franking credit tax offset. The ATO said it will issue a public guidance product to explain its view on how taxation and superannuation laws apply to arrangements with features similar to those in the Alert.

Description

The Taxpayer Alert applies to arrangements that display all or most of the following:

1. A private company (the company) has significant previously taxed accumulated profits, which are available to be paid to shareholders as franked dividends (subject to "top-up" tax at marginal individual rates).
2. A shareholder in the company transfers their shares (the shares) in that company to an SMSF of which the shareholder or their associate is a member. There may be more than one shareholder who transfers shares to the SMSF.
3. The trustee of the SMSF treats the shares as supporting the payment of pensions to the member(s) of the SMSF (and therefore all or part of the income from the shares is regarded as exempt income of the SMSF).
4. After the SMSF satisfies the 45-day holding period rule, the company distributes its accumulated profits to the SMSF as fully or partially franked dividends.
5. The trustee of the SMSF treats the franked dividends and the attached franking credits as exempt income, which entitles the SMSF to a refund of the unused franking credit tax offsets.
6. The company may be liquidated or deregistered after the value of the shares is substantially reduced (or reduced to nil) by the payment of the franked dividends.

The arrangement may also include one or more of the following characteristics or variations:

1. The shareholder may transfer the shares to the SMSF as an in specie contribution and/or the SMSF may purchase the shares from the shareholder using:
   a) existing SMSF assets;
   b) funding obtained from a limited recourse borrowing arrangement (LRBA) or some other form of financial accommodation, including paying for the shares using dividends received under the arrangement; or
   c) a combination of the above.
2. The company may make one or more distributions of franked dividends to the SMSF.
3. Distributions of franked dividends may also be made to other shareholders, if the SMSF does not hold 100% of the shares in the company.
4. The SMSF may receive franked dividends indirectly from the company, such as through a unit trust.
5. The SMSF (or another superannuation fund) may pay a superannuation benefit to enable the members to repay any outstanding shareholder or associate loans from the company prior to the acquisition of the shares by the SMSF.
6. A member of the SMSF may be in the accumulation phase and not receiving a pension, meaning that relevant franked dividends and attached franking credits will be assessable at 15%, resulting in a partial refund of the unused franking credit tax offsets to the SMSF.

ATO concerns

The ATO considers that the **main anti-avoidance provisions** for arrangements of this type are whether:

- the franked dividends received by the SMSF may be part of a dividend stripping operation under para 207-145(1)(d) of the ITAA 1997;
- the arrangement may be a scheme by way of, or in the nature of, or have substantially the effect of dividend stripping to which s 177E of the ITAA 1936 applies; and
- the arrangement may be a scheme to obtain imputation benefits to which s 177EA of the ITAA 1936 applies.

The ATO considers that arrangements of this type may also give rise to **non-arm's length income** for the SMSF under s 295-550 of the ITAA 1997.

Other compliance issues for arrangements of this type may include CGT consequences (eg transfers below market value), ordinary dividend or deemed dividend consequences, superannuation regulatory issues (including non-arm's length dealings between members or associates and the SMSF), and/or excess contributions tax consequences.

Private rulings

The ATO said it will continue to closely examine private ruling applications for arrangements with features similar to those described in the Alert.

Prior to March 2014, the ATO had issued five private rulings on arrangements with similar features and did not apply the "main anti-avoidance provisions" (see above). However, the ATO said it did not consider that this small number of private rulings constituted a general administrative practice on such arrangements.

From March 2014, the ATO said it has consistently issued private rulings on arrangements with similar features and has applied the main anti-avoidance provisions. In addition, the ATO said it has applied the non-arm's length income provision (see above) in some cases, applying the views expressed in Taxation Ruling TR 2006/7.

ATO case study

The ATO has prepared a case study following the release of Taxpayer Alert TA 2015/1. The case study and the ATO's views are as follows.

> *Richard is the sole director and has 100% ownership of the shares in JAX Pty Ltd. He and his wife Diane are the 2 trustees and members of the R&D self-managed super fund (SMSF).*
>
> *JAX has significant retained earnings which are available for distribution to Richard as franked dividends. His personal income tax circumstances mean that any franked dividends he receives are subject to top-up tax at his marginal tax rate of 40%.*
>
> *R&D agree to purchase all the shares in JAX. To finance the purchase, they enter into a limited recourse borrowing arrangement.*
>
> *Two months after the shares are sold the retained earnings in JAX are distributed to R&D as fully franked dividends. Richard decides to liquidate the company and retire from director duties.*
>
> *He begins to draw a pension from R&D and the dividends from JAX are used to support the pension payments. Because the income is supporting a pension the franked dividends and attached franking credits are treated by R&D as exempt income. As a result R&D determines it will pay no tax on the dividend income and will be entitled to a refund of unused franking credit offsets.*

The ATO provided the following points:

- **Non-arm's length income** – the ATO said that based on the facts outlined the dividend income would be considered to be non-arm's length income (NALI).
- **Entitlement to franking credits** – according to the ATO, because R&D used a non-recourse loan to acquire the shares in JAX, the qualified person rules need to be considered. R&D's net position will need to be worked out using the financial concept known as "delta" (outlined in former s 160APHJ of the ITAA 1936). A taxpayer is taken to have "materially diminished" the risks of loss or opportunities for gains on a particular day in respect of shares, or in respect of an interest in shares, held by the taxpayer, if the taxpayer's net position on that day in relation to shares or interest in shares is less than 30% of those risks or opportunities. In this situation, the ATO said the shares are not at risk so R&D's delta is zero and it is not a qualified person. As a result, the franking credits attached to the distribution are not included in its assessable income. It added that franking credit tax offsets are generally not available for that distribution.
- **Outcome of case study** – the ATO said R&D will need to report the dividends received from JAX as NALI and will not be entitled to the franking credits that were attached to those dividends.
- **SMSF auditors and professionals** – the ATO said SMSF auditors and professionals should review similar arrangements and any transactions involving loans and dividends to ensure their clients are complying with the delta rules explained above.

ATO encourages disclosure

The ATO said it encourages SMSF members that may be involved in such arrangements to contact it and make a voluntary disclosure or seek a private ruling. "In our actions, we will engage with affected SMSF trustees and members to develop pragmatic options to address the tax and superannuation consequences of the arrangement," said Deputy Commissioner Tim Dyce.

The ATO said it will also consult on the application of relevant anti-avoidance provisions and consider a public ruling on such arrangements. People with further information on the arrangements can call the ATO on 1800 177 006 (after the initial messages, wait for the "Taxpayer Alert" option, then press 1) or email reportataxscheme@ato.gov.au.

Source: ATO Taxpayer Alert Taxpayer Alert TA 2015/1, 30 April 2015, http://law.ato.gov.au/atolaw/view.htm?docid=%22tpa%2Fta20151%2Fnat%2Fato%2F00001%22; ATO media release, 1 May 2015, https://www.ato.gov.au/Media-centre/Media-releases/SMSF-retirees-face-ATO-scrutiny; ATO publication, "Case study – transferring private company shares to an SMSF", 5 June 2015, https://www.ato.gov.au/Super/Self-managed-super-funds/In-detail/SMSF-resources/SMSF-case-studies/Case-study---transferring-private-company-shares-to-an-SMSF.

Lump sum finalisation payment taxable

The Administrative Appeals Tribunal (AAT) has held that a lump sum finalisation payment received by a taxpayer was assessable as income according to ordinary concepts within the meaning of s 6-5(1) of the ITAA 1997.

In 1993, the taxpayer commenced employment with a company and she entered into certain contractual arrangements which gave her a variety of benefits, including – as part of her remuneration package – the benefit of the Employer's Group Salary Continuance Policy. Under the policy, the taxpayer was insured for total disablement. In 1995, she was diagnosed with a number of illnesses and was deemed unfit for work. As a result, she subsequently made a claim on the policy and was paid monthly benefits on the basis of her total disablement". The taxpayer included the monthly benefits in her assessable income.

The taxpayer continued to receive monthly benefits from the insurer until 2001, when the insurer entered into liquidation. In the 2002 income year, the taxpayer commenced her participation in a Government supported scheme ("the Support Scheme") under which she received monthly benefits (net of tax) from the Commonwealth. In 2008, she was informed that the Commonwealth intended to finalise its obligations under the Support Scheme by paying a lump sum amount ("the finalisation payment") in July 2008, rather than continuing to pay monthly benefits.

Under a deed of release executed by the taxpayer during the income year ended 30 June 2009, the Support Scheme made the finalisation payment to the taxpayer of just over $2 million, less an amount of $931,119. 40 (being tax withheld and remitted to the ATO). The taxpayer applied for a private ruling in respect of the lump sum finalisation payment. The Commissioner considered that the payment was assessable as ordinary income. The taxpayer sought review of the Commissioner's decision to deny her objection against his private ruling decision.

After reviewing the matter, the AAT concluded that the finalisation payment was "income according to ordinary concepts" within the meaning of s 6-5(1) of the ITAA 1997. The AAT concluded that, contrary to the taxpayer's arguments, neither the monthly payments made under the Support Scheme nor the finalisation payment made under the deed were undissected payments or an undissected lump sum which included capital components. It held that the finalisation payment comprised ordinary income within s 6-5(1) and nothing else. It was therefore assessable income to be taken into account in assessing the taxpayer's taxation liabilities for the year ended 30 June 2009.

Re Senior and FCT [2015] AATA 353, Deutsch DP, 22 May 2015, http://www.austlii.edu.au/au/cases/cth/AATA/2015/353.html.

"Nomad" had continuity of association with Australia

The AAT has affirmed the Commissioner's objection decisions and found that a taxpayer was a resident of Australia for the 2006 to 2011 income years. This was despite the taxpayer's claims that he had "let go" of Australia in 1999 to pursue his "nomadic" working life as a diver and diving supervisor for overseas companies in Asia and the Middle East, that his base of operations was in the UK, and that he had relied on ATO advice in claiming his foreign residency status.

Following an audit, the taxpayer had been issued amended assessments for the years in question, increasing his tax liability by close to $300,000 (including shortfall penalties and interest). After setting out the relevant principles and authorities, the AAT found that in the relevant income years he "resided" in Australia and that he had not established a permanent place of abode outside Australia. In doing so, the AAT noted that his physical, emotional and financial ties to Australia in those years were very strong and that, in particular, he jointly owned a home in Australia with his wife of over 23 years and that his emotional ties to her were "clearly the most significant in his life".

The AAT also took into account various other factors, including the following:

- there was no objective evidence that he "resided" or had his base in the UK as he claimed;
- he had spent significant amounts of time living with his wife in their jointly owned Australian home, especially in the last two of the income years in question;
- he had transferred all of his overseas earnings into his Australian bank account in the years in issue, and maintained health insurance cover only in Australia; and

- his outgoing and incoming passenger immigration cards stated that he was a resident of Australia, and also that the purpose of his travel to the UK in the relevant years was either for holiday or for visiting friends or relatives.

Accordingly, the AAT ruled that the taxpayer maintained a “continuity of association” with Australia throughout the relevant income years (primarily through his wife and their home) and that although he claimed to have “let go” of Australia in 1999, the relevant facts and evidence proved otherwise.

The AAT also noted that the taxpayer failed to establish a residence in countries where he worked and therefore he could not be said to have established a “permanent place of abode outside Australia” for purposes of the residency test. Likewise, the AAT also noted that the taxpayer’s “domicile of choice” was Australia – and that even if that domicile was abandoned, his domicile would not revert to his “domicile of origin” (the UK) upon merely forming an intention to abandon Australia.

The AAT then found that the taxpayer had not satisfied the requirements in s 23AG of the ITAA 1936 (as then relevant) to have his foreign sourced income treated as exempt income. In this regard, the AAT pointed out that he had not established that he was engaged in “foreign service” for a continuous period of more than 91 days as required, or that there were “temporary absences” for leave or illness which would act as an exception. The AAT also found that he was not entitled to any foreign tax offsets as he had not produced evidence of any foreign tax paid on his overseas earnings.

Finally, the AAT found that the taxpayer had not demonstrated sufficient grounds for remission of shortfall penalties or interest charges, despite his claim that he relied on ATO advice regarding claiming non-residency status. In this regard, the AAT found, among other things, that there was no objective evidence that he had received such advice from the ATO on the matter or, moreover, that he relied on it.

Appeals update

The taxpayer has appealed to the Federal Court against the decision.

Re Shord and FCT [2015] AATA 355, Walsh SM, 21 May 2015,
http://www.austlii.edu.au/au/cases/cth/AATA/2015/355.html.