THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 2.01 – AUSTRALIA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

SunnyCo is a foreign resident and derives profit from sales to Australian customers, from direct internet sales with Australian residents and commission sales made through an independent Australian based broker. The effective payment by direction of the broker's sales commission fee of 5% of the sale price, is a deductible expense, that reduces the gross amount of assessable income to calculate taxable income payable in Australia.

The source of this ordinary business income is in Australia, and all income derived from those sales would form part of the Australian assessable income of SunnyCo under ss.6-5(3) of ITAA 1997.

Part 2

Expenses tax conclusions:

- Customs duty payable by Sunnyco and paid by the commission agent is fully a general deduction ss.8-1(3) ITAA 1997, deductible for tax purposes as its necessarily incurred in the ordinary course of business s. 8-1 ITAA 1997;
- Retainer fee to keep a contractor is considered as part of on-going management and generally deductible under s.8-1 ITAA 1997;
- Drawing up a new investment plan for future opportunities has the character of an enduring benefit and if a one-off may be considered a capital expense and not deductible [Refer for example analysis in TD 95/60 Deductibility of fees paid for investment advice for taxpayers not carrying on an investment business see paras 5 & 6]. If so, an apportionment issue arises. If argued to be an extension of ongoing existing business, it would be deductible;
- A legal dispute under normal circumstances is a commercial feature of business and is deductible under the general provisions if there is a sufficient nexus to the income producing business (i.e. not peripheral per Magna Alloys and Research Pty Ltd v. FC of T 80 ATC 4542; (1980) 11 ATR 276), and such that they are 'incidental & relevant' (per Ronpibon Tin N.L. and Tongkah Compound N.L. v. FCT case) per s.8-1 ITAA 1997;
- The Australian domestic tax law specifies that penalties or fines payable under an Australian or a foreign law are not allowable deductions per s.26-5 of the ITAA 1997.

Part 3

Generally, a non-resident's enterprise must only register for GST if it is based in Australia for more than 183 days in a 12-month period, and has a GST turnover of A$75,000 or more (per Australian GST presence in s.9-27 of A New Tax System (Goods and Services Tax) Act 1999 (GST Act). However a sale which is connected with Australia may be liable to GST. As a non-resident supplier even without any enterprise in Australia, SunnyCo would be subject to GST on the supply of goods if it imports the yachts into Australia or assembled the yachts in Australia per s.9-25(3).

It would appear that SunnyCo is the importer of the yachts, as it is likely that SunnyCo would be responsible for completing the Customs and other requirements for the importation of the yachts. Alternatively, if the Australian customer, imported the yacht into Australia, then the sale of the goods by the supplier would not be connected with Australia and hence not subject to GST and the customer is liable for the import duty.

SunnyCo should be advised that as a non-resident business, it can agree with its resident agent to accept liability for the GST supplies (made through the agent). Both the non-resident supplier and the agent must specifically agree to this in writing.

If there is an agreement in writing between the non-resident supplier and the resident agent, notice must be given to the recipient of the supply if they are an Australian-based business. The notice must be given by the resident agent unless the agreement in writing provides that the non-resident supplier should issue the notice. The notice must be in the following form, either:

- a tax invoice for the supply; or
- a document that shows the:
    - non-resident supplier's, or their agent's, identity and ABN;
    - price of the supply;
    - amount of GST included in the price; and
    - date the document is issued, and a brief description of what is supplied.

If there is no agreement in writing between the non-resident supplier and the resident agent, the ATO is likely to seek the recipient of the supply to account for any GST.

Question 2

Part 1

The Research and Development (R&D) investment incentive consists of refundable tax offset. To be eligible, the costs incurred by eligible entities (s.335-35) who conduct eligible "core" activities in Australia and "supporting" core activities, which may be conducted overseas, must fit the definition requirements of R&D. However, eligible core R&D activities are described in s.335-25 as being "experimental activities", whose outcome is unknown in advance, based on current knowledge and needs to be carried out to generate new knowledge based on principles of science and those supporting activities that are for the dominant purpose of supporting the core activities - per s.335-30.

From 1 July 2021, the amount of the R&D concession is for amounts up to $150million for R&D entities with aggregated turnover of $20 million or more. The entitlement is to an R&D tax offset equal to their corporate tax rate plus a two-step set "premium" percentage, based on the level of the company's incremental R&D intensity for their R&D expenditure.

A Satellite used for income producing purposes is considered an item of plant or equipment and usually depreciable over the effective life of the equipment. Div. 40 ITAA 1997. Students should demonstrate an understanding of the operation of Div. 40.

For a more complete answer students would include the accelerated asset write-off provisions introduced as part of the government's economic stimulus of 'backing business investment,' certain temporary full expensing (TFE) provisions (for entities with turnover under $50Billion) and accelerated write-off provisions apply for entities with aggregate turnover under $500million were made available. Broadly, for TFE eligible assets (not including buildings and other capital works for which you can deduct amounts under Div.43) with a cost of over $150,000 and in the year first installed and ready for use by 30 June 2022, there is a deduction for 50% of the cost (or adjustable value where applicable) of the depreciating asset. However the accelerated rates are generally not allowable for assets that either will never be located in Australia or will not be used principally in Australia for the principal purpose of carrying on a business. (Subdiv. 40-BA and Subdiv.40-BB of ITAA1997)

If the software is still in development and is not ready for use, the software development pool rules allow for depreciation at uniform capital allowance rates (s.40-50 of ITAA 1997). It must meet the requirements under the definition of in-house software is computer software in s.995,..."that is mainly for you to use in performing the functions for which the software was developed; and ..for which you cannot deduct amounts under a provision of this Act outside Divisions 40..."

Part 2

Other expenses:

- Students should demonstrate a knowledge of the general deduction provision. Expenditure in the course of carrying on a business is generally deductible for those losses and outgoings incurred s.8-1 ITAA 1997. The phrase, "to the extent that" in the provision, means that it contemplates apportionment: Ronpibon Tin N.L. and Tongkah Compound N.L. v. FCT.

  Professional association memberships are deductible where the cost is incidental to the business of Spinner Communications Ltd and where it wasn't paid for any enduring benefit, but characterised as expended to maintain a business position, is deductible under s.8-1. Refer Sun Newspapers case. If some part of the amount was effectively paid or directed to be paid by Spinner Communications Ltd as a contribution to a political party it would be a deductible gift per ss.78(9) so long as it didn't exceed the maximum amount allowed of $100, per ss.78(10).

- Legal expenses may be generally deductible and are specifically deductible when related

to debenture raising being allowable a borrowing expense under s.25-25 ITAA 1997. A deductible for the purpose of producing assessable income is spread over the period of the loan, or 5 years from the date of the borrowing, whichever is the lesser per ss.25-25(4). Other kinds of expenses such as amendments to the companies articles, are of a capital nature to preserve assets and would be characterised as capital expenditure and not deductible ss.8-1(2)(a).

- Broadly, foreign exchange gains in relation to underlying Australian share sales, would also be assessable income for tax purposes and are accounted for when realised under Div. 775 of ITAA 1997 and unless electing otherwise, are to be expressed in Australian currency (Subdiv.960-C). The basic rule under s.775-15 is that all forex realisation gains made as a result of a forex realisation event are included in assessable income in the year it happens, unless it is private or domestic in nature, or not a listed event or has been included under another provision of the ITAA [per ss.775-70(3)]. The five listed events apply to disposal of foreign currency, or for ceasing to have an obligation to pay (or right to pay) foreign currency.

  With foreign share sales, forex realisation event 2 occurs, on cessation of a right to receive foreign currency. For short term sales an election, can be made not to have the 12 month rule apply to relevant transactions denominated in foreign currency (under s.75-80).

  The character of the receipts are business sales and so the CGT provisions are unlikely to be relevant (s.104-260 and s.104-265 for Events K10 & K11).s not “on” mining operations would be outside the specialised mining provisions of Division 40.

PART B

Question 3

When Jackson disposes of his partnership interest it gives rise to a capital gain under s.106-5 of ITAA 1997. Each partner also has a separate cost base for their share of the partnership (per partnership agreement of according to law) in each CGT asset of the partnership. The amount of the capital gain is the amount by which those capital proceeds exceed the cost base, as indexed s.102-22. The amount of a capital gain may be affected by certain exceptions and modifications s.102-30, none of which apply in the facts.

Where an asset of a partnership has been depreciated for tax purposes under Div. 40, and its depreciated price differs from their identifiable sale price, it may require a balancing adjustment amount may arise and no capital gain or loss arises (s.118-24 of ITAA 1997). However, a capital gain or capital loss from disposal of a depreciating asset is not disregarded where CGT K7 happens (i.e., sell the asset). In Jackson's case, if the cost of the partnership asset exceeds its termination sale value, the excess, constitutes a capital loss and if the sale value is greater than depreciated value then the excess is a capital gain.

A restrictive covenant granted by the remaining partners to Jackson is treated as an asset for CGT purposes per s.108-5. The asset consists of the right by the purchaser to enforce the covenant.

Jackson's payment for the covenant will be a capital gain s.104-35. In the absence of any specific allocation of the partnership sale proceeds being attributable to the restrictive covenant, it may be treated like goodwill (Taxation Ruling TR 1999/16). This may be beneficial in certain cases because, although a restrictive covenant and goodwill may both qualify for the active asset concession, the gain on the restrictive covenant cannot qualify for the 50% discount. If the parties allocate separate parts of the sale proceeds to the covenant and the goodwill, the Commissioner will accept the allocation if it is done at arm's length.

If Jackson breaches the covenant, any compensation received will be treated as a partial recoupment which reduces the purchaser's cost base s.110-55, provided that the breach has resulted in permanent damage to the goodwill.

Question 4

Generally, all corporate tax entities must abide by the detailed rules for keeping franking accounts under Div.205 of the ITAA 1997.

Where an Australian resident company pays income tax or a PAYG instalment of tax or incurs a liability to pay franking deficits tax, a franking credit arises to increase a balance on the franking account (s.205-15 ITAA 1997). Alternatively, where a corporate receives a refund of tax, the balance of the franking account is reduced commensurately (s.205-30 ITAA 1997).

Calculating the franking credit on receipt of a dividend of $70,000 with an 80% partially franked distribution is as follows $70,0000 x 80% x 30/70 = $240,000.

When a company pays a franked distribution, a franking debit arises in the franking account equal to the amount of the distribution. Franking deficits tax would only arise if the company pays a dividend franked in excess of its franking surplus, which would expose it to franking deficits tax (FDT) equal to the deficit. However, where the FDT liability is more than 10% of the total franking credits arising in the entity's franking account for the year, the company's tax offset arising from that franking deficit tax is reduced by 30% to the extent that the deficit relates to ss.205-70(8) ITAA 97. It is unlikely this will be the situation with Zee Pty Ltd for the proposed dividends as the credits for the current year are in likely to be excess of 100% franking amount.

Furthermore, the Commissioner has a discretion not to apply FDT where the events causing the deficit were "due to events outside the control of the entity" (company) such as through a business downturn or an event that gave rise to an unforeseeable event per ss.205-70(6) of ITAA 1997.

There is a filing requirement under Part 3-6 of the Income Tax Assessment Act 1997 to submit a franking accounts tax return where there is a liability to pay franking deficit tax and/or over-franking tax and/or a relevant entity has an obligation to disclose any significant variation to their benchmark franking percentage.

PART C

Question 5

A genuine redundancy payment receives tax free or concessional treatment, depending on the employee's length of the service with the employer, age, salary and reasonableness (s.83-170) of ITAA 1997. Any amount above the formulaic tax free component is taxable (s.82-145).

A "genuine redundancy payment" must satisfy the statutory conditions that Jill receives the amount before retirement age, the amount received is arm's length, and there was no re-employment arrangement in place: ss.83-175(2) of ITAA 1997.

On the facts Jill's proposed payment would seem to satisfy the requirements of being completely tax free given her length of service. The fact that the payment is made over three years does not change the character of the payment. For example, payment received after 12 months that would be an "eligible termination payment", as defined under ss.82-130(1), but not received within 12 months is still assessable income (s.83-295).

Long service leave is fully assessable income; however Jill is entitled to a tax offset on unused long service leave on the whole post 1993 component, that ensures the rate of tax does not exceed 30% (per s83-85(2)(b)(i)).

The tax issue with receipt of the gold watch on termination is whether it is characterised as a mere gift, or is assessable as income under s.6-5 ITAA 1997 or a benefit of employment under s.15-2 of ITAA 1997. It is not sufficient to say it was made in consequence of termination of employment (Refer the case of Blank v FCT).

Broadly, receipt of a 'one off', voluntary gift is not ordinary income. Given that the level of eligible termination payout is comparable to what amount should be received, that the employer had no obligation to provide a watch, and it was not expected – it might be argued the watch didn't constitute part of that remuneration or assessable income and could be treated as a mere gift for tax purposes.

If the $1,000 watch was not considered part of a termination for services payment, the direct employment relationship may suggest that the watch was provided as an 'external property fringe benefit' (Div.43 FBTAA 1986) to an employee and hence subject to fringe benefits tax on the notional value at time of receipt, unless classed as an otherwise deductible work related item or exempt.

Question 6

The net income of a trust estate trust income includes any 'net capital gain' from the sale of shares (as defined in s.102-5 ITAA 1997 and the trust provisions of Div. 6 ITAA 1936). Technically it is through Div. 6E that net capital gains are excluded from the trust provisions and dealt with through the CGT provisions of Subdiv 115-C. It is the discounted capital gains provisions apply to reduce the amount of trust income that is subject to tax (ss.115-10(c) of ITAA 1997).

Bonus marks for noting that trust "income" can be characterised in accordance with the Trust deed and didn't have fixed meaning per Bamford v Commissioner of Taxation [2009] FCAFC 66 and that a "share" of trust income rtakes its meaning from trust law concepts and refers to a percentage share of distributable income to which a beneficiary is presently entitled.

A beneficiary of a trust estate is deemed to have a capital gain which reflects the capital gain of the trust estate under ss115-215(3). The sale of shares would normally be considered a capital receipt.

Jacob as a non-resident of Australia, although not ordinarily assessed on such foreign income if derived directly, is in a different situation when attributed capital gains via an Australian trust distribution. This was the outcome of the case of Peter Greensill Family Co Pty Ltd (trustee)v. C of T. The case considered the interaction of the trust taxation rules on capital gains made by trustees (Subdiv. 115-C of the ITAA 1997) and the exemption which disregards capital gains to foreign residents, unless the CGT event is happening to "taxable Australian property" per s.855-10 of the ITAA 1997.

The decision of the Full Federal Court was that the trust income of a foreign beneficiary of an Australian resident trust deriving capital gains from share sales in a similar situation, was not disregarded by virtue of an exemption under s.855-10, but properly assessable.

A share of trust income assessable to Jannika, as not presently entitled to trust income, being a minor and under a legal disability (s.98 ITAA 1936). A such, the trustee is liable to pay tax on the foreign beneficiary's proportional share of the "net income" of the trust estate to the extent that it is "attributable to sources in Australia" s.98(2A). The trustee would pay tax at prescribed rates under Div. 6AA of ITAA 1936.

Jacob is taxable on his share of the trust income as she is presently entitled and is not under any legal disability, at ordinary tax rates of tax (s.97 ITAA 1936).

Question 7

Students are expected to provide a good overall explanation of the Controlled Foreign Company (CFC) measures as defined in s.340. The necessary prerequisite for the accruals system is for defined actual and/or the sum of de facto control tests to be met for attributable taxpayers. Control has been assumed in the facts. It follows that a share of the CFC's attributable income is assessed in Australia, unless exempted.

The CFC must be resident in an unlisted country as specified in Part 8 of the Income Tax Assessment (1936 Act) Regulation 2015, per s.456 of ITAA 1997.

However income is not attributable to X Pty Ltd under the CFC regime if it passes the 'active income' test (s.432 of ITAA 1997) for the statutory accounting period. This applies to the tourism business being carried on, in the Cook Islands. However passive income, as defined to include dividends (ss.446(1)(a) of ITAA 1997) is generally subject to the CFC regime and attributable income of X Pty Ltd.

Question 8

Students are expected to describe the targeted integrity rule in Div.832 of the ITAA 1997, addressing the hybrid mismatch rules. This domestic provision broadly follows OECD BEPS action 2 to prevent multinationals avoiding tax. The provisions apply to a member of a controlled group or parties under a structured group, to neutralise their non-matching taxation outcomes from hybrid financial arrangements for payments on or after 1 January 2019. Specific hybrid mismatch outcomes are relevant where one party escapes tax or achieves asymmetrical treatment across borders.

A deduction is denied to X Pty Ltd where there is a payment of interest to a foreign entity in the same control group, under a scheme and the payment is not subject to foreign tax at more than 10%, per s.832-725. The arrangement must also be carried out for the principal purpose of gaining a deduction, with no corresponding foreign income tax to be imposed on the payment (or to be imposed at a rate not exceeding 10%). The hybrid financial mismatch provisions may well apply to X Pty Ltd.

The situation of creating a deduction in one jurisdiction and the non-inclusion of income in the corresponding country of receipt is discussed in Law Companion Rulings: LCR 2021/1 and LCR 2019/3, which provides ATO interpretations of the Subdivi. 832-J and s.832-210.