

sharptax

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reporting on taxation issues
for business owners.

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This edition of Sharp Tax considers a recent FBT decision and revisits the impact of the **debt/equity provisions...**

Benefits to employees offset against loans

The AAT has recently heard, AAT Case [2006] AATA 666, Re Slade Bloodstock Pty Ltd and FCT. In this case, the taxpayer was a unit trust that carried on an active business. Mr and Mrs Slade had lent funds to the unit trust to enable conduct of the business. The loan was documented and there was evidence that the taxpayer had relied on funding by the Slades to conduct its business.

The taxpayer was audited for the 2000 to 2002 FBT years. As a result, the taxpayer was assessed on a number of benefits provided to Mr and Mrs Slade. The cost of these benefits had been offset against monies outstanding to the Slades.

The ATO claimed that these benefits were provided to the Slades in connection with their employment by the taxpayer. The taxpayer argued however that the payments were made in partial discharge of the loan owed to the Slades. The Tribunal agreed that the Slades were employed by the taxpayer. However, it found that the payments and benefits were provided in connection with the loans that had been provided by them to the taxpayer and they would have been entitled to the repayments regardless of the employment relationship. Accordingly, FBT did not apply to the benefits.

Care needs to be taken when benefits are provided by a trust or company to individuals as they may be subject to FBT. However, as the above case demonstrates, where it can be shown that the benefit was provided to the individual otherwise than in the capacity as employee, FBT should not be payable.

CGT Main Residence Exemption

The ATO has recently released ATO ID 2006/185 'Capital gains tax: main residence exemption - choice to treat demolished dwelling as main residence'.

In this decision, the taxpayer had purchased a dwelling in late 1996 and resided in that dwelling until mid 1998. From that time, the dwelling was rented out until early 2002. The taxpayer continued to treat the dwelling as their main residence during this period. In mid 2002, the taxpayer demolished the dwelling and built a new dwelling that became the taxpayer's main residence in late 2002. The taxpayer continued to live in the new dwelling until it was sold in late 2004.

In short, the ATO allowed the full exemption to apply provided the appropriate choices had been made under the Income Tax Assessment Act.

Generally, if a taxpayer builds a dwelling on land they already own, the land does not start to qualify for exemption under the main residence exemption provisions until the dwelling actually becomes the taxpayer's main residence. Furthermore, it is important to note that where a dwelling is demolished or destroyed and a new dwelling is constructed, the main residence usage of the first dwelling would not count towards an exemption for the new dwelling and land.

However, a taxpayer may choose for the main residence exemption to apply to land for up to four years before the dwelling becomes their main residence. The taxpayer can only make this choice if the dwelling becomes the taxpayer's main residence as soon as practicable after the building work is finished and it continues to be their main residence for a minimum of three months. Additionally, where the premises has been used for income producing purposes, the 6-year limit will also apply to this.

This is an extremely complex area of the CGT regime and advice should always be sought prior to any demolition work being carried out in order to ensure that the CGT exemption may be preserved.

Debt/Equity Rules

The debt/equity legislation was brought in by the Government to overcome its concern about the mischaracterisation of corporate financing arrangements between debt and equity, resulting from the increased use of various hybrid investment products in past years.

The effect of these rules is that interest paid on loans will only generally be deductible where the loans qualify as debt interests, as defined in the debt/equity provisions.

Where a loan does not qualify as a debt interest, it may constitute a "non-share" equity interest. Interest paid will then not be deductible, but may be frankable similar to a dividend.

Accordingly, it is important to correctly classify all financing arrangements.

Debt Interests

A loan facility or funding arrangement will be a debt interest where the company has a non-contingent obligation to repay the borrowed funds, and the total repayments will be at least equal to the value of the funds received.

A non-contingent obligation to repay a borrowing exists if the obligation to repay is not contingent upon any event, condition or situation.

Different valuation rules may apply to determine whether the total repayments are at least equal to the value of the funds received. This depends on whether the term of the loan is greater than 10 years or 10 years or less. The term of the loan may therefore be a critical factor which determines if the interest is debt or equity. Your advisor can advise you further on these valuation methodologies.

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Equity interests

An interest in a company will generally constitute an equity interest if it:

- a. is a share, or if the interest provides for a return that is either:
 1. in effect contingent upon the company's economic performance; or
 2. at the discretion of the company or a related party; or
- b. the interest is convertible to an equity interest exhibiting one of the above characteristics.

If an interest qualifies as both a debt interest and an equity interest, a tie breaker rule applies to class the interest as debt only.

Where a loan constitutes an equity interest, interest paid on the loan will not be deductible. However, it may be frankable subject to the availability of franking credits. The company will also need to maintain a non-share capital account. Repayments against the loan can give rise to other tax implications, including deemed dividends.

At call loans

This is generally a loan that is made with no fixed period for repayment, but rather the loan is repayable on demand. At call loans do not have a non-contingent obligation to be repaid and so they do not satisfy the second condition of a debt interest above.

However, special rules now apply to small businesses to ensure that whilst their turnover is less than \$20m, the rules do not prevent at call loans from being debt interests. If you have at call loans, we recommend you discuss the implications with your tax advisor.

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