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# Developments in Taxation

**In Autumn 2008 we return to taxation issues after covering AIFRS developments in our past two editions of the JR Corporate Newsletter.**

The more significant developments over the past six months included:

- A review is being undertaken of taxation issues impacting on managed funds, including property trusts.
- The Australian Taxation Office (ATO) has continued to focus its GST audits on the property sector and in particular the application of the margin scheme.
- The capacity in the property sector to utilise risk management structures with some ancillary taxation benefits (WIP deductions) remains in place.
- The ATO is taking a very hard line on private companies seeking to undertake demergers. In particular the ATO is only accepting demergers with genuine business (as opposed to shareholder) reasons.

- The ATO has increasing confidence that it can apply Part IVA to any restructures which seek to achieve "contrived" taxation outcomes.

However the position is unclear where one component of a larger transaction may have taxation benefits. This will be a key area of dispute in future Part IVA tax cases.

- The ATO is conducting audits on publicly listed companies with carry forward losses.
- The ATO issued a draft tax ruling setting out its views in relation to the tax consequences of a company issuing shares in exchange for assets.
- The focus of the ATO on high wealth individual audits continues although where the information provided is complete and not controversial the audit action is relatively painless.
- The level of compliance in the audit of self managed superannuation funds appears to be very poor and the ATO is preparing to hit this space with 11,000 audits this year.

The status quo remains that those who operate within reasonably arguable position parameters need not lose too much sleep over ATO audit activity.

In this Newsletter we focus on a number of developments which may be of interest to you.

If you would like more information on any of these articles, please contact us. Please do not rely on any of the articles as a substitute for advice.



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# Taxation of Managed Funds to be Reviewed

**As promised in the election campaign the Assistant Treasurer, Chris Bowen, has announced two reviews of taxation issues impacting managed funds.**

The first holistic review will consider the development of a more internationally competitive taxation regime for the managed funds industry.

The second review will specifically consider proposed interim changes to the application of the public trading trust rules contained in Division 6C of the Income Tax Assessment Act 1936 (the 1936 Act).

No announcement was made regarding proposals to reduce withholding taxes on distributions to non-residents from the current corporate rate of 30% to 15% although this issue remains on the Government's agenda.

As managed funds are generally trusts for taxation purposes they suffer from an archaic regime which had its origins around the time the First Fleet sailed into Botany Bay. Further, much of the recent legislation to curb the use of trusts as tax effective structures (such as the trust loss rules) has also impacted managed funds.

The specific review of Division 6C will be most welcome. In the majority of circumstances managed funds must satisfy a requirement that all their income arises from an "eligible investment business" or the trust itself will be taxed as a company.

The definition of eligible investment business is narrow, potentially causing trusts with only minor non qualifying income to lose their flow through status.

The consultation paper considers a number of potential interim changes to Division 6C that would modernise and clarify the definition of 'eligible investment business' within Division 6C by:

- Clarifying the scope and meaning of critical terms in the definition of eligible investment business in particular defining what is meant by investment in land for the purpose of deriving rent;
- Introducing a 25% safe harbour for non rental income arising from land as a measure for determining what is primarily the purpose of deriving rent; and
- Expanding the range of financial instruments and derivatives which constitute eligible investment business.

The discussion paper can be found on the Treasury website: <http://www.treasury.gov.au> and search "Eligible Investment Business".

## ATO'S Views on Capital Reductions Released

**The Commissioner has issued a draft Practice Statement PS LA 1552 outlining his views on the application of Section 45B of the 1936 Act to capital reductions.**

The policy intent behind Section 45B is to address the perceived mischief of companies making returns of capital in preference to the payment of dividends. In many circumstances the return of capital will provide shareholders with a more favourable tax outcome than the receipt of a dividend.

This policy intent is contentious as in the first instance there is a compelling argument that shareholders should be free to either receive capital or dividends without hindrance from the ATO.

In the practice statement the Commissioner explains that Section 45B was introduced as a result of changes to the Corporation Law in 1998. These changes provided companies with the ability to return capital subject to the reduction being fair and reasonable to shareholders and not prejudicial to creditors.

Section 45B has since its inception provided a headache for companies seeking to return capital or undertake demergers. The uncertainty has caused companies to seek Class and Private Rulings before undertaking capital reductions. Many clients have experienced outrageous administrative hold ups in receiving these rulings potentially causing delays to commercial transactions.

The draft Practice Statement now provides some guidance on the Commissioner's view including a number of worked examples.

Somewhat ironically the Commissioner states that Section 45B is not a profits first rule. The Section was intended to be an anti avoidance rule against tax schemes designed to provide tax advantaged "capital benefits" to shareholders in preference to dividends.

However, the Commissioner's interpretation clearly goes much further than an attack on tax schemes. In circumstances where a company has undistributed profits the Commissioner does not accept a return of capital to shareholders without a dividend component.

Paragraphs 33 – 36 of the draft practice statement evidences the Commissioner's views:

*"However, generation of surplus funds from carrying on business in the ordinary way is the occasion for the distribution of a dividend, not a return of capital. Indeed, the Corporations Law reflects this difference by imposing more onerous statutory requirements on a distribution of share capital.*

*Broadly, the Corporations Act provides that a distribution of profit is a matter for the discretion of the company's directors, provided profits are available and the company is solvent. A distribution of share capital, on the other hand, is a more restrictive exercise which requires the*

*agreement of the shareholders acting in the certainty that the distribution is fair and reasonable to the company's shareholders as a whole and does not materially prejudice the company's ability to pay its creditors.*

*In other words, profits are distributed by executive decision, but distribution of a company's share capital, which is the money contributed by its members for carrying out its objects, requires the members' agreement that, in effect, it is no longer needed by the company for that purpose.*

*If a company can choose to distribute either capital or profits therefore, other than the tax preference of shareholders, there should be compelling, objective and commercial reasons why a company would choose the difficulty of distributing share capital over the relative simplicity of distributing profits. Section 45B provides for those reasons to be identified and considered in determining whether it applies to the distribution."*

This line of reasoning is critical as Section 45B can only apply where the Commissioner considers the capital reduction has a more than incidental purpose of enabling a taxpayer to obtain a tax benefit.

The Commissioner's conclusions seem to be that there is a presumption that a return of capital rather than the payment of a dividend must evidence a taxation preference of shareholders and accordingly has the purpose of achieving a tax benefit.

Section 45B and its penal provision, Section 45C, carry the punishment of treating the return of capital as an unfranked dividend.

We hope that it has caught your attention that there is significant tax risk in undertaking capital reductions where the relevant company has undistributed profits.

# Tax Consolidation and Losses

**As the ATO is in the process conducting audits on publicly listed companies with carry forward losses, we thought it prudent to remind our readers about the rules relating to tax losses and companies joining and transferring tax losses to a consolidated group.**

## Overview

In general terms, if you acquire a 100% owned subsidiary from a consolidated group it will not come with any tax losses (as the losses remain with the parent company of the consolidated group).

However, where an existing consolidated group acquires a new 100% subsidiary with taxation losses (assuming the subsidiary was not previously a member of a consolidated tax group) the losses may, subject to satisfying certain tests, be transferred to and utilised by the consolidated group.

The rate at which such losses can be utilised is regulated by what is referred to as an available fraction. Importantly though, this available fraction will be reduced each time the parent company of the consolidated group raises new capital.

## Tests that must be satisfied

The transfer of un-utilised losses of a company to a head company on joining a consolidated tax group and the rate at which those losses can be utilised is governed by Division 707 of the 1997 Act.

It is important to note that the Division applies to both the losses of a subsidiary on joining a consolidated group or to the losses of the head company when a consolidated group is formed.

The loss in the joining subsidiary may potentially be transferred to the head company of the group if, under certain notional assumptions, the subsidiary would have been able to use the loss in its own right immediately after joining the consolidated taxation group.

In very simplified terms this means that the subsidiary company must have satisfied either a continuity of ownership or some business test for the 12 month period prior to joining the tax consolidated group (note there are a few exceptions which will not be discussed in this article).

The losses successfully transferred to the head company (called transferred losses) are then taken to have been made by the head company for the income year in which the loss was transferred.

## Available fraction

As noted above when a joining subsidiary transfers losses to the head company of a tax consolidated group, the rate at which the losses may be utilised by the head company is restricted by an available fraction.

The losses transferred are kept together in what is referred to as a loss bundle. Each loss bundle has its own available fraction.

In simplified terms the fraction is calculated utilising the following formula.

$$\frac{\text{Modified market value of subsidiary}}{\text{Adjusted market value of the consolidated group (after acquisition of the subsidiary)}}$$

It is critical to note that the available fraction for a bundle of losses may be reduced in accordance with specific formulae should any of the following events occur:

- Losses in a bundle are transferred from one consolidated group to another;
- Previously transferred losses are transferred to a new parent company;
- An existing consolidated group with transferred losses acquires new loss bundles; and
- There is a capital raising in the parent entity.

When utilising transferred losses, care should be taken to ensure that the available fraction has been appropriately calculated.

## How transferred losses are utilised

In a particular income year the taxable income of the consolidated group is calculated in the usual manner.

Any taxation losses arising from the period after tax consolidation (referred to as Group Losses) are then deducted.

The remaining taxable income multiplied by the available fraction caps the amount of losses in the relevant bundle that may be utilised in that year. If any transferred losses remain, the balance is carried forward and a similar calculation is undertaken each year.



## Carry forward of listed company tax losses

**As many readers will be aware to carry forward and utilise tax losses a company must satisfy either a Continuity of Ownership (COT) or Same Business Test (SBT).**

These tests are modified for listed companies hence the terms modified COT and modified SBT.

The modified COT is satisfied if there is substantial continuity of ownership of the company between the start of the relevant year a loss was made and:

- the end of each income year.
- the end of each corporate change in that period.
- the end of the income year in which the loss is to be utilised.

These three times are referred to as ownership test times.

There is substantial continuity of ownership if persons who had more than 50% of the:

- voting power;
- rights to dividends; and
- rights to capital distributions.

at the start of the loss year had more than 50% of these rights at the ownership test times.

A corporate change includes any issue of shares which increases the company's issued shares or issued share capital by 20% or more.

There are concessional tracing rules which makes it easy for many listed companies to satisfy the COT test.

Direct shareholdings of less than 10% in the company are attributed to a single notional shareholder. This notional shareholder is effectively deemed to hold a parcel of shares at the beginning and end of the test period.

This means that if shareholdings of less than 10% comprise more than 50% of the shareholdings at the beginning and end of a test period the modified COT test will be satisfied without having to consider the other shareholdings.

## Interaction Between Scrip for Scrip Roll-Over and the Taxation Consolidation Rules

On acquisition of a new subsidiary a tax consolidated group is required to reset the tax cost of the assets in the subsidiary. The total amount of the reset is determined by what is referred to as an Allocable Cost Amount or ACA.

The ACA has two substantive components being the consideration period for the shares in the subsidiary and the liabilities of the subsidiary at the date of acquisition.

The critical issue to determine in a scrip deal is whether the amount used in calculating the ACA is the market value or the scrip or some other amount.

Prior to a press release from the Minister for Revenue and Assistant Treasurer late last year in most circumstances the answer was the market value.

Please note for completeness that there is a legislative exception to using market value where all parties to the scrip for scrip transaction are required choose to obtain a roll-over under Subdivision 124-M.

The Government considered that the scrip for scrip rules were being abused. The mischief was an artificial reduction in capital gains tax achieved in the following series of steps:

1. An asset in an existing company has an unrealised capital gain. The relevant asset is targeted for disposal.
2. The company holding the asset is acquired by a related company utilising scrip for scrip rollover.
3. A consolidation election is made and the tax cost of the assets in the acquired company is reset.
4. The relevant assets tax cost is uplifted in the tax consolidation process.
5. The relevant asset is subsequently sold with a reduced amount of capital gains tax payable.

In a press release late last year the Government announced that the uplift in the tax cost of assets would not be available following a scrip for scrip roll-over.

This announcement materially prejudiced the conclusion of scrip deals which were now potentially far less attractive than cash deals (as the tax cost of assets on consolidation following a cash deal would be much higher).

The new Assistant Treasurer, Chris Bowen, announced on 11 January 2008 that the new Government intended to revisit this issue, particularly in light of the disruption the previous press release had caused to capital markets.

The intention of the new Government is that "non contrived" scrip for scrip transactions will not be impacted by legislative change.

As always no doubt the devil will be in the detail and it will be a case of closely monitoring the legislative developments.

## Taxation Consequences of a Company Issuing Shares as Consideration for Services or Assets

The Commissioner of Taxation has issued a Draft Taxation Ruling 2008/D1 regarding the taxation consequences of a company issuing shares in consideration for the acquisition of assets.

Set out below are the Commissioner's initial conclusions:

1. When a company issues shares as consideration for assets, the provision of shares is neither a loss or outgoing of the company. Accordingly there is no deduction available under Section 8-1 of the 1997 Act (the general provision under which deductions are available).
2. However where a company splits the transaction into two parts in the following manner a deduction is potentially available:
  - (i) The company acquires the services and incurs a liability; and
  - (ii) The liability in a separate transaction is set off by the issue of shares.
 In other words it is a simple matter of form over substance and the deduction is achieved.
3. Where a company issues shares in consideration for the acquisition of a depreciable asset the market value of the shares is accepted as being the depreciable cost of the property (contrast the conclusion in 1. above).
4. Where a company issues shares in consideration for the acquisition of a capital gains tax asset the market value of the shares is accepted as being the cost base of the asset for capital gains tax purposes.



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