client alert | explanatory memorandum

December 2015/January 2016

CURRENCY:

This issue of **Client Alert** takes into account all developments up to and including 17 November 2015.

Tax negotiation limited to known debt amounts

Two corporate taxpayers have unsuccessfully applied to the Federal Court to have statutory demands set aside.

Facts

Two individuals, Mr C and Ms B, carried on property development activities in Western Australia through several entities, including the taxpayer companies. Mr C alleged that, in April 2014, he reached a "global deal" with the ATO to bring to an end debt recovery action against the companies if adequate security was provided. He claimed the ATO agreed not to issue statutory demands while objection and review proceedings were in process. However, he said the ATO then sought demands that were contrary to this oral agreement, including $8 million security from a related trust. He also claimed that ATO officers repeatedly threatened to issue statutory demands "to coerce implementation of the global deal and to obtain other benefits".

Following the April 2014 meeting, the taxpayers entered into deeds of agreement with the ATO. In September 2014, after the taxpayers allegedly defaulted on the deeds, the Deputy Commissioner served statutory demands on the taxpayers pursuant to s 459E of the *Corporations Act 2001*. The taxpayers applied to the Federal Court to set aside the statutory demands under s 459J(1)(b) of the *Corporations Act 2001* (which gives the Court the power to set aside a statutory demand "for some other reason"). The taxpayers claimed that the statutory demands were unconscionable and were not issued for a proper statutory purpose.

Decision

The Federal Court dismissed the taxpayers' applications, finding that they failed to establish a proper basis for setting aside the statutory demands.

In the Court's view, the taxpayers presented no probative evidence to support their allegation that the statutory demands were issued for any purpose other than to set in train winding-up proceedings against the companies for their unpaid taxation debts. The Court said it did not doubt that Mr C held a "genuine subjective belief" that he and the ATO had entered into a binding legal agreement that went beyond the terms of the deeds of agreement subsequently executed. However, the Court considered that Mr C's subjective belief was not supported by either objective documentary evidence or by the evidence of the ATO representatives who attended the meeting, which it preferred.

The Court also found that there was no probative evidence to support the taxpayers' claim that the statutory demands were issued for the improper purpose of coercing other entities to pledge security in respect of their disputed liabilities. The Court accepted the ATO's evidence that the negotiations involved only "established debts" reflected in a spreadsheet that was used at the meeting and did not include further tax liabilities, including those of the trust.

Source: MNWA Pty Ltd v DCT (No 2) [2015] FCA 1128,
www.austlii.edu.au/au/cases/cth/FCA/2015/1128.html

CGT roll-over for small business restructures on the way

The Government has released exposure draft legislation that proposes to provide roll-over relief for small businesses that change their legal structure. The proposed measures were announced in the 2015–2016 Federal Budget, and will apply to the transfers of assets occurring on or after 1 July 2016.

The proposed measures will insert new Subdiv 328-G into the ITAA 1997 to provide an optional roll-over where a small business entity transfers a business asset to another small business entity without changing

the ultimate economic ownership of the asset. The roll-over can also apply to affiliates or entities connected with the small business entity for assets they hold that are used by the small business entity.

The roll-over will apply to gains and losses arising from the transfer of CGT assets, depreciating assets, trading stock or revenue assets between entities as part of a small business restructure. Discretionary trusts may be able to access the roll-over if the assets continue to be held for the benefit of the same family group.

Note that the proposed new roll-over is in addition to roll-overs currently available where a sole trader or partner in a partnership transfers assets to, or creates assets in, a company in the course of a business restructure.

Eligibility for the roll-over

The two types of entities that may be eligible for the roll-over are:

- small business entities in the income year in which the transfer takes place that satisfy the $6 million maximum net asset value (MNAV) test in s 152-10 or the $2 million "small business entity" turnover test in Subdiv 328-C. In this case, the entity may access the roll-over for CGT assets that are assets of the business carried on by the entity; and
- an affiliate of, or connected with, a small business entity for the income year that satisfies the MNAV test at the time of the transfer. These entities may access the roll-over in relation to CGT assets that satisfy requirements relating to passively held assets that are used by the small business entity in their business.

Effect of the roll-over

Under the proposed measures, the tax cost/s of the transferred asset or assets is rolled over from the entity that transferred the asset or assets (the transferor) to the entity to which the asset or assets are transferred (the transferee). This will be achieved by providing that:

- the transferor is taken to have received an amount which would result in them making neither a gain or loss under the transfer; and
- the transferee is taken to have acquired each asset for the amount that equals the transferor's tax cost for the asset just before the transfer.

However, different costs apply to an asset depending on the asset, as follows:

- for CGT assets, the relevant cost for income tax purposes is the cost base of the asset, while pre-CGT assets will retain their pre-CGT status in the hands of the transferee. In relation to discount capital gains, a transferee receiving an asset under the roll-over is treated as having acquired the CGT asset either when the entity that owned the CGT asset before the roll-over acquired it or, if the asset has been involved in an unbroken series of roll-overs, when the entity that owned it before the first roll-over in the series acquired it;
- for trading stock, the roll-over cost for income tax purposes is the cost of the item for the transferor at the time of the transfer or, if the transferor held the item as trading stock at the start of the income year, the value of the item for the transferor at that time. In addition, the transferee will inherit the same cost attributes of the asset as the transferor just before the transfer. This is to ensure that any deductions claimed by the transferor up to the date of the transfer are taken into account;
- for revenue assets – to the extent that an asset is being assessed as a revenue asset – the roll-over cost is the amount that would result in the transferor not making a profit or loss on the transfer and the transferee will inherit the same cost attributes as the transferor just before the transfer; and
- for depreciating assets, the roll-over relief will be available for depreciating assets under s 40-340 to prevent an amount being included in or deducted from the transferor's assessable income because of a balancing adjustment event. Instead, the transferee can deduct the decline in value of the depreciating asset of the depreciating asset using the same method and effective life (or remaining effective life as relevant) as the transferor was using.

Requirements for roll-over

The roll-over will be available where:

- the transferor transfers a CGT asset or all of its business assets that are CGT assets, depreciating assets, trading stock and revenue assets;
- the transferor chooses to apply the roll-over;
- the transaction is a restructure that has the effect of changing the type of any or all of the entities and/or the number of entities through which all or part of the business is operated;
- no consideration is provided for the transfer (as the ultimate economic ownership of any entity to which assets are transferred under the roll-over will not change);

- the transferor, transferee and the ultimate owners of the assets transferred are Australian residents;
- the transfer does not have the effect of changing the ultimate economic ownership of the asset or assets transferred; and
- the transferee is not an exempt entity or a complying superannuation entity, or none of the transferees are exempt entities or complying superannuation entities.

The roll-over also applies where a small business transfers assets as part of a restructure which either:

- changes the type of any or all of the entities through which all or part of the business is operated; or
- changes the number of the entities through which all or part of the business is operated.

Note also that each of the transferor, the transferee and the ultimate economic owners of the assets must be a resident of Australia in terms of the relevant residency test that applies to them (eg in relation to companies or trusts).

In relation to the requirement that the transaction "must not change the ultimate economic ownership of the transferred asset or assets", the ultimate economic owners of an asset are the individuals who, directly or indirectly, beneficially own an asset. If there is more than one such individual, those individuals' share of that ultimate economic ownership is unchanged, maintaining proportionate ownership in the asset. Where the transferor (or transferee) is an individual – such as a sole trader – the transferor (or transferee) will also be the ultimate economic owner of the asset transferred.

In the case of discretionary trusts, a transaction will be taken as not having the effect of changing the ultimate economic ownership of assets where:

- immediately before or after the transaction took effect, the asset was included in the property of a discretionary trust (a "non-fixed trust") that was a family trust; and
- every individual who, just before or just after the transfer took effect, had ultimate economic ownership of the asset was a member of the family group of that family trust.

In this regard, the draft Explanatory Memorandum prefaces this rule by stating: "... discretionary trusts that have made a family trust election are administered for the benefit of a specified family group. For the purposes of the roll-over members of this group will be the ultimate economic owners of the business assets."

Consequences for membership interests

Under the proposed roll-over, the cost base of membership interests in the transferor (eg shares in a company, units in a unit trust), if any, is reduced to the extent of any "transfer of value" from the transferor (but not below zero). This ensures that an owner of membership interests in a transferor entity cannot realise an artificial loss on disposal of those interests, following the reduction of value of the entity from the assets transferred.

For these purposes, the transfer of value is worked out by multiplying the "asset value" by the "membership interest percentage" for each asset transferred. The asset value is the market value of the asset transferred at the time of the transfer. The membership interest percentage is the proportion of the owner's membership interests in the transferor, expressed as a percentage of all of the membership interests in the transferor. This ensures that the cost base of each owner's membership interests is reduced in proportion to their membership interests in the transferor.

But note that this rule has no operation where no membership interests in the transferor exist, including where the transferor is a sole trader.

Date of effect

The proposed amendments will apply to transfers of assets occurring on or after 1 July 2016.

Comments

Comments are due by 4 December 2015.

Source: Treasury, "Small Business Restructure Rollover", exposure draft legislation, 5 November 2015, www.treasury.gov.au/ConsultationsandReviews/Consultations/2015/Small-Business-restructure-rollover

ATO starts issuing "certainty" letters

The ATO announced on 6 October 2015 that it will commence a "certainty letter" initiative through which it will send letters to approximately 500,000 taxpayers informing them that their 2015 tax returns are finalised.

The aim of this initiative is to provide certainty to taxpayers who have met their tax obligations for the 2015 income year. Only select taxpayers who meet the following criteria can expect to receive the letters. Broadly these taxpayers have:

- straightforward tax affairs;
- a good lodgment and compliance history;
- lodged their income tax return through myTax, e-tax or a tax agent;
- taxable income of less than $180,000;
- derived income only from salary and wages, allowances, Australian Government allowances, interest and dividends; and
- claimed deductions for work-related expenses, interest, dividend deductions, gifts, donations or the cost of managing their tax affairs.

As this is only a pilot program, not all taxpayers who meet the above criteria will receive a certainty letter. It is noted that the ATO considers taxpayers with straightforward affairs as those with no links to other entities. This means that certain taxpayers (such as beneficiaries of trusts) would not expect to receive a "certainty letter". Regardless of whether the letter is received, all taxpayers are still required to maintain accurate and detailed tax records for their 2015 tax returns.

The ATO has indicated that it will use sophisticated data-matching techniques and third party sources (eg banks and other financial institutions) to carry out routine checks on the information disclosed in the 2015 tax returns prior to issuing the letters. Accordingly, taxpayers who receive certainty letters should not be subject to further review or audit for their 2015 tax returns, unless the ATO later becomes aware that there may have been fraud or evasion. In such circumstances, the certainty letters will be void.

This pilot program will cover the 2015 tax return only and therefore does not preclude the ATO from undertaking an audit on earlier income tax returns. Furthermore, the certainty letters do not prevent taxpayers from amending their 2015 returns. However, once a return is amended, comfort letters may be reconsidered. The ATO will also still retain the discretion to amend returns in cases of fraud or evasion. As such, while certainty letters may provide some comfort as to taxpayers' standing with the ATO, they do not provide 100% certainty in all situations.

Take home messages

Whilst this initiative is welcomed because of its aim to provide taxpayers with greater certainty in relation to their tax obligations, this is only a pilot program and not every taxpayer who meets the criteria will receive a letter. Those who receive the letter will have "peace of mind" in relation to their 2015 tax obligations. On the other hand, taxpayers who do not receive a certainty letter should not worry as this does not mean that there is necessarily anything wrong with their tax return.

It remains to be seen how the letters will operate in practice, particularly if the Commissioner will change his position on the issued letter when taxpayers amend their 2015 tax return or if the Commissioner relies on the concept of fraud or evasion to invalidate the certainty letter. It would appear that, depending on the success of the pilot program, this initiative could potentially become part of the ATO compliance program.

Source: ATO media release, "Half a million taxpayers to get the A-OK", 6 October 2015, *https://www.ato.gov.au/Media-centre/Articles/Half-a-million-taxpayers-to-get-the-A-OK/*

Government rejects SMSF borrowing ban recommendation

Direct borrowings by superannuation funds via limited recourse borrowing arrangements (LRBAs) are safe (at least for the next three years), following the Government's decision to reject the Murray Financial System Inquiry (FSI) recommendation to ban or restrict LRBAs. This is welcome news for trustees of self-managed superannuation funds (SMSFs) who have faced uncertainty about the future of such borrowing arrangements which have become popular for investments in direct property and shares.

The final report of the Murray Inquiry, previously released in December 2014, included a recommendation to restore the general prohibition on direct borrowings by superannuation funds by removing the current exception for LRBAs in s 67A of the *Superannuation Industry (Supervision) Act 1993* on a prospective basis.

In releasing its response on 20 October 2015, the Government said that it did not agree with this recommendation. While the Government noted that there are "anecdotal concerns" about LRBAs, it said the data is not sufficient to justify a significant policy intervention at this time.

However, the Government said it will commission the Council of Financial Regulators and the ATO to monitor leverage and risk in the superannuation system and report back to Government after three years. According to the Government, this timing will allow recent improvements in ATO data collection to wash through the system. The agencies' analysis will be used to inform any consideration of whether changes to the borrowing rules might be appropriate at a future date.

So what are the SMSF borrowing stats?

The most recent ATO statistics estimated that SMSFs held $15.6 billion in LRBAs as at June 2015 (ie only 2.6% of the total SMSF assets of $590 billion): see the ATO's *Self-managed super fund statistical report –*

June 2015, released in September 2015. The ATO notes that these figures are estimates based on SMSF tax return data. Changes were made to the 2012–2013 SMSF tax return to improve reporting on LRBAs. As more data becomes available from subsequent tax returns, the ATO expects to be able to provide more accurate estimates.

Note also that ATO statistics (see the ATO's SMSF statistical overview for 2012–2013, released in December 2014) provided a more detailed breakdown of LRBA assets by value. It suggested that the bulk of LRBAs were invested in commercial real property (47%), followed by residential property (42%) and Australian shares (5%). However, that 2012–2013 data was based on less reliable data (prior to the 2012–2013 changes to the SMSF tax return).

Proceed with caution!

Despite the Government's "green light" for LRBAs, a decision to establish an SMSF and invest in property using an LRBA is not one to be taken lightly. A borrowing arrangement is only permitted where it complies with the strict rules under superannuation law – namely, the *Superannuation Industry (Supervision) Act 1993*. This means that each step in the process of establishing an SMSF, putting in place an LRBA (and the property investment itself), must strictly comply with the full range of superannuation rules.

Before committing to purchase a property via an LRBA, an SMSF trustee will need to employ a methodical approach (generally with the assistance of a licensed professional) to ensure compliance with the tax and superannuation borrowing rules. To this end, it would be prudent to identify any possible LRBA issues that should be considered before committing to purchase a property via an SMSF.

Source: Government response to the Financial System Inquiry, "Improving Australia's Financial System", 20 October 2015, www.treasury.gov.au/~/link.aspx?_id=194A2D59EB6F4F9A8B09ACC059978F47&_z=z

Car expenses and FBT concessions on entertainment

The *Tax and Superannuation Laws Amendment (2015 Measures No 5) Bill 2015* has been introduced. The Bill proposes the following amendments:

Work-related car expenses

The Bill proposes to repeal the 12% of original value method and the one-third of actual expenses method. That is, subdivs 28-D and 28-E of the ITAA 1936 will be repealed. Taxpayers will continue to be able to choose to apply the cents-per-kilometre method (for up to 5,000 business kilometres travelled), or the logbook method, depending on which method in their view best captures the actual running costs of their vehicle.

According to the Government, the changes are not expected to adversely affect the vast majority of taxpayers who it says currently use the two methods that will be retained. Citing ATO figures, the Government says the removal of the two methods is expected to affect only 2% of taxpayers.

The Bill also proposes to provide a streamlined process for calculating the cents-per-kilometre method by providing a single rate of deduction. That is, the current three rates based on vehicle engine capacity will be replaced with a single rate of deduction. In the 2015–2016 income year, the rate will be set at 66 cents per kilometre. This rate is said to represent the average per-kilometre running cost of the top five selling cars (a mix of small to large cars) in Australia.

The Commissioner will be provided with the power to set the cents-per-kilometre rate for later years via legislative instrument. When setting the rate of deduction, the Commissioner is to take into account the average running costs of a car. The Commissioner should consider the fixed and variable costs of operating a vehicle including such matters as fuel costs, servicing costs and the cost of replacing tyres, registration and insurance expenses. The Commissioner, at his or her discretion, may determine more than one rate if he or she wishes to set different rates for different classes of car in later income years. The Commissioner is to also publish the rate at the beginning of the income year. This will enable taxpayers to make a more informed choice between the logbook method or the cents-per-kilometre method, depending on which method they feel better captures the running costs of their vehicle.

The changes may affect the way untaxed allowances are calculated. For example, if an employer currently pays their employee an allowance in respect of their motor vehicle use and the allowance is calculated using one of the methods which will be repealed by this Bill, the employer will need to update the method of calculating the allowance. Further, if the rate of the allowance paid by an employer is higher than 66 cents per kilometre, then the employee will need to report this allowance in their tax return. The employee will be entitled to claim a deduction for the amount, up to 66 cents per kilometre, and be subject to tax on amounts exceeding 66 cents per kilometre. Alternatively, an employee may utilise the logbook method to claim for their work-related car expenses.

Note that there will be minor consequential amendments to the FBTAA 1986 to, among other things, remove references to the two methods to be repealed.

Date of effect

The amendments are proposed to apply to the 2015–2016 income year and later income years. Note that consequential amendments to the FBTAA 1986 will apply from 1 April 2016 and later FBT years.

FBT concessions on salary packaged entertainment benefits

The Bill proposes amendments to the FBTAA 1986 to introduce a separate grossed-up cap of $5,000 for salary sacrificed meal entertainment and entertainment facility leasing expenses for certain employees of not-for-profit organisations, and all use of these salary sacrificed benefits will become reportable.

The Bill proposes to limit the concessional treatment of salary packaged entertainment benefits by:

- removing the reporting exclusion in respect of salary packaged entertainment benefits. This ensures salary packaged meal entertainment and entertainment facility leasing expense benefits will always appear as part of an employee's reportable fringe benefits total which is included on their payment summaries;
- removing access to elective valuation rules when valuing salary packaged entertainment benefits to prevent unintended and excessively concessional values being applied to those benefits; and
- introducing a cap on the total amount of salary packaged entertainment benefits that employees can be provided by exempt employers (covered by s 57A) and rebatable employers (covered by s 65J) that are subject to a reduced amount of FBT.

Key features of the proposed new law:

- Meal entertainment benefits and entertainment facility leasing expense benefits will be only excluded from forming part of an employee's individual fringe benefits amount and reportable fringe benefits total where they are not provided under a salary packaging arrangement.
- An employer can elect to calculate the taxable value of all meal entertainment benefits under the 12-week register method or the 50/50 split method. However, the methods do not apply to calculate the taxable value of meal entertainment benefits not provided by an employer or where the benefit is provided under a salary packaging arrangement.
- An employer can elect to calculate the taxable value of all entertainment facility leasing expense benefits under the 50/50 split method. However, the method will not apply to calculate the taxable value of entertainment facility leasing expense benefits provided under a salary packaging arrangement.
- Employers covered under s 57A (public benevolent institutions, health promotion charities, public and not-for-profit hospitals, and public ambulance services) are exempt from FBT where the total grossed-up value of benefits provided to each employee during the FBT year is equal to, or less than, the capping threshold (the standard threshold is either $30,000 or $17,000 depending on the employee and employer). If the total grossed-up value of fringe benefits provided to an employee is more than that capping threshold, the employer will need to pay FBT on the excess.
  - However, in calculating the value of fringe benefits for the purposes of the capping threshold non-salary packaged entertainment benefits (amongst other benefits) will not be taken into account.
  - Salary packaged entertainment benefits currently excluded will be included in the standard capping threshold. If, however, the total value of fringe benefits for the purposes of the standard capping threshold is exceeded in a particular year, it is raised by the lesser of: $5,000 and the total grossed-up taxable value of salary packaged entertainment benefits.
- Rebatable employers are entitled to have their FBT liability reduced by a rebate equal to 47% of the gross FBT payable (subject to a $30,000 standard capping threshold). If the total grossed-up taxable value of fringe benefits provided to an employee is more than $30,000 a rebate cannot be claimed for the FBT liability on the excess amount.
  - However, in calculating the value of fringe benefits for the purposes of the capping threshold non-salary packaged entertainment benefits (amongst other benefits) will not be taken into account.
  - Salary packaged entertainment benefits currently excluded will be included in the standard capping threshold. If, however, the total value of fringe benefits for the purposes of the standard capping threshold is exceeded in a particular year, it is raised by the lesser of: $5,000 and the total grossed-up taxable value of salary packaged entertainment benefits.

Date of effect

The amendments are proposed to apply to the 2016–2017 FBT year and all later FBT years.

Other changes proposed

Other amendments contained in the Bill are as follows:

- Third party reporting – proposes to amend Sch 1 to the TAA to increase the information reported to the Commissioner of Taxation by a range of third parties. Under the changes, third parties will be required to report, among other things, payments of government grants, consideration provided for services to government entities, transfers of real property, etc. **Date of effect:** applies to some transactions that happen on or after 1 July 2016 and other transactions that happen on or after 1 July 2017. Several minor amendments are proposed to apply from Royal Assent.
- Zone Tax Offset (ZTO) – proposes to amend the ITAA 1936 to ensure that the ZTO is appropriately targeted to people genuinely living in the designated geographical zones by limiting access to the ZTO to those people whose usual place of residence is within a zone. **Date of effect:** applies to the 2015–2016 year of income and later years of income.

Source: Tax and Superannuation Laws Amendment (2015 Measures No 5) Bill 2015, parlinfo.aph.gov.au/parlInfo/search/display/display.w3p;page=0;query=BillId%3Ar5536%20Recstruct%3Abillhome

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