THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2023

MODULE 2.01 – AUSTRALIA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Where the benefit of shares is provided to employees at a discount to their market value under an employee share scheme (ESS), generally Australian residents pay tax on the discount which is included in assessable income in the tax year in which shares or rights to shares were acquired. (s 83A-25 ITAA 1997). Such interests are specifically excluded form Fringe Benefits Tax per FBTAA ss136(1)(h).

Subdivision 83A ITAA makes special provision for the deferral of tax, where certain conditions are met, such that an amount is not included in assessable income until a later point in time (called the *ESS deferred taxing point*). An ESS deferred taxing point can occur where an employee share scheme 'genuinely' restricts the immediate disposal of shares, until the sale is no longer so restricted (ss83A-115(4) and (6)). Qualifying shares also need to meet issue and holding conditions contained in s139CD or ITAA 1997. Certain concessionary treatment is available under a salary sacrifice arrangement.

As Dane cannot sell his shares until the first trading day after the second anniversary of his acquisition, it is considered that the employee share plan has genuine disposal restrictions, so an automatic deferral of the taxing point occurs, unless Dane had elected to be assessed at the time of acquisition. The subdivision provides that the shares are taken to have been acquired immediately after the ESS deferred taxing point and ESS interest is taxable at the point of acquisition. The assessable income amount is the market value of the interest less the cost of acquisition (s83A-25(1)).

Dane is not subject to tax in the current tax year on the discount amount which is deferred from the current tax year of receipt. He would be subject to tax on any gain in the year of sale under the CGT provisions of Pt 3-1 ITAA 1997.

Part 2

Football services are essentially services performed for remuneration under a commercial contract, rather than the receipts from an amateur pursuit or hobby. As such, the football match payments are regular and recurrent payments for services and assessable to tax as ordinary income. The 'gift' cards although less regular non-cash payments, are also considered to be directly related to Dane's employment services with The Rockets club. A more in-depth analysis by students would consider the FBT implications of the non-cash payments.

The market value of a non cash benefits (s995-1 ITAA 1997) are included assessable income. The one-off receipt of a motor vehicle from the football association, is a voluntary payment. It is unlikely to be considered a windfall prize or mere gift (*Hayes v. F.C. of T. (1956) 96 CLR 47)*, as it is an incident of an income earning activity and connected to the performance of football services, so in the character of a reward for services, especially if the existence of the award of the motor vehicle was a well-known reward. The market value would be included in assessable income in the year of receipt. Support can be found in case law, for example, *(Kelly v FCT (1985)16 ATR 478, 85 ATC 4283)* is a case of a television station cash award to a season medal winner that had the necessary nexus to income.

Part 3

The tax law defines 'business' as 'including any profession, trade, employment, vocation or calling, but not occupation as an employee' (ss995-1 of the ITAA 1997). If the facts support that a genuine business of farming is being carried on, then the net loss will be deductible against other income for tax purposes. (ss4-15 ITAA 1997).

Case law suggests the "badges "of business need to be present to establish whether a business exists for tax purposes and the fact it is carried on part time is not of itself a barrier to being a business for tax purposes (per *Ferguson v. FCT 79 ATC 4261*). The type of business tests for considerations includes Dane having a profit-making purpose, some type of organisation and system of operations, together with the appropriate size and scale of operations for the activity being conducted.

Dane's small sale land and operation appears to lack any commercial viability, although if he has a genuine belief in his ability to establish the business in some reasonable period of time. It may be sufficient to satisfy the tax courts that his long-term plans are viable, even though conducted in a small enterprise with limited business skills (noting case of *Thomas v FCT* (1947) 3 ATR 165; 72 ATC 4094). It may not assist Dane, that his activities have not reached a sufficiently optimal, economically sustainable level of development and he has two other employment occupations. The costs of diversifying into livestock suggests that part of the outlays or expenses are attributable to a new business endeavour and considered to be of a capital nature, hence not deductable for tax purposes (per *Softwood Paper & Pulp Ltd v. FCT* (1976) 76 ATC 4161, 7 ATR 101 and *Magna Alloys v. FCT* (1980) 80 ATC 4542, 11 ATR 276) or characterised as a hobby.

The non-commercial loss provisions of Division 35 ITAA 1997 may apply to claim or defer a business loss, to be offset against other income. Requirements cover specific tests to be passed for provision to apply as follows:

- Business test (including not a hobby, intention to make a profit, records kept for business activities); and
- Net investment losses under $250,000 ceiling for current year; and
- Meets one of 4 test threshold (assessable income at least $20,000, profits made in three of last 5 years, real property of at least $500,000 used in activity, other assets used in the business of at least $100,000 (or evidence that special circumstances applied). Where 4 tests not met may apply in certain circumstances for the Commissioner's discretion.

Question 2

Part 1

The case in question involves the nature and extent of partnership interests and what proportion of assessable income is attributed to each partner who has a bona fide interest in the ABC partnership (s92 ITAA 1997).

Generally, a partnership is not a separate legal entity as defined in (ss 995-1(1) of ITAA 1997) as in the facts of this case being an association of persons carrying on business as partners or in receipt of ordinary income jointly.

Partners generally derive an equal share of partnership profits, ascertained at the end of the year of income when the net income of the partnership is determined. Each partner is separately liable for tax on their partnership share of income according to the tax laws each partner is generally taxed on the partner's share of the net income of the partnership (Division 5 of Part III ITAA 1936). Such a partnership would need to register for GST where turnover thresholds were met.

An anti-avoidance provision operates in the domestic tax law Division to prevent income splitting where a nominal partner is used to split profits although that partner has no real and effective control over their share of net income or disposal of their share on the partnership interest. (s94 ITAA 1997).

The facts point to this conclusion with respect to Bonnie, although there is no requirement that a partner must be involved in a business, the facts point out that Bonnie has no real and effective control over her partnership interest which has been ceded to Alfie. The real partnership interest would be likely to be considered as split between Alfie and Corban and each with having 50% partnership and entitlement to half interest in the net income of the partnership.

The LLC formed in the United States of America is a non-resident of a general law partnership. It is characterised as a foreign hybrid entity (per Div. 830 of ITAA 1997) and Corban as a single member of the LLC is treated as partner in that partnership for Australian income tax purposes. This is distinguished from a foreign hybrid that is taxed in Australia as a resident company but taxed overseas as a partnership. Corban would return his share of Australian sourced income as a non-resident (s6-5 ITAA 1997).

Part 2

The Courts have characterised a 'partnership salary' does not create a contract for services with a partner and should be treated as an agreement to vary the sharing of profits between the partners. It is essentially a drawing of profits by each partner, rather than expenses of a business which reduces net income of the partnership. In addition, compulsory superannuation contributions are only compulsory for Australian employees who earn a wage or salary, that is not the case with a partners share. Broadly, an Australian partner may be eligible to claim a tax deduction in their individual tax return for personal superannuation contributions made from a partnership share or distribution. In this regard the ATO treats the partner as similar to a sole trader.

Part 3

The commercial loan from Commerce bank to fund working capital is a normal incident of business. In determining the deductibility of a loss or outgoing requires there to be a relevant connection between the outgoing and the business. In this case the amount borrowed and used for working capital is 'necessarily incurred' appropriate to that business. The on-lending to a partner at uncommercial, below market rates would is a tax risk. When a partner is withdrawing partnership capital, the ATO view is that such a withdrawal cannot exceed their actual capital contributed. See Ure *v FC of T*, 80 ATC 4264; 10 ATR 908, F*C of T Roberts*; *FC of T v Smith*, Tax Ruling TR95/25. As such interest on a dual-purpose loan may be partially allowed (refer s8-1, s8-5 and ss25-25 ITAA 1997).

PART B

Question 3

Candidates are expected to explain the difference for income tax purposes, between profit making undertaking or scheme making profit ordinary income (s 25 ITAA 1997), as opposed to an isolated business venture and capital gains tax (*FCT v. Myer Emporium Ltd* (1987) 87 ATC 4363 compared *FCT v. Whitfords Beach Pty Ltd* (1982) 150 CLR 355). Astute candidates would note that case law has ruled on the actions of a company changing its company Articles to permit commercial ventures, followed by rezoning and subdivision of land, to find it was sufficient for the Full High Court decide that it amounted to an income profit making undertaking or scheme (refer *Whitfords Beach* case).

The intended purpose of the taxpayer according to the facts, points to long-term holding interrupted by unforeseen events.

As Landco Pty Ltd purchased the one asset (land), to method to calculate profits of the company on the transaction would be to apportion the costs on the basis of market values of the subdivided properties on a reasonable basis to determine the capital gain on each new asset (per s112-30 and s112-25 of ITAA 1997).

The one year of rental income would normally be ordinary income and assessable to tax, reduced by allowable deductions (s4-15, s6-5, s8-1 ITAA 1997).

Broadly, a GST registered entity is liable for the GST payable on the taxable supplies that it makes. The rate of tax payable is set at a standard flat 10%. Where the gain or loss on the sale is considered to be a capital gain, Landco Pty Ltd will also have GST consequences on the sale if the land was used in an enterprise being carrying on. The sale of the subdivided land is generally be undertaken as part of that enterprise. Only in a situation where Landco Pty Ltd merely realised the property value and did not use the land in an enterprise would the sale not be subject to GST.

Landco Pty Ltd may also be entitled to input tax credits, depending on the extent to which an acquisition of land was for a creditable purpose according to certain 'use' tests (per s 11-15 and s15-10 of GST Act 1999). The GST treatment is one type of 'use' is input taxed (rental), and the other taxable (sale of the unit block). A change of use of the premises has occurred. Where an entity determines the extent of creditable purpose based on intended use, the entity may be required to make adjustments if its actual use of the thing (sale) differs to its intended use (rent).

The position might be different where attempts are made to sell a property contemporaneously with the rental of the property (see GSTR 2009/4, paragraphs 48-57).

Question 4

Candidates are expected to broadly explain the tax treatment of trust and understand how discretionary trusts are treated for tax purposes with respect to the treatment of net capital gains subject to discount (ss155-109 (c) of ITAA 1997 and Division 6E ITAA 1936).

Broadly, a trust is not a taxable entity, and the net income of a trust estate can be attributed to either the trustee or the presently entitled beneficiaries in accordance with Division 6 of the ITAA 1936. The trustee of the Frills Family Trust has resolved to distribute the income to the two adult beneficiaries who each include their share in their assessable income, while the Kids Charitable Trust, if a registered charity, is exempt from income tax under Division 50 of the ITAA 1997. A registered charity for tax purposes is defined as an entity that is registered under the Australian Charities and Not-for-Profits Commission Act 2012 (ACNC) as the type of entity mentioned in column 1 of item 1 of the table in ss25-5(5) of that Act (s995-1 ITAA 1997).

If the Kids Charitable Trust did not qualify as a registered charity in the relevant tax year, then depending on the nature and type of trust, it may need to include any share of trust income as its own assessable income in the year of receipt, with the income taxable to the trustee (s99 ITAA 1936) or treated as distributed in accordance with its own trust deed provisions. The members of any fixed or discretionary sub-trusts are the beneficiaries, unitholders or objects of the trust.

A trustee is able to stream capital gains to particular beneficiaries, provided it has the power either express or implied, under the trust deed. To be expressly effective at law, there should be a provision in the Frills family trust deed that specifically defines income as ordinary income not including capital gains. This provides the Trustee with authority and the power for streaming of capital and income to different classes of beneficiaries. Anything not so explicit but implied, would need to be supportable by trust accounts and records; say with the trustee conferred with the power to amend the trust deed – where it was deficient in this regard (s262A of ITAA 1936). Another trust provision usually necessary to preserve the CGT distributable discount is a clause that trust income equals net income of the trust estate.

The capital amounts of trust income are included in assessable income (s115-C of the ITAA 1997). The Kids Charitable trust is a beneficiary of the trust estate, has been made specifically entitled to one half the capital income and is deemed to have the half of the gross capital gain of the trust estate. The Kids charitable trust may be a bona fide charitable organisation not subject to tax on the receipt of income, although as its not registered with the ACNC it may not qualify for exemption and may be taxable on its full share of trust income. Anti-trust stripping provisions operate where distributions are made to tax exempt entities, who then pass them onto the real beneficiary free of tax (s100A ITAA 1936)

Any capital gains that are not effectively streamed will continue to be taxed to the beneficiaries under Division 6 ITAA 1936 on a proportionate basis where beneficially entitled. This results in Freida and Freddy being entitled to the income plus a proportion of the capital gain.

PART C

Question 5

The provisions on the application of Australia's Diverted Profits Tax (DPT) for a certain class of large entities is contained in Schedule 1 to the *Treasury Laws Amendment (Combating Multinational Tax Avoidance) Act 2017*.

The application of the DPT depends on satisfying the following criteria, such that:

- Reef Tours Pty Ltd has obtained a tax benefit (the DPT tax benefit) in connection with a scheme in a year of income (paragraph 177J(1)(a) ITAA 1936). In the case of Reef Tours Pty Ltd this would be paying less tax than would be the case for an otherwise profitable enterprise.
- it would be objectively concluded, that Reef Tours Pty Ltd entered into or carried out the scheme (s177J (2) ITAA 1936) in whole or part, for a principal purpose of, or for more than one principal purpose that includes a purpose of:
  - enabling the relevant taxpayer to obtain a tax benefit, and/or to reduce one or more of the relevant taxpayer's foreign tax liabilities, in connection with the scheme, or
  - enabling the relevant taxpayer and another taxpayer (or other taxpayers) each/both to obtain a tax benefit and to reduce one or more of their foreign tax liabilities, in connection with the scheme 177J(1)(b))- this includes group associates Service Holdings Inc and Explora Pty Ltd.
- Reef Tours Pty Ltd is a significant global entity for the relevant year of income (paragraph 177J(1)(c) ITAA 1936)
- Explora Pty Ltd (a foreign entity) is an associate of the relevant taxpayer at any time in the relevant year of income (paragraph 177J(1)(d) ITAA 1936)
- Explora Pty Ltd entered into or carried out the scheme or any part of the scheme, or is otherwise connected with the scheme or any part of the scheme (paragraph 177J(1)(e) ITAA 1936)
- Reef Tours Pty Ltd is not an entity listed (paragraph 177J(1)(f)) ITAA 1936), and
- it is reasonable to conclude that none of sections 177K ITAA 1936 ($25 million income test), 177L ITAA 1936 (sufficient foreign tax test) and 177M ITAA 1936(sufficient economic substance test) apply in relation to the relevant taxpayer, in relation to the DPT tax benefit (paragraph 177J(1)(g)). In this case, it could be concluded that the liability to foreign tax of 9% is provides a tax benefit in the differential to Australian corporate tax rate of 30% (or 25% for turnover under $50m), broadly being 30% -9%= 21% and the economic substance does not appear to reflect the economic reality of booming market profit results, absent the scheme.

The facts indicate all of the above are capable of being answered positively. The implications are the imposition of DVT at a rate of 40% (per Diverted Profits Tax Act 2017) on the tax benefit. The Australian Tax Office's engagement program encourages discussion of DVT risk issues and consideration of mitigation approaches, such as including the particular covered transaction in an Advance Pricing Arrangement (ATO Practical Compliance Guideline 2018/5).

Question 6

Candidates are expected to explain the types of ATO advice that is administratively or statutorily binding on the Commissioner of Taxation in the context of the relevant provisions of Schedule 1 of Taxation Administration Act 1953 (TAA). One of types of matters best suited to private binding rulings are fact based matters, such as tax liability and residency or source of income issues where the relevant tax law provision operates on conclusions of fact (s6 ITAA1936).

The written private binding ruling provided by the Commissioner has specific boundaries contained in Div 357 and Div 359 of Schedule 1 of the TAA, with features as follows:

- “A ruling binds the Commissioner if it applies to you and you act in accordance with it. If you do act in accordance with it and the law turns out to be less favourable to you than the ruling provides, you are protected by the ruling from any adverse consequences.” in Sch 1, Div 357 TAA 1953.
- Each private ruling must specify the particular entity to which it applies to (359-20(2) ITAA 1997) and is only binding on the Commissioner of Taxation for that entity.
- A private ruling is an expression of the Commissioner 's opinion of the way in which a relevant provision applies, in relation to a specified scheme.
- Private rulings are made on individual application to the Commissioner.
- The Commissioner must then make the ruling applied for (unless unable to be ruled upon).
- The Commissioner must record the ruling in writing and give a copy of it to the applicant.
- The ruling must include certain details including the name of the taxpayer and any assumption made.
- An objection under the general appeal provisions can be made to a private ruling if the decision ruled upon is adverse to the view of the applicant, or the Commissioner fails to make a ruling (s14ZW TAA1953).
- Penalties can apply for failure to follow a ruling issued by the Commissioner of Taxation.

If the private ruling is inconsistent with a later public ruling, the earlier private ruling is taken not to have been made if, when the public ruling is made, the following two conditions are met:

1) the income year or other period to which the rulings relate has not begun; and
2) the scheme to which the rulings relate has not begun to be carried out.

As a private binding ruling issued to another entity cannot apply Zero Pty Ltd, the company cannot rely on it as it is not a binding ruling for another entity (non-rulee).

To obtain certainty, Zero Pty Ltd may want to apply for a private binding ruling. A separate application is required in writing by Zero Pty Ltd based on the particular facts of the Australian business operations of Zero Pty Ltd, the company must supply all necessary information to enable the Commissioner to make a ruling that is based on that relevant information.

Question 7

The rate at which transferred losses can be used by the head company of a consolidated group is generally restricted to approximate the rate of use that the joining entity would have experienced had it remained outside of the consolidated group (ss707-120(1) ITAA 1997).

When an entity becomes a member of a consolidated group its unused carry-forward losses are available to be transferred to the head company if the losses satisfy modified versions of the general domestic loss tests; being a 'continuity of ownership' test, for the period between the start of the loss year and or the 'business continuity' test. The tests are applied as though the 12 months prior to the joining time were the loss claim year (known as the trial year). The facts indicate both tests are satisfied as the same majority ownership of the joining entity was maintained from the start of the income year in which the loss was made until just after consolidation. Similarly, the same business was carried on just after the joining time as just before the joining time.

Losses are bundled, according to the particular time of transfer, in the same year of income (s707-315). The extent to which losses of a joining entity can be used by the head company of a consolidated group in a given year of income depends upon the available fraction for those losses.

One such instance where a fractional calculation is required is when a post consolidation event occurs – such as a takeover (per Table item 4 of ss707-320(2) of the ITAA 1997). Under adjusting item 4, the available fraction (s719-310 ITAA 1997) for a bundle of losses must be adjusted if the market value of the company to which the losses were most recently transferred is increased as a result of an injection of capital into the group, or a non-arm's length transaction that involves the group or an associate of the group.

The utilisation of the bundle of losses in Z Co are subject to limits determined by reference to the available fraction method. The available fraction for the bundle of losses is reduced by the following formula (ss719-310(2)):

$$\frac{\text{*Market value of the ongoing head company just before the application event}}{\text{*Market value of the ongoing head company just after the application event}}$$

Applying the market values in the problem, the adjusted available fraction is then calculated as follows:
0.425 X 10/30 = 0.142

This leaves an amount of $6,000,000 x 0.142 = $852,000 adjusted carry forward losses available for use.

Assuming no other adjustment events occur during the income year, the available fraction that applies to bundle Z Co for the 2023 income tax year is 0.142 (s707-335 and s719-310 ITAA 1997).

After consolidation, the loss becomes that of the head company to use. If the joining entity ceases to be a member of the consolidated group, all losses remain with the head company of the consolidated group. Cessation of membership of the consolidated group will occur through liquidation of the joining entity.

Question 8

Candidates should be able to outline the general provisions of the FBTAA 1986. The Fringe Benefits Tax Act makes an employer liable to pay FBT for all the fringe benefit taxable amounts during the 12 months from 1 April to 31 March each year (s66 FBTAA 1986) at a rate of 47%. The definition of fringe benefits includes certain categories and also excludes certain categories of fringe benefits.

The loan to Geraldine was provided last FB tax year on 31 March 2021 and that loan extends into the current year. The making of the loan to an employee constitutes a fringe benefit and the forgiveness of the debt potentially constitutes another fringe benefit in the current tax year beginning 1 April 2022 (Div 3 and Div4 of FBTAA 1986).

The taxable value of loan fringe benefits is the amount by which the yearly notional amount of interest on the loan, exceeds interest that has accrued on the loan in the year (s18 FBTAA 1986) unless an exempt loan benefit (s17 FBTAA). A low rate of interest is one that is below the statutory rate, being a large bank variable owner-occupied bank benchmark interest rate for the FBT year. In his case the interest rate charged was nil, so the full statutory rate applies.

As Brick Pty Ltd didn't enforce any payment of interest at the end of the FBT year when the debt became due, the unpaid amount is treated as a loan to the employee. Such a loan commences immediately after the due date, at the rate of interest that should have accrued on the unpaid amount. A debt waiver fringe benefit arose when Brick Pty Ltd waived the obligation of its employee Geraldine to repay half the $20,000 owed to her employer.

In circumstances where the employer writes-off a genuine unrecoverable bad debt and the write-off is made for reasons unrelated to the employment relationship, a debt waiver fringe benefit does not arise.

A genuine bad debt may be able to be written- off for reasons including that:

- all reasonable efforts were made to recover the debt; and
- the write-off was consistent with company policy applied to business debts owed by non-employees.

In circumstances where the settlement of a debt owed by an employee to an employer is negotiated and results in the repayment of half the amount (in this case $10,000) that is less than the total debt of $20,000 outstanding, consideration must be given to whether a debt waiver fringe benefit has been provided. The taxable value to the debt waiver fringe benefit is the amount of debt released, being $10,000 (s15 FBTAA 1886).

Candidates may go the further step of explaining that the FBTAA generally determines the calculation depending on the type of aggregate fringe benefits supplied and it may be assumed in this case that the loan and debt waiver fringe benefits were type 2 (not GST creditable benefits).

The ss5B(1C) FBTAA 1986 amount is the amount worked out using the following formula and methodology:

$$\text{Type 2 aggregate fringe benefits amount} \times \frac{1}{1 - \text{FBT rate}} = 1.8868 \times 47\% \times \text{Total type 2 fringe benefits}$$

If it can be established that the reasons for releasing part of the debt are entirely unrelated to the employment relationship, a debt waiver fringe benefit will not arise. This situation does not match the facts presented.

In addition, no reduction of FBT would be likely as the otherwise deductible rule wouldn't apply to a housing loan.