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- (iii) The sell back rights were a product of the taxpayer's shareholding and not the disposition of any interest in that shareholding.
- (iv) It is not determinative that there was no distribution of retained earnings by St George;
- (v) There was no disposition by St George of any of its assets; and

(vi) The taxation of dividends was not an exclusive code for the taxation of returns to shareholders.

Whilst in one sense the decision may be seen as specific to the creation of sell back rights it is likely to broaden the definition of what can be ordinary income for taxation purposes.

## FBT SHOCK—FC OF TV SLADE BLOODSTOCK

Every now and again the Court throws up an absolute shock—this year's award is sure to fall with Justice Heerey of the Federal Court.

In this case a husband and wife had provided loan funds to fund the working capital of a company.

Over time the company paid various expenses on behalf of the shareholders and debited these payments against the loan funds owing to the shareholders.

The Taxation Commissioner sought to assess the loan repayments as fringe benefits paid to the shareholders as they were also employees of the company.

In the first instance the Administrative Appeals Tribunal said that the payments were not fringe benefits made in the course

of employment as there was no nexus between the employment of the shareholders and the provision of benefits. The Tribunal accepted that the payments were regarded by the shareholders as the repayment of loans. In this regard the shareholders would have been entitled to the loan repayment regardless of any employment relationship.

On appeal the Federal Court ruled that the repayments were made by virtue of the shareholders' employment and accordingly were taxable fringe benefits (and not loan repayments). Justice Heerey appeared to be influenced by the fact that the shareholders did not draw a salary.

The case is on appeal to the Full Federal Court where one hopes sanity will prevail.

## INTRODUCING OUR NEW CORPORATE TAX EXECUTIVES



Megan Larsen has joined our Corporate Taxation team as a Director. The Director's position allows Megan to sign off advice on behalf of the Partnership.

Megan is an experienced taxation practitioner with substantial experience in the property industry.



Katrina Tideman joined us prior to Christmas as a Manager in our Corporate Taxation team. Katrina has recently completed a Law Degree and is an experienced CA. Megan and Katrina's teams are full of new faces as our taxation group continues to expand.

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The information provided in this newsletter is a guide only and should not be relied upon as advice from Johnston Rorke.

## INTRODUCTION

After some heavy yards on AIFRS last edition we are moving back to a taxation focus this quarter.

For those of you who we haven't yet contacted, Johnston Rorke has moved to Levels 29 and 30 at CP1.

Whilst we are committed to maintaining significant daylight between our charge out rates and those of the Big 4 firms, our

new premises are more in keeping with our corporate presence in South East Queensland.

For those of you considering a change of premises feel free to contact Ross Walker who now moonlights as an interior decorator.

## ACQUIRING A COMPANY FROM A CONSOLIDATED TAX GROUP

Notwithstanding whether or not it is intended to consolidate the target company, it is necessary to consider the taxation consolidation legislation where a company is being acquired from a tax consolidated group.

Where the purchaser is an existing consolidated group, all new 100% shareholdings are automatically consolidated.

Accordingly where adverse taxation problems arise on consolidation it may be necessary to acquire less than 100% of the shares.

The implementation of an employee share scheme where greater than 1% of the stock is held by the employees on acquisition is one possible strategy. However as with all taxation planning it would be necessary to consider if the anti-avoidance provisions in Part IVA have any application.

Where the purchaser is not a consolidated group there is a choice as to whether an election to consolidate will be made.

To consolidate it should be noted that the purchaser must be a company.

The driving reason consolidation is generally elected is the ability to reset the cost base of the various assets in the company being acquired.

The circumstances where this will be of considerable potential value include the following:

- The historic cost of assets held by the target company is significantly lower than their market value;
- There is internally generated goodwill in the target company;
- The market value of plant and equipment held by the target company is higher than its tax written down value; or
- The target company holds patents, copyright or registered designs.

Problem issues which may arise in the reset of asset values include the following:

- Allocation to debtors should be at face value even though a provision for doubtful debts may exist.
- Where a same business test is failed post acquisition by the target company, the write off of these debts will not be

tax deductible.

- Technically debts previously written off which may still be collected should receive an allocation (although this is not done as a matter of practice as it would create both an unfair outcome and a logistical nightmare).
- Following amendments announced in December 2005 any allocation to consumables should provide future deductions on a usage basis.
- Where an allocation is made to work in progress the better view is that a deduction will then be available when this WIP is billed (as the billing represents assessable income).
- It should be noted however that the technical support for this deduction is uncertain and this issue will require legislative clarification.
- The cost base of foreign exchange liabilities does not reset (only the cost of assets resets). Accordingly the payment of liabilities post acquisition may give rise to assessable gains or deductible losses.
- Where the target company has elected to use a low value pool for depreciation purposes the acquiring company will be required to maintain this approach and also use the low value pool method for all new acquisitions in the entire consolidated group (not just the target company).

**ISSUES WHEN A CONSOLIDATED GROUP SELLS A SUBSIDIARY**  
As expected the sale of shares in a subsidiary company will give rise to a potential capital gains tax liability.

However rather than using the historic cost of the shares in the subsidiary in calculating any gain, the cost of the shares is reset (referred to as an Exit ACA).

The rest cost of the shares is calculated using the following formula:

**Terminating value of the assets of the subsidiary**  
PLUS **Market value of loans made by the subsidiary to the rest of the consolidated group (which remain in the books)**  
MINUS **Liabilities of the subsidiary**

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The terminating values are essentially the tax written down value of depreciable assets, the tax value of trading stock and the CGT cost base of other assets.

If the above formula gives rise to a negative number, the cost base of the shares is nil and the head company of the consolidated group will be deemed to have realised a capital gain (CGT Event L5) equal to the negative ACA amount.

Note that Section 165CD may reduce any capital loss to the extent the subsidiary leaving the group has unrealised tax losses in respect of assets on its balance sheet.

### ASSET OR A SHARE ACQUISITION—ARBITRAGE OPPORTUNITIES

Where the acquisition involves a private company it is often a requirement of the vendor that the shares in the company be sold rather than the underlying assets.

This requirement arises as the vendor may be entitled to the 50% capital gains tax discount with a share sale. As companies are not entitled to the capital gains tax discount, vendors will often not accept an asset sale.

This historically disadvantaged purchasers as the target company assets were left at their historic cost for taxation purposes.

Where the target company is consolidated for taxation purposes the cost base of the underlying assets are able to be reset.

Accordingly an arbitrage opportunity exists for vendors to enjoy the capital gains tax discount and the purchaser is able to reset the cost base of the company's assets.

### LIQUIDATING A COMPANY IN A CONSOLIDATED GROUP

Consolidated taxation groups operate under what is referred to as the single entity rule. Under this rule subsidiary companies are in effect treated as divisions of the head company.

During the period of taxation consolidation all transactions between entities within the consolidated group are ignored for taxation purposes.

The Commissioner has ruled in an Interpretative Decision (ATO ID 2003/965) that a liquidator's distribution within a consolidated group will also be ignored for taxation purposes.

However, it should be noted that if the head company of the consolidated tax group is liquidated, it is the Commissioner's view that any distributions made in the course of winding up a subsidiary will be taken into account in determining whether distributions by the liquidator of the head company represent "income derived" and are therefore deemed to be dividends under Section 47 of the 1936 Tax Act. For example, if the liquidator of the subsidiary makes a distribution of \$150 to the head company, comprising a return of capital of \$50 and profits of \$100, the \$100 will be counted as profits in determining the amount of the dividend deemed by Section 47 to be paid by the liquidator of the head company, even though the \$100 is not assessable to the head company because of the single entity rule (Draft Taxation Determination TD 2007/D5).

Membership of a consolidated group is not impacted by the appointment of a liquidator. However on either liquidation or deregistration a subsidiary will cease to be a member of the consolidated group for taxation purposes.

Any disposal of assets by the subsidiary prior to liquidation will be taken into account for taxation purposes by the head company of the consolidated group.

On liquidation the cost base of the shares in the subsidiary are reset under what is referred to as an exit ACA. The exit ACA is broadly the terminating value of assets (i.e. their tax cost or written down value) less the liabilities in the subsidiary.

Where there is a negative amount (i.e. the liabilities exceed the tax cost of assets) a capital gain arises in the head company under CGT Event L5.

This can be a problem issue as the Commissioner of Taxation takes the view that unsatisfied debts of the subsidiary at the time of liquidation are recognised for the purposes of the ACA exit calculation. Accordingly CGT Event L5 may then have application giving rise to a potential capital gain in the parent company.

Liquidators have the following taxation responsibilities:

- Notification of appointment must be forwarded to the ATO within 14 days;
- Seek a notification from the Commissioner of all outstanding taxation liabilities;
- Set aside funds and then make payment of outstanding taxation liabilities.

#### JR'S PARTNERS ARE:

Bruce Annabel	Chris Ball	Peter Camenzuli	Jason Evans	Nigel Fischer	Katrina Haiduk	Teresa Hooper
Clark Jarrold	Mark Nicholson	Ken Ogden	Ross Walker	Ian Jones	Kylie Lamprecht	Norman Thurecht

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## DEMERGERS—NEGOTIATIONS WITH THE ATO

Undertaking a demerger without negotiating with the ATO is a dangerous course of action.

Whilst the demerger rules themselves can be navigated without too much pain, the problem issue arises in the Commissioner's interpretation of Section 45BA of the 1936 Tax Act.

Section 45BA is an anti-avoidance provision which targets demergers which carry an underlying purpose of achieving a taxation benefit (whether or not the dominant purpose but not including an incidental purpose).

Where the Commissioner seeks to apply this provision the receipt of shares in the demerged subsidiary may give rise to unfranked dividends in the hands of shareholders.

The Commissioner's determination regarding the purpose test is made by having regard to certain relevant circumstances which are defined in Section 45B(8) of the 1936 Act.

The Commissioner considers that it is necessary to consider if the accounting for the demerger reflects the circumstances of the demerger (the implication being that if it doesn't there will be a potential tax benefit).

In substance this involves determining the extent to which the debit entry on demerger should be applied against either paid up share capital or retained earnings.

The Commissioner's position is that if he is not happy with this allocation Section 45BA may have application.

Accordingly the prudent course of action when undertaking a demerger is to lodge a Class Ruling request and negotiate the accounting treatment of the demerger with the ATO.

Surely that wasn't Parliament's intention when the Demerger relief legislation was enacted.

## HIGH COURT BROADENS THE CONCEPT OF INCOME

In a majority decision the High Court has held that the proceeds from the sale of sell back rights received by a taxpayer were assessable as ordinary income. This decision overturned the Full Federal Court decision that the sell back rights were neither assessable income nor capital gains.

The relevant history was that in January 2001 St George announced an off market buy back of ordinary shares representing around 5% of its then issued capital. For every 20 shares held St George issued one sell back right. Each sell back right was effectively a put option obliging St George to buy back one share for \$16.50.

The sell back rights were themselves listed on the ASX and on the date of listing had a value of \$1.89 each.

St George shareholders could either give a direction to have relevant shares bought back or in the absence of such direction their sell back rights were sold on their behalf.

In this case the sell back rights were sold on the taxpayer's behalf and consideration of \$2.12 per share was paid. The total consideration paid to the taxpayer was \$576.64 (note this was a test case).

The Commissioner assessed the taxpayer on the \$576 received comprising the following:

- \$514 as ordinary income being the value of the sell back rights when issued; and
- \$62 as a capital gain representing the increase in the value of the sell back rights.

The taxpayer appealed to the Federal Court against the inclusion of the \$514 in assessable income on the basis that it was neither ordinary income nor a capital gain.

Both a single judge in the Federal Court and then on appeal the Full Federal Court agreed with the taxpayer's position that the \$514 was not assessable.

The Full High Court held that whether a particular receipt has the character of income depends on its quality in the hands of the recipient, not the character of the expenditure by the other party.

In ruling that the \$514 was assessable as ordinary income, the High Court made the following observations:

- (i) The nature of the sell back rights was not determined by the capital restructuring undertaken by St George;
- (ii) A gain derived from property has the character of income (as distinct from a gain from the disposition of the property itself);