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# TAX matters

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## Some rates drop in 2010 – some stay the same

In recognition of the economic climate, Norton & Smailes has made no increase to charge-out rates for partners since July 2008, and we have also kept solicitors' rates largely unchanged, with a few exceptions arising from qualification and status adjustments. Of course, charge-out rates form only one part of the story, and we remain committed to providing top class professional service with the intention that clients continue to get value for fees. The

GFC should not mean greater fee charges.

Some clients will notice that our standard engagement letter has changed with effect from 1 July 2009. This is to comply with the new Legal Profession Act 2008 which now governs our lives – the changes will not be of any great significance for most clients.

A drop of good news: if you are a resident individual who had taxable income of \$180,000 in the 2009 income year you would pay tax (excluding Medicare levy) of \$58,000. The same taxable income this income year will mean tax of \$55,850 – a drop of \$2,150 or some \$180 per month. If your taxable income was \$80,000 last income year and is the same this income year, the decrease in tax for the year is only from \$18,000 to \$17,850. So, the more you earn the higher your tax saving?

The marginal rate for resident individual taxable incomes over \$180,000 remains unchanged on 45% (excluding Medicare levy). For a hardworking well organised family of 4, each of whom derives taxable income of \$180,000, the total tax reduction this year is \$8,600.

Even though measures already announced by the Government and

not yet enacted mean that the volume and complexity of tax legislation will inevitably grow substantially this year, we at Norton and Smailes hope and trust that the 2010 income year will be one of improved economic times for all our clients.

Contacts: Richard Norton

## The grass is not always greener on the other side – borrowing from overseas

The GFC has caused local investors in some cases to seek lending from sources other than the big four banks. One such funding alternative is the obtaining of funds from foreign investors. Typically, the foreign investor will require a higher rate of return from the Australian taxpayer to compensate it for the perceived higher risks. Where the borrowing is in the form of a loan, a higher interest rate will be the norm. From the Australian taxpayer's perspective, claiming the interest deduction becomes all important.

In the context of interest deductibility alone, there are a number of important income tax issues which require consideration. Some of these issues are:

- (a) Section 8-1 of the *Income Tax Assessment Act 1997* (Cth) (“ITAA97”) - interest is only deductible to the extent to which it is incurred in gaining or producing assessable income or in carrying on a business for that purpose and is not of a capital, private or domestic nature.
- (b) Debt/equity rules.
- (c) Section 25-85 ITAA97 – broadly this section provides that a deduction will not be prevented from being deductible under section 8-1 in certain circumstances to do with “debt interests”. However, the deduction is allowable only up to certain limits.
- (d) Section 51AAA(1) of the *Income Tax Assessment Act 1936* (Cth) (“ITAA36”) – under this section an interest deduction is not allowable if it is to derive a net capital gain.
- (e) Thin capitalization rules – these rules operate when a debt used to finance the Australian operations exceeds specified limits. The rules disallow a proportion of the otherwise deductible finance expenses attributable to the Australian operations.
- (f) Transfer pricing rules – these provisions leave open the possibility for the Commissioner to reduce the interest expenses claimed by the Australian taxpayer under a loan received from a non-resident if the interest expense on the loan is more or less than an arm’s length amount.
- (g) Division 16E ITAA36 – broadly, these provisions alter the basis for taxing income and allowing deductions accruing

on discounted and other deferred interest securities from a realization basis to an accruals basis.

- (h) Section 26-25 ITAA97 – which provides that interest is not deductible if the Australian taxpayer has not met the relevant withholding tax requirements which will typically apply to a foreign borrowing.

The above list of issues is not exhaustive.

#### *Other issues*

Interest withholding tax is payable on interest derived by a non-resident unless an exemption applies. It is not uncommon for the foreign lender to require the Australian taxpayer to agree to undertake to pay the withholding tax for which the foreign lender is liable by way of indemnification payments. This raises several tax questions including:

- (a) Are the withholding tax indemnification payments subject to withholding tax on the basis that these payments are interest or an amount in the nature of interest?
- (b) Are the withholding tax indemnification payments made by the Australian taxpayer tax deductible?
- (c) Is interest on money borrowed by the Australian taxpayer to pay the withholding tax indemnification payments tax deductible?
- (d) Is the foreign lender subject to Australian tax on the withholding tax indemnification payments?

As you can see, there are a number of issues which arise in the context of

borrowing from overseas. They are complex and cannot be ignored.

Contacts: Chris Smailes and Alan Krawitz

#### **Bam Bam, Bamford - the impact on discretionary trusts**

The *Bamford v the Commissioner of Taxation* (Bamford) decision is of great importance to a number of entities, including trustees, advisers and practitioners. The decision clarifies two crucial areas relevant to the operation of Division 6 of the *ITAA 1936* and specifically section 97.

Bamford confirms that the term ‘income’ of the trust estate for section 97 purposes is income as determined by the relevant trust instrument. Where a trust deed essentially equates income to taxable income under section 95 of the *ITAA 1936*, or empowers the trustee to determine the income of the trust, the assessable net capital gains can be regarded as income for distribution purposes, and so the trustee is able to decide to distribute the assessable net capital gain to beneficiaries.

The decision also confirms the proportionate method for assessing presently entitled beneficiaries, as opposed to the quantum method.

Going forward, for those trusts where income is essentially defined to equate to net income under section 95 of the *ITAA 1936* or, where the deed empowers the trustee to determine the income of the trust in which ever way it sees fit, we see two main issues.

The first is drafting of trustee resolutions especially where non-taxable items, capital gains and franking credits are received (as

both assessable and non-assessable gains will need to be considered).

Secondly, preparation of financial statements and the treatment given to non-taxable receipts (both of a capital and income nature) and the reconciling of amounts distributed.

Practitioners will need to keep abreast of developments and upcoming announcements in this area, namely:

- (a) The release by the ATO of a Decision Impact Statement shortly on their views of the Bamford decision, which, hopefully, will provide some practical guidance.
- (b) The ATO has sought leave to the High Court to appeal the decision in Bamford. Bearing in mind that the ATO were previously denied leave to appeal in the Cajuskic case, will the High Court finally provide some closure on this issue?

Contacts: Chris Smailes and Reagan Gruenthal

**Tax Sharing Agreements & Tax Funding Agreements**

*Tax Sharing Agreement (“TSA”) – Protection Against Joint and Several Liability*

The legislation governing consolidated groups is contained in Part 3-90 of *Income Tax Assessment Act 1997*. Division 721 provides that all members of a group can be jointly and severally liable to pay the tax liabilities of the head company, if it fails to pay those liabilities when they are due and payable.

TSA’s are particularly important to avoid an unforeseen tax liability upon sale of shares in a group company to an unrelated buyer. The buyer

understandably will wish to purchase shares in the company and be free and clear of a tax liability of the company’s former group.

Section 721-15 provides that joint and several liability will not exist if the group liability is covered by a TSA. For these purposes a TSA must comply with section 721-25; in essence it must provide for a particular amount to be determined as the member’s required contribution to the group liability and that the amount determined must represent a reasonable allocation. The TSA must be in force before the group liability becomes due and payable by the head entity.

The legislation provides for a leaving group member to pay to the head company its allocated share of the group liability, and to be able to then leave the group clear of any liability to the ATO.

The ATO may request a copy of the TSA, and if this is not provided within the time required then the protection from liability which would otherwise be available is taken never to have been available.

*Tax Funding Agreement (“TFA”) – Providing an Accounting Framework*

A purpose of a TFA is to provide for agreement between group members as to their liability to contribute to and fund payment of the tax liability of the group which is payable by the head entity. The group is not accountable to the ATO for the outcomes under a TFA.

The main purpose of the TFA is to provide for fair and reasonable allocations between members as regards deferred tax balances (a matter not usually covered in a TSA) and to ensure compliance with relevant accounting standards (AASB 112 and UIG 1052).

Unlike the TSA, a TFA will recognise that there may be situations when a head entity should give credit to or be liable to pay an amount to a group member, for example when the member’s activities give rise to losses which reduce the tax liability of the group.

Norton & Smailes can provide draft TSA’s and TFA’s which can be adapted to suit the circumstances of clients and the requirements of their auditors.

Contact: Richard Norton

**Norton & Smailes**

We advise on:

- income tax, GST, capital gains tax, FBT
- superannuation and superannuation deeds
- stamp duties, payroll tax and other State taxes
- wills, estate planning and business succession planning
- trusts and trust deeds
- objections and appeals
- tax and commercial litigation
- commercial law