



ANU LAW STUDENTS' SOCIETY

LAWS2221 Income Tax 2nd Semester 2003

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Question 1

80/100

ADVICE TO THE PARTNERSHIP

The law partnership on the facts is a partnership for the purposes of s 995-1. The net income of the partnership is calculated as if the partnership is a separate entity (Div 5), being assessable income less allowable deductions (s 90). Here, the partnership's assessable income for the 2002-03 income year was \$800,000. Partners are then assessed individually on their share of the income received (s 92).

Deductions

To be deductible, an expense must satisfy a positive limb in s 8-1(1) and not breach the four negative limbs of s 8-1(2).

Employment of Clerks and Ownership of Premises

The expenses of employing staff and owning premises are allowable deductions as they are outgoings necessarily incurred for the carrying on of a business to produce assessable income (s 8-1(1)(b)).

Leasing Office Equipment from Spouses

The leasing of office equipment is necessarily incurred for the carrying on of a business to produce assessable income (s 8-1(1)(b)) and is deductible to the extent that the expense is reasonable as it is paid to spouses, who are related entities (s 26-35; *Phillips*).

Partners' Salaries

Partners' salaries are not deductible expenses for the partnership as they are distributions of partnership income (*Case 81*)

Cost of Legal Defence

The legal costs in defending the partners will be deductible if necessarily incurred in carrying on a business for the purposes of gaining income (s 8-1(2)). "Necessarily incurred" includes expenses incurred by a taxpayer to protect its business reputation (*Snowden Willson*) and here these costs are for business purposes as the interests of the partnership and that of the partners themselves are inseparable (*Magna Alloys*). However, because the partners narrowly avoided

being suspended from practice, the partnership itself was in peril during the investigation, rather than just business reputation and hence the expenses are likely capital in nature (*Snowden Willson*) as the expenditure refers to the business entity rather than the process of carrying on business (*Sun Newspapers*). Deduction is therefore not allowed for the legal expenses as they are capital expenditure (s 8-1(2)(a)).

ADVICE TO KATE

Kate is an Australian resident for tax purposes as she has Australian domicile of origin (s 6(1)(a)) and no domicile of choice (s 9(4) *Domicile Act*).

In assessing Kerrie's taxable income, the amount of her assessable income is reduced by allowable deductions (s 4-15). On the facts, Kerrie's assessable income from the partnership is \$400,000 plus \$50,000 salary (s 92). [*early distribution*]

Treatment for sweaty hands

To be deductible, Kate's expenses must satisfy s 8-1 (see above).

The medication will be deductible if incurred in gaining or producing assessable income (s 8-1(1)). Deductibility turns on the nature and character of the operations which produce the assessable income (*Smith's Case*) and the expenditure must be relevant and incidental to deriving income (*Ronpibon Tin*), but it does not matter that an expense is unpredictable and indirectly connected to the earning of income (*Charles Moore*). Kate purchased the medication improve her income earning capacity, of which being able to greet clients and work contacts properly is an incidental part, even though indirectly related to her legal work. However, the expense may not be sufficiently relevant to her income earning capacity as grooming requirements do not automatically operate to confer deductibility (*Mansfield's Case*), and it is her legal skill rather than her personal skill at shaking hands from which earns her income. Also, as Kate does not work in a harsh environment that requires protective measures, the medication is probably a private expense (*Mansfield's Case*) and therefore not deductible (s 8-1(2)(b)). [*Cooper's Case*]

Trust Income

The net income of the trust is the total assessable income of the trust estate, less all allowable deductions (s 95(1)) and less exempt income (s 6-20). As Kate is an Australian resident (see above), the trust is a resident of Australia for tax purposes (s 95(2)) and hence is assessable income includes the income from all sources, whether Australian or not (s 6-5(2)). [*ss 97 + 98 contain the source / residency requirements*]

Kate's brother, as sole beneficiary, has a vested and indefeasible interest in the fixed trust and is deemed presently entitled despite no distribution having been made (s 95A(2)). As he is in a nursing home he may be unable to give a valid discharge for payment made to him (*Taylor*) and hence subject to a legal disability, but this is unclear on the facts. In either case, Kate as trustee is liable to pay tax in respect of the \$30,000 trust income at her brother's marginal rate of tax (s

98). There is no double taxation agreement to alter Australia's taxation rights on Cook Islands sourced income. [s 97?]

There is no mention on the facts of the beneficiary's age, however, if he is a minor, then s 98 would apply, with the income derived from the investment of personal injury compensation money excepted from assessable income (s 102AE(2)). This would result in the net income of the trust being nil, and hence no tax liability on Kate arising from the trust.

Split Loan

Under (*Hart*), both ordinary and compound interest on the investment loan in a split loan arrangement are deductible. However, the Commissioner has leave to appeal to the High Court on the deductibility of compound interest and on the validity of this type of arrangement under Part IVA (*Hart*). Under (TR 98/22), the Commissioner has ruled that compound interest on an investment loan in a split loan arrangement is not deductible, so for Kate to successfully claim a deduction for compound interest, she would be forced to litigate as it would initially be refused.

The Commissioner would be likely to challenge this split loan arrangement under Part IVA. Part IVA requires there to be a scheme (s 177A), a tax benefit (s 177C) and that the dominant purpose of tax avoidance can be objectively (*Peabody* per Hill J) demonstrated on balance of the factors in s 177D(b). "Scheme" is broadly defined (*Peabody*), and the split loan arrangement would I satisfy this element as it is capable of standing on its own. "Tax benefit" requires that Kate obtain a benefit that would not have reasonably been expected to get had she not entered the scheme (*Peabody*). Under the split loan, Kate would get a tax benefit by claiming greater deductions than otherwise available to her without the capitalisation of interest on the investment loan. Factors i-iii of s177D(b) indicate that the purposes of the loan scheme are to allow earlier repayment of the residential loan and earlier investment in other property by Kate, while providing her with greater tax deductions than otherwise available. It seems that Kate's dominant purpose for the loan is financing, however, given the size of deductions which are provided by compound interest on the arrangement and that this issue in (*Hart*) is on appeal to the High Court, relying on this purpose is a risky strategy. [*advice?*]