

the report | explanatory memorandum

May 2007

Year-end Tax Planning

Year-end tax planning is very important for all taxpayers, large or small. In order to achieve the best possible tax outcome, various strategies need to be considered. Broadly, this may involve deferring the derivation of assessable income to the next financial year and/or applying techniques to bring forward deductions to the current year. In recent years, Australian tax law has become even more complex with continuously evolving rules regarding trust distributions, shareholder loans, family trust elections, capital gains tax concessions and the introduction of the tax consolidation regime.

Deferral of assessable income

The derivation of assessable income depends upon the nature of the income involved and whether the taxpayer returns income on a cash or accruals (earnings) basis. Deferring derivation provides an opportunity to reduce the assessable income of the current year. The timing of derivation is considered below.

Business income

Business income is assessable in the year in which it is earned (derived). The Australian courts have held that income assessable on an accruals basis is derived when a recoverable debt is created such that the taxpayer is not obliged to take any further steps before becoming entitled to payment.

One exception is where such amounts are received in advance of the goods or services being supplied (as in the case of *Arthur Murray NSW Pty Ltd v. The Federal Commissioner of Taxation* (1965) 114 CLR 314). Under the *Arthur Murray* principle, income will not be assessable until the services are rendered.

Interest and rent

Interest and rent derived by parties at arm's length terms are generally derived in the year of receipt.

Dividends

Dividend income is assessable only when the dividend has been paid to the taxpayer.

The new regimes of consolidation and simplified imputation have the combined effect of superseding the former inter-corporate dividend rebate. The consolidation regime ignores intra-group dividends within consolidated groups and all recipients of franked dividends receive a franking tax offset equal to the amount of the franking credit.

Sale of depreciable assets

Deferring the sale of an asset can defer any assessable profit to the next year. Consequently, such a course of action would defer any payment of tax for up to 12 months. However, if the disposal will result in a loss then it may be more beneficial to bring the disposal forward to the current year.

Royalty income

A royalty is only assessable when it is received (or otherwise applied on the taxpayer's behalf). Royalty arrangements may be able to be structured so that the receipt does not occur until after year-end.

Insurance proceeds

Insurance proceeds for loss of profits or for loss or damage to trading stock, are recognised as assessable income when they are received. Consequently, there may be an opportunity to defer the income until after year-end.

Maximising deductions

Losses and outgoings of a revenue nature are allowable as a deduction in the year in which they are incurred. This is the case if the losses and outgoings are incurred:

- in carrying on a business to produce assessable income; or
- directly in gaining assessable income.

It is important to ascertain whether the expenditure is on revenue account and whether it has in fact been incurred.

It is also important that taxpayers are aware that, where a loss is no more than impending, threatened or expected, it has not been incurred. In order for a loss to be incurred for tax purposes, an existing obligation must be present. Where there is a presently existing obligation, it does not matter whether the size of the liability cannot be precisely ascertained.

Audit fees

The Tax Office's views on claiming a deduction for audit fees are expressed in Taxation Ruling IT 2625. The facts of each case are very important and will ultimately determine the correct tax treatment. The following examples provide guidance:

- If the auditor is entitled to receive fees progressively as work is performed, a deduction is available for each fee instalment as work is performed.
- If the auditor is only entitled to be paid at the end of the audit, a deduction will only be available at the end of the audit.
- If the auditor is only entitled to be paid once he or she expresses an opinion on the accounts, no deduction will be available until such an opinion has been expressed.
- If the client is required to pay the full audit fee at the start of the audit, the full fee is deductible at the time of payment.
- If the auditor is entitled to receive fees as particular milestones are reached, a deduction will be available as the milestone is reached and that fact is communicated to the client. No bill is required for a deduction to arise.
- If the auditor is entitled to the full audit fee on entering into the contract but agrees to accept payment by instalments, the full amount will be deductible when the contract is entered into.

The final example in the ruling provides a good planning opportunity.

Depreciation

Low cost assets

Taxpayers will be entitled to an immediate deduction for assets costing \$300 or less where **all** of the following conditions are satisfied:

- the asset is used predominantly to produce assessable income that is not income from carrying on a business; and

- the asset is not part of a set of assets that the taxpayer started to hold in the income year where the total cost of the set of assets exceeds \$300; and
- the total cost of the asset and any other identical, or substantially identical, asset that the taxpayer starts to hold in that income year does not exceed \$300.

Small business taxpayers that elect to be part of the simplified tax system (STS) (having turnover of less than \$1 million and depreciable assets with adjustable values of less than \$3 million) can obtain an immediate deduction for depreciating assets costing less than \$1,000.

Pooling

STS taxpayers may pool their assets (except low cost assets for which an immediate deduction is available) for depreciation purposes. Assets with an effective life of less than 25 years are to be included in a pool that is written off at 30%. The other remaining assets are included in a pool written off at 5%.

As the rate is halved in the first year that assets are allocated to a pool, there may be some advantage in acquiring plant at the end of the relevant tax year. This would result in an entitlement to an immediate 15% or 2.5% write-off, plus a full year of depreciation in the following period.

For other taxpayers, assets costing less than \$1,000 can be grouped into a low value pool. Once a pool is established, then all assets subsequently acquired costing less than \$1,000 must be included in the pool. The pool is written off using a write-off rate of 37.5% (diminishing value). Any additions to the pool during the year are depreciated at 18.75% regardless of when they were acquired.

Other

Broadly, deductions for losses on disposal may be brought forward for assets the taxpayer stops using and expects never to use again. As such, asset registers should be reviewed for any assets that fit this category. Specifically a balancing adjustment event occurs and the amount of the written down value can be deducted from taxable income.

Asset registers should also be reviewed for assets that can be depreciated rather than written off under the capital allowance provisions for income-producing buildings. For example, demountable partitions should be classified as fixtures and fittings, and not part of capital expenditure on the building, resulting in a higher annual deduction.

Taxpayers must use the effective life of an asset to determine the applicable depreciation rate. For plant acquired after 11.45 am AEST on 21 September 1999, the effective life of the asset may be calculated more than once if circumstances cause a previous estimate to become inaccurate. It may be wise to reconsider effective lives as part of the annual tax planning process.

A reviewed effective life can result in an increased or decreased rate of depreciation; however, it must be based on market or technological developments or other changes in circumstances connected with usage. In determining the effective life of an item of plant, the methodology explained in Taxation Ruling TR 2006/15 is useful. A copy of TR 2006/15 can be found on the ATO website at <<http://law.ato.gov.au/pdf/tr2006-015.pdf>>.

Prepayments

One of the simplest tax deferral methods is the prepayment of deductible expenses for the provision of services to be provided over a period of less than 13 months. When considering prepayments it should be noted that the Commissioner takes the view in Taxation Ruling IT 2613 that taxpayers that fail to claim a deduction for expenses incurred in one year of income cannot claim those expenses in a later year, when the liability is discharged.

The deductibility of prepayments for most business taxpayers has been phased out. It should be noted, however, that an immediate deduction is still available for:

- expenditure that is less than \$1,000;
- payments required under a court order or by law; and
- expenditure for salary or wages.

Certain taxpayers will, however, still be entitled to prepayment deductions. In particular, where:

- the taxpayer is in the STS; or
- the taxpayer is an individual and the relevant expense is not business-related.

Such taxpayers will be entitled to claim an immediate deduction for prepayments made where the eligible service period does not exceed 12 months and ends in the income year after that in which the expenditure is incurred. The eligible service period is essentially the period over which the relevant services are to be provided.

Bad debts

The criteria for deductibility of bad debts are:

- the debt must be bad;
- it must be written off during the year of income; and
- the amount must have been either:
 - previously brought to account as assessable income; or
 - lent in the ordinary course of a money-lending business of the taxpayer.

In the context of tax planning, taxpayers should undertake a review of doubtful debts prior to year-end and assess which debts may be written off as bad. Whether a debt is bad will depend on an objective analysis of the facts surrounding each debt. As a practical guide, the taxpayer should be able to show that appropriate steps to recover the debt have been taken.

It should also be noted that trusts with bad debts must satisfy the trust loss rules (see below). Companies that have undergone a change in underlying ownership during the year will need to pass the 'same business test' to recoup bad debts.

Trading stock

For tax purposes, trading stock can be valued at:

- its cost; or
- its market selling value; or
- its replacement value.

Any of these values can be used for each individual item of stock, regardless of the value used for accounting purposes. Using the most appropriate valuation for tax purposes can assist in deferring profits to a later year or in bringing assessable income into a current year, if this is appropriate due to tax loss issues.

Each taxpayer should also review closing stock to consider whether obsolete items should be scrapped.

Bonuses

Taxpayers should ensure that where a bonus has not been paid at year-end, they are able to demonstrate an established commitment to the expense at that time. The critical indicators of this are:

- the bonus entitlement is included in contracts of employment;
- by year-end the taxpayer had decided on the amount of the bonus, or an agreed formula or process to be followed to determine the amount;
- if there is an agreed formula or process, it is not subject to management discretion that can be exercised after year-end; and
- a binding board resolution has been made.

Superannuation

In order to obtain a deduction for superannuation, the taxpayer must have 'paid' the superannuation by year-end. A mere accrual of the liability or a book entry is not sufficient.

A liability for the Superannuation Guarantee Charge (SGC) arises where an employer does not contribute the prescribed minimum level (9% for 2006/07) of superannuation contributions within the relevant time frame. Employers have until **28 July 2007** to make the required contributions for the quarter ended 30 June 2007. This is a critical date as there are no provisions in the *Superannuation Guarantee (Administration) Act 1992*, nor any discretionary powers vested in the Commissioner, that allow for an extension of time.

Where there is a shortfall in the required superannuation support, the shortfall, as well as interest and an administration charge, become payable on 14 August 2007. The shortfall is credited to a superannuation fund on behalf of the employee. The shortfall is not deductible by the employer, whereas contributions are deductible in the year paid.

Accordingly, all superannuation contributions relating to the 2007 income year must be made at the latest by 28 July 2007 in order for a deduction to be available when the amount is paid (otherwise, the non-deductible SGC applies).

Changes to the superannuation legislation

As part of the 2006 Federal Budget measures, significant changes have been made to the superannuation regime that have resulted in several year-end tax planning strategies which may unlock substantial benefits for eligible taxpayers including:

- salary sacrificing up to the prescribed Aged Based Limit (ABL) from each non-associated employers;
- making personal deductible superannuation contributions up to the prescribed ABL (subject to satisfying 'eligible person' rules);
- considering the level of remuneration and/or profit distributions received from closely held entities (potentially enabling multiple deductible ABL superannuation contributions by an employer and as an eligible person);
- increasing personal undeducted superannuation contributions (subject to a \$1 million ceiling from 10 May 2006 to 30 June 2007); and
- considering a date of retirement where appropriate (taking into account the restricted ability to roll-over employer Eligible Termination Payments (ETPs) after 1 July 2007).

In addition to the above, taxpayers should be aware of the reforms brought about by the legislative changes including:

- abolition of compulsory cashing of superannuation savings;
- abolition of Reasonable Benefit Limits;
- all superannuation benefits paid to persons aged 60 and over will be tax-free;
- simplification of superannuation pension arrangements; and
- tax-free lump sum death benefit payments to 'tax' dependants.

Repairs v. improvements

To determine the appropriate tax treatment of expenditure on repairs, the taxpayer must answer the following questions:

- When is a repair a 'deductible repair'?
- When does it become an item of capital?

The term 'repair' is described in Taxation Ruling TR 97/23 as:

'the remedying or making good of defects in, damage to, or deterioration of, property to be repaired (being defects, damage or deterioration in a mechanical and physical sense) and contemplates the continued existence of the property'.

In relation to repairs, the income/capital issue generally involves three main areas:

- initial repairs;
- the replacement of a subsidiary part or the replacement of the entire item; and
- the item's repair versus improvement (i.e. restoration of the item's former state or an improvement in its functionality).

Initial repairs, improvements and the replacement of the entire item are not deductible, but may qualify for a periodic write-off under the capital allowance provisions. In addition, the expenditure may form part of the cost base of an asset for capital gains tax purposes.

Business-related costs — blackhole expenditure

The Government has recently released legislation that increases the circumstances under which a deduction is available for 'blackhole' expenditure. This is expenditure that is incurred by a business where there is no deduction available under tax law. Taxpayers should review expenditure to ensure that all potential deductions are captured.

Under the rules, taxpayers will continue to be entitled to a deduction on a straight line basis over five years for certain business expenditure. The available deduction is expanded to include expenditure that is incurred in relation to a past, present or prospective business, to the extent that the business is, was, or is proposed to be carried on for a taxable purpose. This is in addition to expenditure incurred to establish a business structure, convert a business structure, raise equity, defend a business against a takeover and costs related to ceasing a business.

Expenditure on a business plan, the establishment of business premises, research into likely markets or profitability of a business and capital investment in assets of the business are also deductible.

In addition, shareholders, beneficiaries of trusts and partners are able to deduct liquidation and deregistration costs where the company, trust or partnership carried on the business.

The deduction is only available if the expenditure cannot be deducted under any other part of the tax law. It is noted also that if a taxpayer is not carrying on a business, the deduction is not available.

Capital Gains Tax

The Capital Gains Tax (CGT) regime applies to CGT events that result in a receipt of a capital amount by a taxpayer. A net capital gain is the taxpayer's total capital gain less certain capital losses. If a taxpayer has made a net capital gain, this amount is included in their assessable income for the income year.

Broadly, for CGT events occurring on or after 21 September 1999, the net capital gain of an individual or a trust may be discounted by 50% (33 1/3% for a superannuation fund) before being included in assessable income, where the relevant asset has been held for more than 12 months.

For companies, the 50% discount is not available. However, the law includes several CGT concessions and roll-over relief provisions that are available to certain companies.

The law contains four small business CGT concessions which apply to CGT events on or after 21 September 1999. There have been some significant amendments to the small business CGT concessions which alter the eligibility criteria.

Broadly, the changes have altered some points of the eligibility criteria in qualifying for the concessions, however, the following basic conditions must still be satisfied:

- A capital gain results from a CGT event, such as disposal of a CGT asset.
- The sum of the net assets of the entity, its connected entities and its small business affiliates does not exceed \$5 million (proposed increase to \$6 million as of 1 July 2007).
- The asset relevant to the CGT event is an 'active asset'. An asset is an 'active asset' if the taxpayer owns it and uses it, or holds it ready for use in the course of carrying on a business.

Two additional basic conditions must also be satisfied if the CGT asset is a share in a company or an interest in a trust. These are as follows:

- The company or trust must now have a 'significant individual' just before the relevant CGT event. An individual is a 'significant individual' of a company if he or she has at least a 20% small business participation percentage, which includes direct and indirect interests in the voting power, dividends and capital distributions of the entity.
- A taxpayer who wishes to benefit from the concessions must be a 'CGT concession stakeholder' in the company or trust. Broadly, the 'CGT concession stakeholder' is the 'significant individual' (and his or her spouse) of the company or trust.

The four small business CGT tax concessions include:

- The **15-year asset exemption**: a capital gain may be disregarded if the relevant CGT asset has been continuously owned by the taxpayer for at least 15 years. If the owner is an individual, he or she must be over 55 and retired or permanently incapacitated.
- The **50% active asset reduction**: a capital gain resulting from a CGT event happening to an 'active asset' of a small business may be reduced by 50%.
- The **retirement exemption**: broadly, a capital gain will be exempt if the relevant taxpayer chooses to use the capital proceeds in connection with their retirement.
- The **asset roll-over**: a taxpayer is allowed to defer the making of a capital gain from a CGT event relevant to an 'active asset' if the taxpayer acquires a replacement asset.

The Tax Office also allows two general asset rollovers which effectively ignore any capital gain or loss that is made when a CGT event occurs. There are two types of rollovers available, the replacement asset rollover and same asset rollover. Both of these rollovers are available to all types of taxpayers.

Broadly, a replacement asset rollover allows a taxpayer to defer a capital gain happening in relation to one or more small business assets if the taxpayer acquires a replacement asset within the period of one year before or two years after the last CGT event in the income year for which the rollover is being claimed.

A same asset rollover involves the deferral of a CGT event where the asset in question changes hands from one taxpayer to another. The rollover applies to the taxpayer who receives the asset and the capital gain or loss is ignored in the hands of the transferor. Any subsequent CGT events occurring in relation to the asset only affect the asset holder.

Modification of cost base

Taxpayers should review expenditure to ensure that all is captured within the cost base or reduced cost base of the CGT asset.

Under the cost base rules, the second, third and fourth elements of the cost base and reduced cost base will be modified to include the following expenditure:

Second Element

- marketing expenses (e.g. furniture hire to help sell a rental property);
- search fees relating to a CGT asset (e.g. fees payable in checking land titles);
- the cost of a conveyancing kit; and
- borrowing costs (e.g. loan application fees).

Third Element

- capital costs of ownership of assets acquired after 20 August 1991.

Fourth Element

- expenditure with the purpose or expected effect to preserve the asset's value (i.e. legal expenses incurred to oppose a nearby development that would negatively affect the value of the asset). This also includes the removal of the requirement that such expenditure in relation to the preservation or improvement of the asset be reflected in the condition or nature of the asset at the time of the CGT event; and
- capital expenditure in relation to installing or moving the asset.

In addition, certain expenditure is excluded from the cost base or reduced cost base including, for example:

- entertainment;
- penalties; and
- bribes.

Tax consolidation

The consolidation rules commenced from 1 July 2002. The rules impact both large and small taxpayers, potentially applying whenever a company wholly owns one or more other companies or unit trusts.

The basic features of the consolidation rules are as follows:

- one consolidated tax return will be lodged for each consolidated group;
- losses and franking credits are transferred into the consolidated group;
- all intra-group transactions, including dividends, are ignored for tax purposes;
- consolidation is optional, but inter-corporate CGT rollover relief, loss transfers and dividend rebates will not be available to non-consolidated groups after 1 July 2003; and
- an election to consolidate should be made by the due date for the first consolidated tax return.

Who can consolidate

A head company can consolidate with:

- all of its 100% owned Australian resident subsidiaries;
- wholly owned fixed trusts and discretionary trusts which can distribute only to group members; and
- partnerships comprising group members.

A head company must be an Australian resident company (which is not a wholly owned subsidiary of another resident entity).

However, a number of directly owned 100% subsidiaries of a foreign company can still be consolidated in the absence of an Australian holding company.

All eligible entities must be included in the consolidated group.

Subsidiaries are taken to be divisions of the head company and subsidiaries' assets are taken to be owned by the head company. The purchase of a new subsidiary will be treated as a purchase of its assets and liabilities.

Allocable cost amount

In general, new cost bases will be allocated across assets using an Allocable Cost Amount (ACA) determined in a very complex eight-step calculation.

Very broadly, the ACA will comprise the adjusted cost of membership interests, for example shares (limited to market value), plus liabilities and frankable profits, less certain distributions of pre-acquisition profits and certain losses.

Assets can move freely between entities in a consolidated group, as intra-group transactions are ignored. On disposal of an entity, the cost base of the shares will be determined based on the cost base of the assets in the entity at that time.

Tax losses

The consolidated group tax loss rules apply to both capital and revenue losses. A subsidiary is able to transfer capital and other losses into a consolidated group if the losses could be otherwise available for utilisation. A modified Continuity of Ownership Test (COT), or, failing that, a modified Same Business Test (SBT) will be applied. Losses that cannot be transferred into the consolidated group will expire. Once losses are transferred in, the head entity for the group will still have to satisfy the COT or, failing that, SBT in order to recoup losses in the future.

The rate of utilisation of losses transferred will be limited by an 'available fraction' which, very broadly, will be based on the value of the loss subsidiary as a proportion of the value of the group. The available fraction may be affected (reduced) by capital injections made into the consolidated group.

Private company loans and distributions — Division 7A

In order to minimise any adverse Division 7A consequences, taxpayers must consider the following:

- repay private company loans by the due date for lodgement of the income tax return;
- ensure commercial loan agreements are in place by the due date for lodgement of the income tax return;
- ensure minimum repayments are made on loans from prior years;
- a deemed dividend can only arise to the extent of a company's distributable surplus, so this issue should be considered along with planning opportunities;
- payments under a guarantee can trigger a deemed dividend and must be considered carefully;
- the payment of an actual franked dividend by a company to offset a loan which has been deemed to be a dividend can have adverse implications and should be carefully considered;
- the exemptions available should be considered, and used where possible; and
- a deemed dividend can also apply where property is provided, so companies should consider requiring shareholders to pay market value.

Trust distributions

The Tax Office has issued Practice Statement LA 2005/1 (GA), which clarifies how the Commissioner will tax net capital gains derived by resident trust estates. A copy of PS LA 2005/1 can be found on the ATO website at <http://law.ato.gov.au/pdf/ga05_001.pdf>.

In the Practice Statement, the Tax Office states that it will accept what it describes as the 'capital beneficiary approach' or the 'trustee approach' where inequitable tax outcomes arise under the 'proportionate approach'. To be able to access these approaches, documentation as discussed below must be entered into within two months of year-end.

The Practice Statement concerns trusts that have separate and distinct income beneficiaries and capital beneficiaries (i.e. capital profits are distributed to separate beneficiaries). However the document acknowledges that the different entitlements to income or capital may be subject only to the exercise of trustee's discretion.

The Practice Statement focuses on the situation where a trust derives a capital gain which has been discounted. When the beneficiary receives the distribution, the capital gain is grossed up to the pre-discount amount. The beneficiary will then apply capital losses prior to applying the 50% discount.

Inequitable tax outcomes can result under the proportionate approach where income is distributed to one beneficiary and capital gains are distributed to another. Specifically, under section 97 of the *Income Tax Assessment Act 1936* (ITAA 1936), the taxpayer who is entitled to the 'income' would be taxed on all of the 'taxable income' (including the capital gain, even though they will not receive any of the capital distribution). In that situation, the Tax Office will permit the use of the capital beneficiary approach or the trustee approach as discussed above.

Capital beneficiary approach

The capital gain may be assessed to a beneficiary (or a trustee on their behalf) where:

- the beneficiary has a vested and indefeasible interest in the trust capital representing the trust's capital gain; or
- if the trust's capital gain is a 'deemed' amount for tax purposes, the beneficiary would have had an interest if the gain were represented by actual trust capital; or
- the beneficiary has been allocated the trust's capital gain as a present entitlement no later than two months after the end of the income year.

To use this approach the capital beneficiary must agree in writing that the approach be used and they must prepare their tax return in a way that corresponds to the agreement. The agreement must generally be made within two months after the end of the income year, or such further time as the Commissioner allows. The trustee resolution allocating the capital gain must also be made by the time the agreement is made.

Trustee approach

If there is a capital gain that is not to be included in the share of the net income of a beneficiary, the trustee will be assessed under section 99 or 99A.

This approach can only be used if beneficiaries and the trustee have agreed in writing to use it. Any agreement must be made within two months after the end of the relevant income year.

If a party does not prepare their income tax return in accordance with an agreement, the Tax Office will ignore the agreement in assessing the capital gain.

Trust losses

The trust loss legislation is very complex and restricts the utilisation of both current year and prior year losses. Following is a summary of the steps involved:

Step 1: Classify the trust

Is the trust a fixed or a non-fixed trust?

This will depend on the definition of 'fixed entitlement' in section 272–5 of Schedule 2F of ITAA 1936, and the notion of 'vested and indefeasible interest'.

Step 2: Ascertain which tests apply

The trust loss rules categorise trusts into different types (e.g. fixed trusts, unlisted widely held trusts, non-fixed trusts and family trusts) and then applies certain tests to determine if the trust losses can be recouped (e.g. 50% stake test, pattern of distribution test, control test, income injection test). Therefore, the second step is to determine which tests apply. It should be noted that the pattern of distribution test does not apply where the trust does not make a distribution in that year.

Step 3: Apply the relevant test(s)

Particular attention must be given to the income injection test. If the pattern of distributions test would be failed, consider accumulating income and capital.

Step 4: Elections

Consider whether a family trust election or interposed entity election should be made to preserve losses.

The trust loss rules should be very carefully considered as part of any tax planning process.

Simplified dividend imputation

We summarise below some of the key features of the imputation regime.

Franking credits recorded as tax paid

An entity's franking account will be credited with the amount of tax paid. Consequently, \$1 of income tax paid will equate to a \$1 franking credit.

Distributions that can be franked

All distributions (i.e. dividends or payments taken to be dividends) are frankable unless specifically deemed unfrankable under the Tax Law.

Unfrankable distributions include the following:

- loans or other distributions by private companies which are taken to be dividends under Division 7A of ITAA 1936;
- certain other loans to shareholders and associates; and
- excessive remuneration payments.

Benchmark rule

Subject to certain rules, entities are now free to frank a frankable distribution to whatever extent they consider appropriate, subject to a 'benchmark rule'. This rule provides that all frankable distributions made by an entity during the franking period (refer below) must be franked to the same extent (referred to as the 'benchmark franking percentage').

It should be noted that a corporate tax entity would incur over-franking tax where the franking percentage for a distribution exceeds the benchmark percentage, or a franking debit (for under-franking) where the franking percentage is less than the benchmark rate, in addition to the debit that arises in the account on payment of the distribution. Certain concessions to this rule may apply to public companies.

Where the benchmark percentage used in a period varies by more than 20% from the percentage used for the last frankable distribution in the last franking period, entities must notify the Commissioner in writing.

Franking period

For a private company, a franking period equates to its income year. Therefore, there will be one franking period of 12 months in a normal 12-month year (every six months for public companies).

Reporting obligations

Entities that make frankable distributions must provide their shareholders with a distribution statement. For private entities, the distribution statement must be given by the entity within four months of the end of the income year in which the distribution was made. If this statement is not received, the shareholder will not be able to claim a franking credit tax offset.

Franking account balance

A company's franking account should be reviewed to ensure that the company is not liable for franking deficit tax. Where the company is liable for franking deficit tax, it must be paid within a month of the end of the franking year. Franking deficit tax is not a penalty but an early payment of income tax that is offset against future tax obligations.

Personal services income (PSI)

The PSI regime aims to prevent individuals from reducing their tax by alienating their PSI to an associated entity. The PSI regime, which took effect in the 2000/01 tax year, forces taxpayers to include income generated by their personal skill or efforts in their own personal assessable income. The classification of income as PSI is a question of fact and the Tax Office has issued TR 2001/7 to assist taxpayers with the rules.

The deductions of a taxpayer who receives PSI are generally limited to the amount that they would be entitled to deduct if the income had been received as an employee. Deductions may include expenses incurred in relation to gaining work, income protection insurance and personal superannuation contributions.

A Personal Services Business will be exempt from the PSI regime if it satisfies at least one of the required tests as outlined in TR 2001/8 and listed below:

- The results test;
- The unrelated clients test;
- The employment test; and
- The business premises test.

In addition, the Commissioner has the power to grant a Determination, which has the effect of exempting a Personal Services Business from the PSI regime.

Broadly, the Commissioner will grant a Determination if unusual circumstances existed that prevented the business from satisfying the above mentioned tests or the business would have had but for the unusual circumstances, two or more unrelated clients in the current income year. Taxpayers may wish to review their own arrangements in view of their ability to meet one of the four tests. Where appropriate, they may wish to apply for a Determination.

Tax shelters

At year-end taxpayers may consider utilising tax shelters to take advantage of potential benefits. Many different structures have been used over the years. It goes without saying that independent advice should be sought.

With effect from 11 November 1999, new rules were introduced to limit the availability of up front deductions under the prepayment rules in relation to certain types of tax shelters subject to limited exceptions. Effectively, these rules spread the available deduction over the period in which the services are performed.

The Tax Office has issued a constant stream of product rulings regarding these issues. These must be considered before the arrangement is entered into so that the tax position of the investment can be determined.

It is important to also note that the proposed investments should be considered from a sound commercial perspective.

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