THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2017

PAPER 2.01 – AUSTRALIA OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Blue Octopus is an Australian resident company so it is taxable on its worldwide income, subject to any exceptions or qualifications that may apply. It is also subject potentially to the controlled foreign company (CFC) rules in Part X of the Income Tax Assessment Act 1936.

More specifically:

- The dividend from the wholly owned subsidiary in the Cook Islands will be non-assessment non-exempt income under Div 768A, unless it is paid out of a pool of profits that had been subject previously to attribution under CFC rules, in which case the dividend will nonetheless be non-assessable, non-exempt income under section 23AI of the Income Tax Assessment Act 1936. In the latter case, the dividend will already have been taxed under section 456 ITAA 1936 so it is not necessary to further tax the dividend.

  Either way, if interest has been incurred by Blue Octopus on borrowings to fund the equity contribution that generated the dividend, the interest will continue to be deductible – section 25-90 ITAA 1997

- The dividend from the US subsidiary derived from business activities carried on in the United States will be non-assessable, non-exempt income under Div 768A, again, unless there was a prior attribution of income under the CFC rules. The likelihood of that arising in this case is remote, as the dividend was generated from genuine business activities carried on in the United States and would therefore not fall into the category of passive income. The US subsidiary would therefore likely pass the active income test and there would consequently be no attribution under section 456 ITAA 1936.

  The dividend from the wholly owned US subsidiary would not be subject to any US withholding tax as a result of article 10(3) of the Australia/US double tax agreement if:

  (a) the US subsidiary is itself a listed public company or owned directly or indirectly by US resident listed companies; or
  (b) the US competent authority has determined that the establishment acquisition or maintenance of the US subsidiary and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Agreement.

  If not, a maximum 5% rate of withholding tax can be imposed as a result of Article 10(2)(b) of the Agreement.

- Interest income received from the term deposit with a bank in Shanghai will be fully assessable as a dividend derived by Blue Octopus but with an offsetting foreign income tax offset (FITO) for any withholding tax paid in the PRC. The interest would be subject to PRC withholding tax which would be capped at a maximum of 10% as a result of Article 11(2) of the Australia/PRC Double Tax Agreement. In addition, interest expenses incurred by Blue Octopus in generating the interest derived from the Chinese bank would fully deductible subject only to the thin capitalisation rules in Australia.

- The capital gain from the sale of shares in a company based in Vanuatu which carried on a tourist business in Vanuatu, is likely to be a capital gain that is entirely disregarded as a result of Div768G. This assumes that the totality of the capital gain is derived from assets used a carrying on a business in Vanuatu. If it is more than 90% so carried on, the whole of the capital gain on the sale of the shares would be disregarded. If on the other hand it is less than 10% from such activity, it will be entirely subject to capital gains tax. Anywhere between 10% and 90% the referable percentage would be applied to the capital gain and that amount will be subject to tax in the hands of Blue Octopus.

- The royalty it receives for certain intellectual property rights associated with a trademark owned and maintained in Ireland would be fully assessable in Australia with a FITO for any withholding tax paid in Ireland. The royalty would be subject to Irish withholding tax which would be capped at a maximum of 10% as a result of Article 13(2) of the Australia/Irish Double Tax Agreement. In addition, interest expenses incurred by Blue Octopus in generating the royalty income derived from Ireland would be fully deductible.

Question 2

Resonant is resident outside Australia for Australian law purposes and in Singapore, for Singapore purposes. Accordingly, as far as Australian law is concerned it should only be subject to tax in Australia on capital gains if the gain arises from the disposal of taxable Australian real property (TARP) and for other items of income only if the income is sourced in Australia subject to any possible withholding tax application.

Income Derived

- The rental income derived from the Perth property will be fully subject to tax in the hands of Resonate and this is unlikely to be affected by the terms of the Australia/Singapore double tax agreement – see Article 4A which specifically permits taxation by the State in which the property is located.

- The fully franked dividends will not be subjected to any further Australian tax either on a withholding tax basis or by way of assessment on Resonate – see section 128B(ga) and section 128D of the ITAA 1936.

- The unfranked dividends received by Resonate would be subject to withholding tax in Australia at 30% but as a result of the application of Article 8(1) the Australia/Singapore double tax agreement, this rate would be reduced to 15%.

- Under Australian law the business income is most likely to be viewed as having a source in Australia and accordingly subject to tax in Australia – see Kirk v The Commissioner of Taxation.

However, the unrelated distribution company is likely to be viewed as an agent of independent status unless it is acting only for Resonate, in which case it may be an agent of dependent status. Assuming that it is an agent of independent status under the contractual arrangements between Resonate and the distribution company, it is unlikely that the distribution company would constitute a permanent establishment of Resonate under Article 4 of the Australia/Singapore DTA because it is an agent of independent status acting in the ordinary course of its business – Article 4(6). Consequently, the business income of Resonate derived from its Australian activities would be precluded from tax in Australia as a result of the application of Article 5.

- The interest income received by Resonate from a term deposit in Australia will be subject to withholding tax in Australia. The normal rate of withholding tax would be 10% and this is unchanged as a result of the Australia/Singapore DTA – Article 9(1).

Sales of Assets

- The property holding in Perth is TARP and accordingly, if the asset was purchased after September 1985 it will be subject to tax in Australia as a capital gain in the hands of Resonate at 30%. The terms of the Australia/Singapore double tax agreement do not change this outcome – see article 10A.

- The sale of the shares in the speculative mining company is likely to give rise to a capital gains tax liability on the basis that the mining company is likely to have Australian real property interests - see Div 855, ITAA 1997. The terms of the Australia/Singapore double tax agreement do not appear to affect this outcome.

- In both cases, if they are not taken to hold mainly Australian real property interests, there should be no Australian capital gains tax payable under our domestic law. Again, this outcome will not be affected by the terms of the Australia/Singapore double tax agreement.

- In relation to the business income, it appears that there are no Australian holdings of Resonate so there can be no capital gain arising, even if the unrelated distribution company is sold by its owners to Resonate.

- If the term deposit held in Australia is liquidated the deposited amount would be returned to Resonate with no further tax payable in Australia.

PART B

Question 3

We assume that Michelle Rubicon is an Australian resident deriving these various amounts of benefits.

Michelle's salary of $125,000 would be fully subject to Australian tax but it would be split over 2 years, namely the year to 30 June 2015 and the year to 30 June 2016. There is insufficient information available to know how much is derived in each of those two years, but if it was derived uniformly across the calendar year, an amount of $62,500 would be recorded in each year. The tax on that amount for that year would be calculated on the basis that the first $18,200 is not table, the next $18,800 is taxed at 19% and the top $25,500 is taxed at 32.5%. Most of this tax should have been collected on a PAYG basis, and the final lodgement of the tax return will simply determine whether as a result, she is entitled to a refund or needs to pay a further top up amount.

Each of these amounts must first be judged against the Fringe Benefits Tax categories to see whether each one would be subject to Fringe Benefits Tax and if so, as to how much.

In respect of each benefit received it must be received as an employee. If they fall within the Fringe Benefits Tax categories, they will be taxed as a Fringe Benefit in the hands of the employer, namely IT Specs, and tax would be payable based on the Fringe Benefits Tax year which ends 31 March. Thus, again there would be two Fringe Benefits Tax years involved, the first ending 31 March 2015 and the second ending 31 March 2016. The amounts assessable would be allocated to the relevant Fringe Benefit Tax year on the basis of one quarter in the year to 31 March 2015, and three quarters falling into the following year.

- The benefit deriving from the car would be assessed as a car fringe benefit under section 7 of the Fringe Benefits Tax Assessment Act. The amount of the benefit can either be calculated as the statutory value having regard in particular to the original cost of the vehicle or under the operating cost method (section 10) which primarily takes into account the running costs. With the limited information provided it is impossible to say which is likely to give rise to the better result since we are not given the running costs.

- The telephone expenses paid by IT Specs amount to a Fringe Benefit. The amount of the Fringe Benefit will be the amount paid on her behalf, multiplied by a gross-up factor, which takes into account the fact that the employer will be able to claim an input tax credit in respect of the GST paid on the telephone expense. The amount calculated after gross-up would be multiplied by 46.5% to arrive at the FBT amount. The taxable value may be reduced if Michelle provides to her employer a declaration detailing the deductible part of the expenditure. In most cases the deductible component is fairly small, but if the phone was used substantially for work related calls it may be different.

- The benefit of the zero interest loan will be taken into account as a Fringe Benefit and will have regard to arms-length rates of interest that are charged at banks at the relevant time, namely 1 January 2015. There would be no gross-up here, but Fringe Benefits tax would be calculated at 46.5% of the calculated benefit the monetary difference between the arms-length interest rate and that which is actually charged??

- Professional subscriptions, where they relate to the persons work, are an exempt benefit under section 58Y of the Act and accordingly no Fringe Benefits Tax will be payable on this benefit.

- If the payment is made by IT Specs to a complying superannuation fund the benefit is not subject to FBT being specifically excluded from the definition of fringe benefit in section 136(1). Whether IT Specs Super Fund is a complying superannuation fund is unclear, but it is most likely to be complying in this way. If not, Fringe Benefits Tax would apply to the value of the benefit.

Question 4

In the absence of Division 165:

1. Fred buys the table for $5,500

Collects	$500 GST
ITC	$nil
Net GST Payable -	$500

2. Fred sells table to SHGC for $20,000

Collects	$nil GST
ITC	$nil
Net GST payable -	$nil

3. SHGC sells table to end consumer $30,800

Collects	$2,800 GST *
ITC	$2,000
Net GST payable	$800

*Entitled to an ITC for imported GST even though no GST was paid by SHGC when purchased and even though there is no tax invoice – GST Act s66-5.

If SHGC had purchased the table directly for $5,500, the ITC would have been $500 not $2,000.

Division 165

For Division 165 it must be shown that:

- There is a scheme
- There must be a GST benefit
- The dominant purpose or effect was to obtain the GST benefit

Scheme

Clearly the scheme is “Fred purchases for himself and on-sells to SHGC”.
It is important for Commissioner to identify the scheme involved. However even if misinterpreted it is not fatal.

GST Benefit

The GST benefit is the added credit received by SHGC (i.e. $2,800 instead of $500)

Purpose

May be difficult to show purpose as Fred was not aware of real value at time of purchase. He may have thereby acquired it for personal use.

Factors to look at in determining purpose are mentioned in s165-15 and students would be expected to raise these matters and evaluate them in the context of the facts pertaining to Fred and SHGC.

Dominant effect may be more objectively demonstrable as the effect is more easily evaluated on an objective basis.

Where Div 165 applies the Taxation Commissioner will negate the avoider' advantage – in the context of these facts this would mean if there was a finding that Div 165 applies which looks likely then the transaction between Fred and the original second hand goods dealer would be negated and the transaction would become one between SHGC and the original second hand goods dealer.

SHGC would then return the GST of $2800 it collected on selling the table to the end user and claim an input tax credit of $500.

This would require an increasing adjustment for SHGC of $1500 being the difference between the $2000 claimed as an ITC and the ITC SHGC is entitled to on the basis of the reconstructed transaction namely $500(see subdivision 165-B and esp s165-40).

There are heavy penalties arising from the application of Division 165b which can be remitted in certain circumstances as to which refer Practice Statement PSLA 2006/2

PART C

Question 5

The property purchased by way of exchange of contracts in June 1985 is clearly a pre-CGT start date contract. Even though the settlement occurred after September 1985, the critical date is the date of exchange of contracts.

Accordingly, the sale of this property will give rise to no tax in Australia, providing of course that:

1. The expenditure outlaid in 2003 did not give rise to a new asset under subdivision 108-D, which would appear to be very unlikely in the circumstances.
2. The property is held on capital and not revenue account. This would seem to be likely to be the case here where there are so few property transactions occurring and those that did were clearly intended as long term holdings.

In relation to the city property, this was purchased in June 1999 by way of exchange contracts and accordingly it is within the capital gains tax net. Again however, how this will be treated will depend on a number of factors. Most importantly, it is assumed that the expenditure in 2003 does not give rise to a new asset, and the property is held on capital and not revenue account, as per the rural property.

With all that in mind, if the property is sold for $3.6million, the capital gain will be $3.6million - $1.2million, being the cost base made up of the original acquisition price plus the expenses incurred in 2003.

This assumes that the 2003 expenses are capital, not revenue expenses. If they were revenue expenses, they which should have been claimed in 2003 when they were incurred. In regard to the amount of expenditure it is likely that the 2003 expenses were capital in nature.

This would give rise to a total capital gain of $2.4 million. As it is owned in Linda Germaine's name personally, there should be available a CGT discount of 50% thereby reducing the capital gain to $1.2million. This will need to be included in her tax return for the year to 30 June 2017, assuming that the property is sold before 30 June 2017.

All interest expenses have already been claimed on an annual basis and cannot be claimed again.

As the property was acquired before 21 September 1999, and the sale took place after, the taxpayer, Linda Germaine, will have the choice of including in assessable income the capital results from either, calculating the capital gain of the cost base which includes indexation frozen as at 30 September 1999, or calculating the capital gain without indexation and then reducing the notional capital gain by the relevant CGT discount of 50% in her case as she is an individual. Having regard to the numbers in question, it is clear that applying the CGT discount will be preferable.

In addition, there will be other expenses which can be included in the cost base, such as stamp duty, agent's fees, etc.

Question 6

The answer should canvas the following possibilities:

- Beneficiary presently entitled and not under a legal disability – taxed at beneficiary's marginal rates (s 97);
- Non-resident beneficiary presently entitled – taxed in the hands of the trustee at the non-residents rates of tax; also included in the beneficiaries' assessable income with credit for the tax paid by the trustee (s 98 98A);
- Beneficiary presently entitled but under a legal disability – taxed in the hands of the trustee on behalf of the beneficiary at the beneficiaries' marginal rates (s98 100); and
- No present entitlement – taxed in the hands of the trustee at top marginal rates (s99 99A)

The main problem arises if there is a difference between trust income and taxable income and in determining whether a proportionate or quantum method applies. Reference should be made to Bamford v FCT 2010 ATC 20170, Cajkusic v FCT (No 2) 2006 ATC 4752 and Zeta Force Pty Ltd v FCT 98 ATC 4681.

Special rules apply to deal with capital gains (subdivision 115–C)

In dealing with minors, Division 6AA of the ITAA 1936 applies to ensure that such minors upon receiving their distribution from a discretionary trust would be taxed at penalty rates.

Trust losses are dealt with in a special way such that they can only be carried forward without restraint where a family trust election has been made.

There are specific anti-avoidance rules targeting trust arrangements:

- Section 102 ITAA 1936 dealing with irrevocable trusts;
- Division 6AA dealing with income of minors received through a discretionary trust; and
- Section 100A dealing with reimbursement agreements.

Question 7

The critical issue is whether losses incurred in 2011 and 2012 can be carried forward.

As a result of losses incurred in 2011 and 2012, the company required further capital and on 1 July 2013 issued a further 2 million $1 shares to a company called Gratis Pty Limited.

In and of itself that would not cause a problem, since there appears to be no question that there is a continuity of the business that is being carried on. Even though there is a break in the continuity of ownership the continuity of business is enough to allow the losses to be carried forward.

Thus the losses of 2011 and 2012 can be carried forward to 2013 and 2014. Thus $260,000 is being carried forward and offset against $300,000 derived in the 2013 and 2014 years, thereby leaving an amount of $40,000 subject to tax in 2014. This would be taxed at 30% and give rise to tax of $12,000 due for the year ended 30 June 2014.

On 1 July 2015, the directors expand the business offering, which means that the company may now well fail the same business test. This will require some analysis of cases such as Avondale to determine whether a change of business has occurred by adding the range of services to cover hardware issues as well as software issues. In all likelihood this has caused a change of business and accordingly the same business test has failed. When coupled with the failure of the continuity of ownership that occurred on 1 July 2013 this would be fatal and would bring to an end any further carry forward of losses. Fortunately, all the losses have at this point been recouped and accordingly there is no major detriment.

The next question arises in relation to the 2015 losses. They are now incurred at a time when the shareholding is 2million $1shares held by Gratis Pty Limited and 1million $1shares held by the founding members Rod and Carol. In addition, the business is now the provision of both services dealing with both software and hardware issues. Accordingly, losses should be able to be carried forward, however, on 1 July 2016 the shares in Reboot Pty Limited are sold in their entirety to a boutique firm for an agreed cash price and this of course would trigger a failure of the same ownership test. However, the same business test would continue to apply unaffected. Accordingly, the losses of 2015 could be carried forward.

In all of the above, we have assumed that there is no consolidation of entities.

Question 8

Myer Emporium

The taxpayer in this case undertook a pre-arranged plan to obtain working capital from an outside financier.

First, the taxpayer lent $80million to a member of the corporate group at a commercial rate of interest for a term in excess of 7 years.

Approximately 3 days later, it assigned its right to interest under the loan to an outside financier, namely Citicorp, for a lump sum and retained the right to receive repayment of the principal sum. The Tax Office argued that the lump sum was income according to ordinary concepts. Alternatively, if not income from ordinary concepts, it took the view that it was a profit making undertaking or scheme under s26(a) ITAA1936, as it then was.

The issue – was the payment of the lump sum amount income according to ordinary concepts or income according to s26(a)?

The decision – according to the High Court the receipt was income was according to ordinary concepts and if that were not the case it would be income under s26(a).

Undoubtedly, the assignment is best described as novel, unusual, or extraordinary when judged by reference to the transactions normally engaged in by the taxpayer. However, these transactions were still entered into by the taxpayer in the course of carrying on its business and therefore the profit was part of the ordinary income of the taxpayer.

There are several strands to the judgement and different views as to the basis of the decision.

The first strand suggests that a gross profit derived in the course of a business enterprise that is subsidiary or incidental to the taxpayer's ordinary business activities acquires an income character similar to profits from the ordinary business activities. On this view the sale of the interest stream is incidental to the taxpayer's ordinary retail and commercial operations, and the gross profits are therefore also income.

A second narrower strand suggests that the proceeds of the assignment were assessable to the taxpayer on the basis of the compensation receipts doctrine. This doctrine is to the effect that an amount received in exchange for an income stream requires an income character as it compensates for something which itself would have an income character. In other words, the taxpayer had exchanged a future income stream, namely the interest entitlements into a present income, namely the lump sum. The broad principles established in Myer Emporium are still applicable in the sense that, income according to ordinary concepts will include profits made even from unusual or extraordinary transactions, where those transactions are made in the course of carrying on a profit making business, even not necessarily in the ordinary course of that business.

However, if Myer Emporium were to occur today, consideration would need to be given to the consolidation regime if the Myer group was consolidated and to Division 230 dealing with financial arrangements.

Whitford's Beach

Facts – the taxpayer was established by a number of individuals to acquire beachfront land so as to provide access to shacks erected on that beach. After a number of years, the decision was made to sell the land. The sale was effected by the sale of the shares in the company rather than a sale of the underlying land itself. The purchasers of the shares were all engaged in the business of property development, and after the change in shareholding the company proceeded to rezone, subdivide and sell the underlying land.

Issue – whether the profits derived from the sale of the land were ordinary income or assessable income under the s26(a) ITAA 1936 (Currently section 15-5 ITAA 1997).

Decision – the decision of the High Court was to the effect that the taxpayer here had acted, not so as merely to realise a capital asset, but had actively engaged in what amounted to the carrying on of a business of land development. The profits accordingly were derived as ordinary income under section 25 (now section 6-5). Alternatively, the profits would equally have been assessable under the second limb of section 26(a).

Most particularly, the purpose of the company taxpayer was to be determined by the purposes of the shareholders, as they may exist from time to time. Some members of the High Court considered the change in shareholders to be critical to the conclusion that the taxpayer commenced the land development businesses (Gibbs and Mason JJ). By way of contrast the decision of Mason J suggests that the same result would follow if the original shareholders had retained the company but had themselves changed their purpose in holding the land.

If this case occurred today, it is more likely to be treated as a situation where a taxpayer has held an asset as a capital asset but has converted it into trading stock, thereby triggering s70-30 ITAA 1997 and the result would be a notional sale and repurchase of the asset with consequential tax obligations. The taxpayer could elect to use cost or market value for the notional sale and repurchase, and this will also have implications for capital gains tax purposes. If the taxpayer elects to use cost, the gain or loss will be recognised only under the trading stock or ordinary income provisions and any potential capital gain or loss would be disregarded under section 118-25 ITAA 1997. If, on the other hand, the taxpayer elects to use market value, a capital gain or loss based on the difference between the original cost and the value at the time of the deemed sale and repurchase may be realised under CGT event K4 - see section 104-220 ITAA 1997.