THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2024

MODULE 2.01 – AUSTRALIA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

Candidates would be expected to discuss the statutory and case law guidance, together with the central factual circumstances determining an individual's residency. Archer initially satisfies the definition of resident for Australian tax purposes under s6 of ITAA 1936 having continuously lived in Australia and Candice having resided in Australia for 10 years from the time of her marriage to Archer and purchase of their house in 2000.

Their situation changes in 2012 when they depart Australia, to live in another country, Fiji, residing there continuously until the current tax year. Case law supports both of them being considered non-residents of Australia under ordinary concepts in the current tax year after living overseas long term: (FCT v Applegate (1979) 9 ATR 899, 79 ATC 4307 and FCT v Jenkins 82 ATC 4098; (1982),12 ATR 745). The ATO has issued Taxation Ruling TR2023/1 Income Tax: residency tests for individuals, which outlines scenarios and sates that …" [73]. The longer you stay in any one particular place, the more permanent it is likely to be. This is because of the practical reality that extended periods will usually and naturally lead to the formation of durable connections overseas and loosening of connections with Australia."

Part 2

Income from property sourced in Australia and capital gains from the disposal of Australian property, a form of statutory income, are both taxable in Australia when derived by non-residents (s 6-5 and ss6-10(5) ITAA 1997). Archer owns an interest in two properties in Australia and can only nominate one as his main residence to gain the statutory exemption from CGT. The issue is whether any tax arises from profits on sale of their residence in the current tax year, after they became non-residents.

The capital gains tax (CGT) main residence exemption under s118-110 of ITAA 1997 applies to individuals who are residents of Australia in respect of a dwelling they purchased, which is their main residence throughout the period of ownership and one of several CGT events may be applicable to the capital gains analysis` (CGT Event A1, B1, I 1) per Div 104 of ITAA 1997.

Archer and Candice cannot access the exemption if they are excluded foreign residents within the meaning of ss118-110(4) ITAA 1997, which applies to a person who has been outside the country for more than 6 years. There is an exception for certain life events within the meaning of s118-110(5)(b) ITAA1997, however Archer and Candice are unlikely to satisfy the life events test as they have been out of the country for 12 years (with no other circumstances to trigger it). Consequently, their taxable Australian property would be subject to a capital gain of $1,500,000; being $2,000,000 less $500,000 (of cost base), by the capital gains withholding provisions. A discount is only available to non-residents on assets acquired on, or before 8 May 2012.

Where a private house is let out for rent, there is an input tax supply with no GST consequences where it's used for private or domestic purposes. However, where 80% was used by the tenant, primarily used for carrying on a business, there is potentially a taxable supply of commercial accommodation (80%X $300,000= $240,000) plus an input taxed supply of rental accommodation ($60,000). As Archer and Candice's GST turnover from taxable supply exceeds the $75,000 GST threshold. Property owners in these cases are/ required to register and the supply of mixed property will be partly taxable. (refer GSTD 2000/9). However, special rules apply for non-residents, depending on their agency agreement, although their managing agent would be likely to be registered or required to be registered for GST. The owners would generally account for their GST liability to the ATO and can claim an input tax credit for a proportion of the agent's commission.

Part 3

The net rental income Archer's share of rental income from his Melbourne home is taxable in his hands (s4-1 ITAA 1997). However, Archer's home unit is not income producing in the current tax year, with the only assessable income being derived from rental of a different rental income property. As no assessable (rental) income is derived on his home unit property, then no deductions can be separately claimed for tax purposes, as the tax provisions prescribe that you can only deduct from assessable income any losses or outgoings incurred in producing assessable income or carrying on a business (s8-1 ITAA 1997).

This type of rental property arrangement would not constitute the carrying on of a business as the activities have insufficient relevant factors to qualify as a business (refer to Tax Ruling TR97/11), nor is there a situation where any expenses could be allowed up to the amount of rent received (per IT 2167) given that no rent was actually received. Consequently, if no taxable loss is derived from the rental activity, then it cannot be offset against other assessable income.

Question 2

Part 1

Irene has terminated her employment, and the payments made to her will be treated according to whether they fall within specific categories of income. Candidates are expected to discuss the character of the payments received by Irene, and whether they are in the nature of income, capital receipts, or payments received as a consequence of employment termination and taxed concessionally (per Div 6, Part 3-1, or Div 82 ITAA 1997).

Firstly the $200,000 Irene was paid on termination of employment and in the first 12 months after termination, although was part of existing entitlements to profit shares on sales. As such the character of the payment would be in the nature of deferred income, notwithstanding that the payment is made by another tax group entity, rather than Procedural Pty Ltd. In the case of Blank v. Commissioner of Taxation, (2016) HCA 42 deferred compensation for services performed while in employment was considered income according to ordinary concepts. The amount was held not to be assessable as a capital gain or of a capital nature, because it did not represent the proceeds of the exploitation of interconnected rights that conferred on him a future right to receive a proportion of the profits.

In relation to Irene's restrictive covenant under which Irene had agreed, either verbally or in writing, not to pass on her professional knowledge on any similar development research work which she had led with her employer Procedural Pty Ltd, she has received no payment. No income has been received to be subject to tax, so the analysis would need to determine whether a CGT asset has been brought into existence (e.g. know how) under a CGT event (D1) and whether the CGT provisions bring any amount to tax.

The definition of CGT asset includes where the legal rights are transferred as a legal or equitable right, that is not property (s108-5 ITAA 1997). The effect of the CGT provisions is that the legal rights are created by Irene and transferred to the purchaser, Procedural Pty Ltd, from the date of the agreement or termination of employment. As Irene has not received any consideration in respect of the disposal of her rights, for which the cost base is nil, the issue is whether the market value substitution rule applies between two parties dealing at arm's length (s116-130 ITAA 1997). However, as Irene created a contractual right in Procedural Pty Ltd for no consideration, she avoids capital gains tax under the general modification provisions, per ss122-20(3) of ITAA 1936.

Part 2

FBT: Candidates are broadly expected to outline the liability to Fringe and Benefits Tax (FBT) under s66 of FBTAA 1986, and employer liability for FBT in each tax year beginning on 1 April. The FBTAA requires a nexus or link to employment and categorises fringe benefits into groupings. In Irene's case one specific type of FBT would have been a car fringe benefit for the car used during her employment. As the facts state that Irene's employer, Procedural Pty Ltd is Australian medical research company, we can assume the property being a car is not provided to outsiders and is an external property fringe benefit provided as a result of the termination of a salary packaging arrangement. The taxable value is prescribed under s43 of FBTAA 1936 as the cost to the provider or the notional value (being a reasonable arm's length price) depending on the circumstances of purchase of the property.

LEGAL Expenses: Payment of $25,000 for legal advice is considered deductible if it is incidental or relevant to the production of the Irene's business operations, (Invest&Go company) per s8-1 of the ITAA 1997. The cost is likely a business claim and not personal. Case law indicates that the expenses must have a close connection to income producing activities (Magna Alloys and Research Pty Ltd v. FC of T 80 ATC 4542) and if the nature of the advantage sought is an enduring benefit, then the expense is of a capital nature (refer Hallstroms Pty Ltd v. FCT (1946) 72 CLR 634). The distinction must be made between expenditure incurred for the purpose of preserving and protecting business assets (i.e capital and non-deductible in the event of litigation by Procedural Pty Ltd), and expenditure which the business may require as part of prudent management (i.e. deductible). The facts indicate that the payment is unlikely to have sufficient nexus to income to be tax deductible.

Part 3

On cessation of employment, the car is likely to be considered a property fringe benefit, provided to Irene's spouse under a lease transfer. The spouse falls within the definition of associate (s136 of the FBTAA refers to s318 of ITAA 1936) and is subject to FBT on the taxable value of the benefit. Section 40 of FBTAA 1986, covers provision of property (as defined in s136 of FBTAA 1986) to another person, and the taxable value is determined differently, depending on whether it's an in-house or external, property fringe benefit.

PART B

Question 3

Candidates should recognise the issue of Unpaid Present Entitlements (UPE) under Divi 7A of Part III of ITAA 1936, where a private company will be taken to pay an unfranked dividend in an income year if it makes a loan, or provides credit, or forgives a debt to a shareholder or their associate and the loan is not repaid before the private company's date of lodgement.

Issues include whether the outstanding amounts are a loan within meaning of ss109D(3), and a deemed dividend under ss109D(1) of ITAA.

In the case of the individual Mike Taylor, a loan is made to by the corporate trustee as evidenced in a loan agreement and the amounts outstanding were forgiven, which attracts Div 7. Some amount is therefore should be included in assessable Mike Taylor's income. The effect of the formula in s109Y is that the Div 7A dividend cannot exceed the amount of 'distributable surplus', so it is proportionally reduced by the formula:

Net Assets	+	Div & 7A amounts	–	Non commercial Loans	–	Paid-up share value	–	Repayments of non-commercial Loans

The facts indicate that a provision of finance could be construed as being made to Glee Investments Pty Ltd by the corporate trustee. In these circumstances the ATO takes the view that where a private company beneficiary holds a UPE and has knowledge of the UPE and does not call the UPE for payment, ss109D3(b) of the ITAA 1936 is engaged due to there has been a provision of a financial accommodation (equivalent to a deemed loan) and so a deemed dividend is to be included in the company's assessable income. Alternate arguments may also be available to the ATO to argue assessable income must be included under Subdiv EA or s100A of ITAA 1936.

Subdiv EA, which operates in circumstances when the trust, in addition to an UPE, lends money to a corporate beneficiary and under s109XA, and …" a reasonable person would conclude (having regard to all the circumstances) that at the time the original transaction took place shareholder, intended to make a loan to a trustee." Under s 109XB, the Div 7A amount is included in assessable income of the company as if it were a dividend paid in the year the actual transaction took place. There is subject to a discretion under s109RB.

Under the provisions of s109XA the amount involved in the actual transaction to be assessed, is the lesser of:

- the amount actually involved in the actual transaction; and
- the amount worked out using the formula:

Unpaid present entitlement less previous transactions(under s109UB).

An anti-avoidance provision under s100A of the ITAA 1936 is triggered in instances where, for the purpose of avoiding tax, a beneficiary is provided a trust distribution, but another entity benefits from the distribution. If applicable, s100A will make the trustee liable to tax at the top marginal rate.

Refer to TD 2022/11 Income tax: Division 7A:

> *when will an unpaid present entitlement or amount held on sub-trust become the provision of 'financial accommodation.*

Question 4

Candidates are expected to broadly cover the personal services income rules which are contained in Part 2-42 of the Income Tax Assessment Act 1997. These provisions act as a type of specific anti-avoidance rules ensuring that professionals who enter into contracts of service with related entities cannot reduce, alienate, or split their income through their interposed trusts, companies, or partnerships. The rules do not apply to employees or sole traders.

The effect of the tax provisions is that PSI income of the entity is attributed to the individual who generated the income (Div 86 ITAA 1997) and for the personal services entity the rules restrict the types of deductions that can be claimed. For an individual subject to the PSI rules, deductions are only allowable to the extent of those claimable for salary and wages type claims (Div85 ITAA 1997). The net generated PSI received by the Ice Family Trust may also give rise to pay-as-you-go withholding in respect of the individual.

The tax analysis requires application of the principal "results test" (s87-81 ITAA 1997), and failing that test is another 80% rule and further test termed 'unrelated clients' test, 'employment test' and 'business premises' test. The Commissioner of Taxation has a discretion that he can choose to exercise in unusual circumstances where he considers that one or more of the tests could have reasonably been satisfied (Subdiv 87-B ITAA 1997).

Firstly, applying the results test to the facts presented, it is clear that the test is not passed, and the PSI provisions would be applied. Although income is received under a contract for specific audit tasks and payment is not made until the tasks are completed (or a result is achieved), it is not assured that any defects would be corrected, and the premises and equipment is provided to Glenice by her client/accountant. Next is consideration of the client base which Glenice obtained through a word-of-mouth referral, without advertising or tendering. Accordingly, Glenice would be unlikely to satisfy the 80% test, the employment test or the unrelated client's test.

Candidates should be able to outline the general operation of Part IVA of the ITAA 1936. The ATO may consider that cancelling any tax benefit (under s177F of ITAA 1936), if that tax benefit arose in relation to a scheme which involved an income splitting arrangement. The requirements of Part IVA of ITAA 1936 are that the dominant purpose of the scheme is to obtain a tax benefit resulting from the alienation or income splitting of the PSI, particularly if the profits were distributed to relatives at lower marginal rates of tax: see for example where the ATO considers the anti-avoidance provisions may apply in Taxation Ruling TR2022/3 at [162].

PART C

Question 5

Candidates are expected to explain relevant provisions of A New Tax System (Goods and Services Tax) Act 1999., which applies broadly to consumption in Australia. At any particular time, GST is payable when sales exceed $75,00 turnover as measured during the previous 12 months (s188-15 GST Act)

A supply of goods is GST-free under item 2 of s38-185 of the GST Act where: the consideration of the supply is provided in instalments under a contract that requires the goods to be exported; and the supplier exports the goods from Australia either before, or within 60 days of the first of the following two events:

- the supplier receiving any of the finals instalment payment for the goods; or
- if on an earlier day, the day on which the supplier issues an invoice for the final instalment of the goods.

An export occurs when the goods depart from an Australian port, and where commercial delays occur, the supplier can request that the Commissioner of Taxation's discretion to be applied to extend the 60-day period where the goods cannot be exported within the 60-day period. Where the purchaser takes delivery in Australia and later exports them from the warehouse directly it is still treated as GST free provided the purchaser is an overseas resident, the goods are not altered before being entered for export and a reasonable level of documentary evidence is maintained.

Goods and Services Tax Ruling, GSTR 2002/6, explains when supplies of goods are GST-free exports under item 2 and requires evidence to verify the and when it occurred, to substantiate treating their supply as GST-free export.

Question 6

Candidates are expected to set out the broad statutory provisions which provide for a taxpayer's rights to an objection, review, and appeal, that are contained in Part IVC of the Taxation Administration Act 1953, including decisions to which the provisions apply, time limits and grounds of objection. Alternatively, a request for amendment of an assessment may also be made under s170 ITAA 1936, if it is made within the requisite period of review.

The requests for review, objection and appeal can be made against assessments for both Freddie and his private companys. However, if it is assumed that Freddie's company may be a resident of an offshore jurisdiction, which has a double tax treaty with Australia, then a request can also be made for mutual agreement proceedings to relive any double tax (per Article 25 of OECD Model Tax Convention).

As a basis for the grounds of objection, Freddie is advised that he bear the onus of proof in contending that he should not be assessed personally on his image rights under either s6-4 or s6-5 of ITAA, on the basis that these rights are associated with activities that constitute a business being carrying on (a question of fact and law per ss 995-1(1) ITAA 1997 and CofT v Murry [1998] HCA 42). There can be found some case law authority for allowing management fees for sports people carrying on a business of exploiting their skills as a celebrity (for example Spriggs v CofT; Riddell v CofT [2009] HCA 22) which may be persuasive.

While the ATO contends Freddie can't make a legal transfer of his image separately from any business enterprise, you could also highlight to Freddie in your advice that if the ATO did recognise a transfer, the ATO is also likely to question whether adequate consideration was paid the transfer (for example under s108(5), and CGT event C2 in s104-25 of the ITAA 1997). There may also be the suggestion of whether it attracts the operation of the royalty provisions under s15-20 of ITAA 1997.

Candidates are awarded extra marks if they point out that consideration may also need to be given to whether the income constitutes personal services income under Part 2-42 of ITAA 1926.

Question 7

Different consequences flow from debt instruments as compared to equity financial instruments. The economic substance tests used for determining whether an instrument should be treated as debt or equity for tax purposes is contained in Div 974 of ITAA 1997.

The main test for a debt instrument is whether under the scheme, a financial benefit will be obtained in connection with an 'effectively non contingent obligation' (per s974-135 of ITAA1997) to provide financial benefits to investors equal to that received. A scheme that qualifies as an equity interest, is not a debt interest in the company or a connected entity and the financial arrangement allows the investor to become a member of the company or stockholder, having a right to a return from the company (s974-75 of ITAA 1997). In addition, equity interests encompass an interest issued to provide a return that can be variable or fixed, and from the company or a connected entity of the issuing company, or the return gives the holder a right to be issued with equity in the company or convert to equity in a connected company.

Accordingly, although converting preference shares would not be regarded as debt, they may be considered debt if Checko's proposed financial instrument will not be an equity interest if the company is obliged to buy them back or they are non-contingent because they convert into shares in a connected group company.

Question 8

The controlled foreign company (CFC) legislative provisions are contained in Part X of ITAA 1936, which seeks to tax Australian resident companies on their share of CFC tainted income.

The conditions to be met under the CFC legislation are that there must be a controlled foreign company (s340 ITAA 1936), with an attributable taxpayer (s361 ITAA1936) and attributable income (Div 7 ITAA 1936) against which an attributable percentage is applied to determine assessable income. All preconditions are satisfied as Austeria Pty Ltd has an aggregate associated inclusive control through direct and indirect interests of above the threshold. As Austeria Pty Ltd.'s attribution percentage is 60%, the company must include $600,000 in its assessable income for the income year in which the CFC's statutory accounting period ends (s 456 ITAA 1936).

The tax-paid deeming rules will apply to Austco Pty Ltd.'s interest in the Offshoreco, a controlled foreign company, due to it satisfying the following factors:

- It is a resident company that has included an amount as assessable income, representing its controlled foreign interest, and
- foreign income tax has been paid by the Offshoreco in respect of the amount included in its notional assessable income for the relevant statutory accounting period, and
- it has an attribution percentage of greater than 10% at the end of the relevant statutory accounting period.

The amount of foreign income tax that Austco is deemed to have paid on its attributed income is the $200,000 paid by Offshoreco, multiplied by Austco's attribution percentage of 60%, that is, $120,000 is deemed to have been paid, which Austco Pty Ltd must gross-up in its assessable income.