

21 July 2006

Fiscal Watch

Tax e-Bulletin

New CGT Rules for non-residents

Formerly under Australian income tax laws, non-residents were required to include in their assessable income any net capital gains arising out of CGT events which occurred in relation to any CGT asset that had a necessary connection with Australia.

There are now new rules. First, the relevant CGT assets affected by this rule are now called taxable Australian assets and the number of CGT assets which are taxable Australian assets is substantially limited.

In summary, the relevant assets are now only:

- > real property situate in Australia
- > mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry materials are situated in Australia
- > non-portfolio membership interests in entities whose principal asset is any of the above
- > a CGT asset that was used in carrying on a business through a permanent establishment in Australia
- > an option or right to acquire any of the above assets
- > a CGT asset where you chose to disregard a gain or loss on ceasing to be an Australian resident

Therefore such assets as shares in private companies, non-portfolio investments in shares and units in listed entities are no longer within the CGT net for non-residents.

This has some consequential changes to the rollover relief available under the CGT provisions. This is because rollover relief will no longer be necessary because the CGT asset is no longer within the CGT net for the non-resident eg scrip for scrip rollover is no longer necessary for a non-resident except where the shares are non-portfolio interests in a company whose principal asset is real property or mining, quarrying or prospecting right (to the extent that the right is not real property), if the minerals, petroleum or quarry materials are situated in Australia.

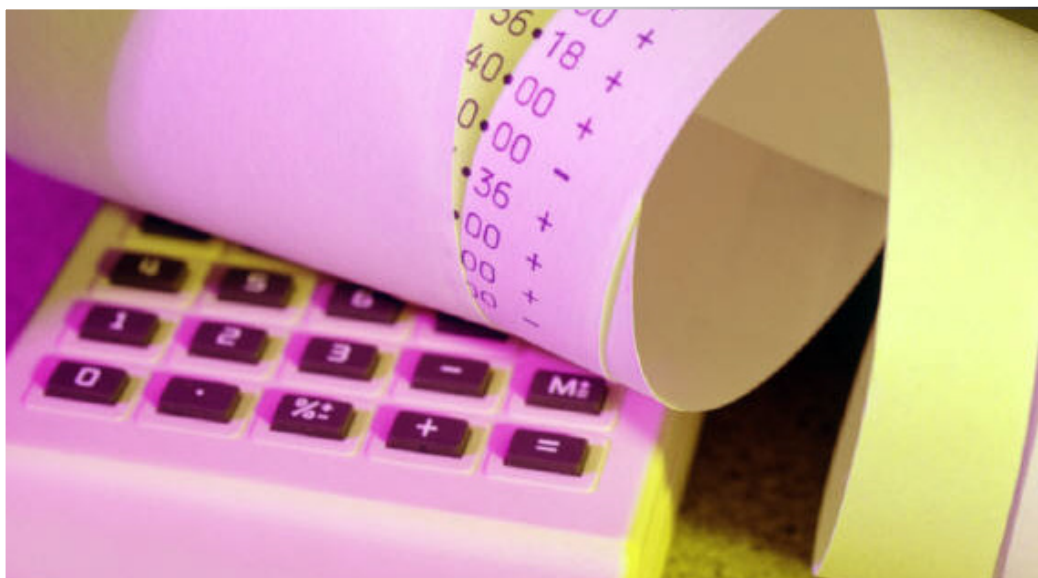
New CGT rules for non-residents not all milk and honey

In some cases the new rules widen the tax net. For example, on death, if the deceased was a resident at the date of his or her death and the beneficiary is a non-resident, a CGT event occurred if an asset passed to that non-resident on death and the asset did not have a necessary connection with Australia.

Shares in private companies and non-portfolio interests in listed companies, for example, had a necessary connection with Australia. Therefore, if these type of assets passed to a non-resident, there was no CGT event but rollover applied. The non-resident would then only be bound to account for any capital gain or loss when a CGT event such as a disposal of that asset occurred.

However, now such assets are not taxable Australian assets and therefore any capital gain or capital loss will have to be taken into account by the executors in working out the net capital gains of the deceased just before he/she died to include in the assessable income of the deceased.

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The capital gain or capital loss is worked out using the market value of the CGT assets just before the deceased died.

Similarly there will be an issue where you cease being an Australian resident. Subject to certain exceptions, a CGT event occurred with respect to assets not having a necessary connection with Australia upon your ceasing to be a resident. Now there are fewer assets that fall within this description widening the tax net upon your ceasing to be an Australian resident e.g. shares in private companies and non-portfolio interests in listed companies.

Small business tax concession

The small business tax concession is a valuable concession. However, the concession only applies with respect to what are called active assets. Generally real property is considered a passive investment and therefore not subject to the small business tax concession. In fact it is specifically provided that an asset whose main use is to derive rent is not an active asset.

However, recent draft taxation determinations by the Commissioner are a reminder that not all real property is a passive investment and may fall within the category of an active asset. Examples are:

- > premises used in a business of providing accommodation for reward

- > holiday apartments used in a business of providing holiday accommodation by the taxpayer
- > storage units used in the business of providing commercial storage space
- > a boarding house used in the business of providing boarding house accommodation by the taxpayer
- > an industrial shed used by the taxpayer in the conduct of a motor cycle business
- > the freehold of a hotel owned and used in a hotel business by a hotelier
- > a property leased to a connected entity for use in a connected entity's business

Also a reminder that there are proposed changes to the small business tax concession.

Following the budget the Treasurer issued a press release on 9 May 2006 in which he stated that some changes to the small business tax concession would apply to CGT events which occur from the current financial year.

Among these proposed changes includes an amendment to the current controlling individual 50 per cent test which will be replaced with a new significant individual 20 per cent test that can be satisfied either directly or

indirectly through one or more interposed entities. This is an important concession.

Currently there is a limit of two controlling individuals or one controlling individual and their spouse who has an interest in the business. The controlling individual test applies where the concessions extend to an entity that did not make the relevant capital gain (that is, the 15-year exemption and the retirement exemption).

The new significant individual test would enable up to eight taxpayers to benefit from the full range of concessions instead of the current limit of two controlling individuals.

Superannuation funds – special income warning

Sometimes taxpayers consider making their self-managed superannuation funds discretionary beneficiaries of their family trust so as to divert income to a tax favourable environment. However, this will not work. The reason is that such income is categorised as special income and will be taxed at the highest marginal tax rate within the fund thus defeating the purpose of the scheme. There are 4 types of special income and care must be taken to ensure that the fund is not the recipient of such income if the highest marginal tax rate on such income is to be avoided:

- > dividends paid by a private company, including income derived indirectly from a dividend and non-share dividends
- > income from a transaction where the parties are not dealing at arm's length
- > income received from a trust in the capacity of a beneficiary other than by virtue of holding a fixed entitlement
- > non-arm's length income received from a trust in the capacity of a beneficiary holding a fixed entitlement.

Shipping and aircraft leasing profits for US and UK enterprises

The Commissioner has issued a draft ruling on his interpretation of the US and UK double tax



agreements in relation to shipping and aircraft leasing profits following the Federal Court decision in *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* and in particular in relation to the substantial equipment deemed permanent establishment clause of both double tax agreements.

The draft ruling only deals with the application of the Business Profits Article of the double tax agreements (Article 7) and not the Shipping and Aircraft Article (Article 8). However there is nothing that is terribly dramatic about the ruling which appears to be in accordance with current law.

However, care needs to be taken with such arrangements by reason of the definition of a permanent establishment under the US and UK double tax agreements. There may be a deemed permanent establishment where an enterprise maintains substantial equipment for rental or other purposes within one of the contracting states for more than 12 months although equipment let under a hire purchase agreement is excluded.

Royalties on leased equipment – UK and USA exceptions

Under Australian domestic law, lease payments under operating leases fall within the definition of a royalty and are subject to a 30% withholding tax. However, this position may be affected by a double tax agreement.

Generally Australia's double tax agreements also define royalty as including payments made as consideration for the use of or the right to use industrial, commercial or scientific equipment and therefore there will be royalty withholding tax on such payments. This would cover operating leases of such equipment. The rate under the double tax agreement is less than the domestic rate and is generally 10% but each agreement needs to be checked because it is higher in some agreements.

However, with the USA and UK double tax agreements, the definition of a royalty since 2001 and 2003 respectively has specifically excluded the above payments. This means that there is no royalty



withholding tax on such payments where these double tax agreements apply.

Horticultural plant - establishment expenditure

The Commissioner has recently issued a tax determination on what he considers to be establishment expenditure for the purpose of deductions for the decline in value of horticultural plant.

You are entitled to deduct the decline in value of horticultural plant for the income year in which it starts to decline in value for the capital expenditure attributable to the establishment of the plant.

Capital expenditure includes expenses incurred in establishing or extending a plantation up to the stage of planting horticultural plants in their long-term growing medium. It therefore includes:

- > the cost of purchasing plants or seeds
- > any costs incurred in preparing to plant
- > the cost of planting the plants or seeds
- > the costs of pots and potting mixtures (for potted plants)
- > the costs incurred in grafting trees
- > the cost of establishing plants used for associated purposes, such as for companion

planting (if those plants are not horticultural plants in their own right)

- > costs incurred in preparing to plant include the part of the cost of ploughing, top dressing, fertilising, top soil enhancement, soil analysis tests, forming up planting rows and planting site surveys that are attributable to the establishment of a horticultural plant
- > the cost of maintaining plants until they are ready to be planted, because the dominant purpose of the expenditure is to preserve and improve the plants until they are ready to be used, by planting or establishing them in their long-term growing medium

The following is not establishment expenditure:

- > the cost of maintaining an established plantation (which is revenue in nature and therefore should be fully deductible in any event)
- > the cost of replacing a plant in an established orchard or plantation because of premature death or disease (which is revenue in nature and therefore should be fully deductible in any event)
- > the cost of purchasing land to be used for growing a horticultural plant
- > the costs of draining swamp or low-lying land and of clearing land.

Recovery of tax losses – company takeovers

In company takeovers it needs to be borne in mind that the ability of a company to use tax losses is very restrictive. If the change of control test fails, which it almost certainly will with a takeover, then the same business test must be satisfied.

However, it needs to be borne in mind that the same business test does not apply to a company if the total income of the company for the income year is more than \$100m. Therefore, large companies will not get the benefit of the test.

The application of the same business test is also restrictive. The company will not satisfy the test if at any time during the test period it derives assessable income from or incurs expenditure in a business of a kind that it did not carry on before the test time or a transaction of a kind that it had not entered into in the course of its business operations before the test time. If you start a business or enter into a transaction of a kind that you have not entered into before, before the test time for the purpose of seeking to satisfy the same business test after the test time then you also do not pass the same business test (which is an anti-avoidance rule).

The test is further complicated when dealing with a consolidated group. However the Commissioner has issued a draft ruling. Although the test is carried out at the head company level, ie, the head company must satisfy the test nevertheless it is necessary to have regard to the activities of the subsidiary members of the group.

The Commissioner is of the view that the one overall business of the head company is to be identified by examining all of the activities,

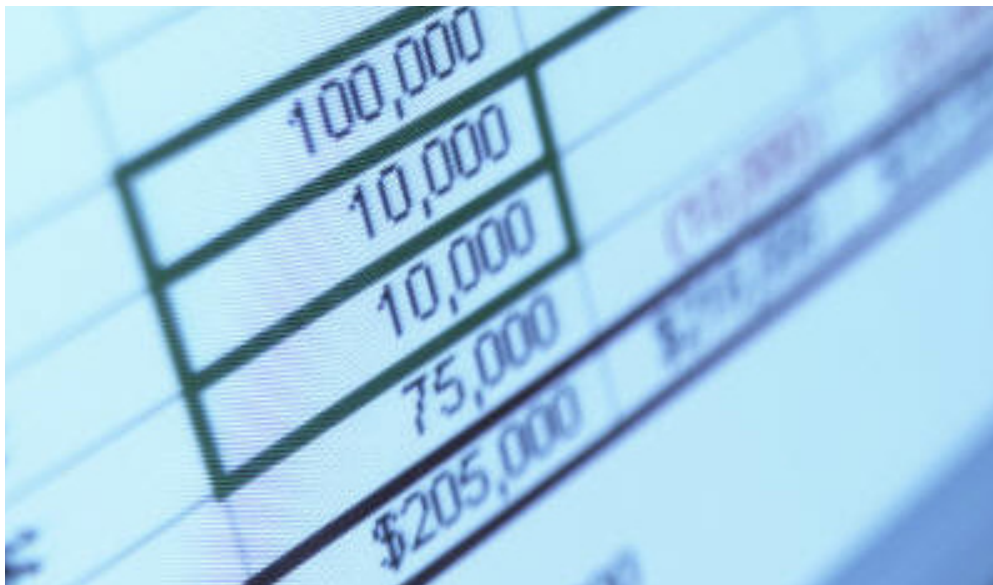
enterprises or undertakings carried on at the appropriate test time by all those entities that were members of the consolidated group at that time and by all entities during that part of the same business test period when they were members of the consolidated group.

Therefore, when applying the new business test and new transactions test to the head company, regard must be had to the enterprises, undertakings and transactions that were carried on or entered into before the test time by entities while they were members of the consolidated group. These activities are then compared with the enterprises, undertakings and transactions carried on or entered into by all entities while they are members of the consolidated group during the same business test period. This comparison determines whether the enterprises, undertakings and transactions before the test time and during the same business test period are different in kind.

However, it is not necessary that a business carried on during the same business test period by an entity in the group be of a kind carried on by that same entity before the test time, provided an entity within the group carried on that activity during the period before the test time when that entity was a member of the consolidated group.

Because of the restrictive nature of the same business test, care must be taken in company takeovers to determine whether tax losses in fact have any value. They may well have no value.

If you need any assistance in relation to your taxation or superannuation affairs please contact one of our taxation professionals listed in this brochure



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