General year-end tax planning for business

1 June 2015

With 30 June fast approaching, now is the time for companies with a 30 June tax year end to consider year-end tax planning strategies and issues. Some important issues to consider include:

Thin capitalisation

The thin capitalisation (TC) tax rules have the effect of denying a tax deduction for some or all of the costs incurred in obtaining or maintaining ‘debt’. Generally, a taxpayer is thinly capitalised where ‘average adjusted debt’ that gives rise to ‘debt deductions’ (i.e. tax deductions that would be available but for the TC rules) exceeds the ‘average maximum allowable debt’.

Firstly, some taxpayers may find that due to the increase in the annual de minimus threshold from $250,000 to $2 million of associate-inclusive debt deductions they no longer need to apply the TC rules for this income year.

For those taxpayers that remain subject to the TC rules, in many cases, taxpayers will use the average ‘safe harbour debt amount’ in determining the maximum allowable debt. It is important to note that because of legislative changes to the calculation of the safe harbor debt amount that apply from 1 July 2014 for a June balancer, which will generally have the effect of producing a lower safe harbor debt amount than in prior years, some taxpayers may now need to consider the alternative methods for calculating maximum allowable debt. These are the arm’s length debt amount and the worldwide debt amount. In the case of the worldwide debt amount, it is also important to note that commencing with this tax year, the worldwide debt amount method may be used not only (as in the past) by entities that are solely ‘outward investing’, but also by entities that are either ‘solely inward investing’, or both outward and inward investing.

As a starting point, before the end of the year, taxpayers should check what their likely TC position will be at the end of the year. If it is anticipated that adjusted average debt will exceed average maximum allowable debt, some planning options may be able to be implemented to reduce the adverse consequences under the TC rules, which will otherwise arise. Possible planning issues for consideration before year end include repayment of debt from surplus assets, injection of equity, and repatriation of profits from overseas controlled entities or foreign branches. Each of these and other options need to be carefully considered before implementation as there are other tax rules that might be inadvertently triggered (including those in overseas jurisdictions).

Taxpayers may also enhance their TC position by a revaluation of assets where the revaluation complies with the ‘accounting standards’. Additionally the TC rules allow certain revaluations to be made notwithstanding that the revaluations are not permitted under the accounting standards. While goodwill cannot in any circumstance be revalued, it may be possible for other intangibles to be revalued for TC purposes. It is important to note however that there are prescribed requirements with respect to the revaluations that must be complied with for TC purposes.
**Franking account**

Companies should check the balance of the franking account to determine whether the company will have a liability to pay franking deficit tax (FDT) at year end or have sufficient franking credits to enable the payment of franked dividends before year end. The possibility of improving the account balance before year end (such as through the receipt of franked distributions) would need to be considered on a case by case basis.

**Tax losses and net capital losses**

Companies need to check whether tax losses and net capital losses are available for utilisation subject to satisfying either the continuity of ownership test (COT) or the same business test (SBT). If neither test is satisfied, the losses will not be able to be used. Tax consolidated groups also need to consider the impact of specific loss utilisation rules including the ‘capital injection rule’ which may apply where there has been a ‘capital injection’ after entry into consolidation.

**Bad debts**

The requirements for obtaining a bad debt deduction include that the debt must be bad and must be written off as such (while the debt still exists) before the end of the year of income. Now is the time to review debts owing to the company to determine if a bad debt deduction can be obtained by writing the debt off before year end. Other requirements that need to be considered include satisfying specific COT or SBT conditions.

**Debt forgiveness**

If your company has had a debt forgiven during the year, the debt forgiveness rules will need to be considered as they can result in losses and deductions that would otherwise be available being reduced. Note that a debt forgiveness is specifically defined in the tax law and includes, for example, an assignment of a debt (with some exceptions) and the extinguishment of a debt through either a debt for equity swap or the use of monies subscribed as share capital by a lender to enable the lender's debt to be repaid.

**Depreciating assets**

Have you reviewed your asset register to identify ‘depreciating assets’ that may have been scrapped or which are no longer used or installed ready for use? Generally, the cost of a scrapped depreciating asset, which has not been claimed as a decline in value deduction (depreciation), can be claimed as a deduction in the year in which the asset is scrapped. Similarly the undeducted cost of a ‘depreciating asset’ which is no longer used or installed ready for use may be claimed as a deduction where there is no longer an intention to again use the asset.

For remaining depreciating assets, have you checked the depreciation rate that is used to claim the depreciation deduction? Perhaps it would be tax effective for you to self-assess the effective life of certain assets instead of simply using the rates published by the Commissioner of Taxation. In some cases there is a requirement for you to self-assess the effective life.

Consideration should be given to the timing of expenditure in relation to ‘in-house software’ as the Government is proposing to increase the period over which capital expenditure on in-house computer software can be depreciated from 4 to 5 years with effect from 1 July 2015. This measure is not enacted at the time of writing.

Small businesses – defined as those with an ‘aggregated turnover’ of less than $2 million - should also note the impact on the current year’s taxable income of this year’s Federal Budget proposal that will allow an immediate tax deduction for the cost of a depreciating asset that has a cost of less than $20,000 where the asset is acquired and held ready for use after 7.30pm (AEST) 12 May 2015. At the time of writing, this proposal was not enacted.
**Black hole expenditure**

Have you incurred capital expenditure that is not included in the capital gains tax (CGT) cost base of a CGT asset and which is not otherwise tax deductible? If so, you should check whether the expenditure can be deducted as 'business capital expenditure' (black hole expenditure) over five successive years starting with a flat deduction of 20 per cent in the year that the expenditure is incurred.

**Superannuation**

Superannuation contributions for employees need to be made before year end if you want to claim a tax deduction this year for the contribution. Note that it is necessary that the contribution be received by the relevant superannuation fund before the end of the year else the deduction will not be available this year. Be careful with bank transfers as many of these take time to go through the banking system and may not be received by the payee (superannuation fund) for a number of days after the originating transaction is processed.

In making contributions you should be conscious of the fact that if the total tax deductible contributions in the year for an employee from any source exceed the individual’s ‘concessional contribution cap’, the excess will be assessable to the employee as assessable income, with the employee being entitled to a 15 per cent tax offset which reduces the tax otherwise payable. If the employee does not choose to have the excess (net of 15 per cent tax) refunded by the fund to the employee, the excess will be treated as a non-concessional contribution paid to the fund by the employee. Where the non-concessional contribution cap is exceeded, other complications (including a liability to non-concessional contributions tax) would need to be considered.

**Foreign currency gains and losses**

Review all foreign currency exchange (forex) contracts and exposures before year end to determine whether a foreign exchange gain or loss will arise before year end. Under the forex rules, a core realisation principle applies to ensure that gains and losses are brought to account on revenue account when realised, regardless of whether there is an actual conversion of foreign currency amounts into Australian dollars.

Consider the effects of realising a forex gain or loss prior to year end. Typically, accelerating realisation of a forex gain may be beneficial if the gain is offset by losses which may be lost in a later year (such as through a likely failure of COT and SBT). Realising a forex loss would generally be beneficial where the entity can offset the loss against other assessable amounts.

Note however that where a valid retranslation election has been made, typically on a ‘qualifying forex account’ (which can also cover inter-company transactional accounts, unrealised forex gains and losses are recognised for income tax purposes.

**Trading stock**

In the current economic environment, it may be worth considering the merits of carrying out a detailed review of the value that can be ascribed to trading stock at year end for income tax purposes. In cases where stock is either ‘slow moving’ or obsolete, a year end value lower than cost (for stock acquired in the year), or the value applied to the stock if held at the beginning of the year, would generally have the effect of lowering taxable income for the year (assuming that the company does not have a tax loss). The recent volatility of the Australian dollar may also impact on the market selling price of stock or the value at which existing stock can be replaced, and using these options to value trading stock at year end (instead of simply using cost) may be beneficial for some taxpayers.

**Capital gains tax**

Since net capital losses can only be used to offset capital gains (i.e. and cannot be used to reduce assessable income), it is important to ensure that capital losses are not wasted by incurring these losses in a year subsequent to the realisation of a capital gain. There may therefore be merits in crystallising a capital loss before year end, to ensure that it can be used to offset against current year capital gains.
In cases where a CGT asset is sold under a contract, the CGT event (which results in a capital gain or capital loss) is taken to have occurred at the date of contract formation, and not at date of settlement. Accordingly, deferring settlement of a contract entered into before year end will not defer the making of the capital gain or capital loss. The capital gain or loss will be taken to have been made at date of contract formation.

Deferring the time of making a contract until the start of the next tax year will however mean that any capital gain or capital loss from sale of the relevant asset is made in that next year. Take particular care to consider contract conditions often referred to as ‘conditions precedent’. If there are conditions precedent to completion of the contract (as opposed to being conditions precedent to formation of the contract) the conditions will not be relevant in determining the date at which the contract is entered into (i.e. formation) and the conditions will have no impact on the date upon which the CGT event occurs. Proper advice needs to be obtained on this issue on a case by case basis.

For a company that has net capital losses carried forward from prior years, it may be beneficial to trigger the making of capital gains this year (i.e. for offset against the net capital losses) particularly where there is a possibility that the COT may cease to be available in subsequent years.

**Transfer pricing**

Have you considered whether the transfer pricing rules may apply to your cross-border dealings? Typical dealings to which the transfer pricing rules may apply include loans to or from related parties located in an overseas jurisdiction and the provision (or acquisition) of goods or services to (or from) such related parties.

Generally the transfer pricing provisions apply where, under a cross border arrangement, parties do not deal at arm’s length, with the result being that a ‘transfer pricing benefit’ is obtained. A transfer pricing benefit occurs where, because of the arm’s length dealing, either:

- taxable income is lower
- a loss of a particular sort is higher
- a tax offset is higher, or
- withholding tax payable is lower than the position that would have applied if the parties had dealt at arm’s length.

Under the current transfer pricing provisions, taxpayers are required to self-assess the application of arm’s length principles in filing income tax returns with the Commissioner and meet documentation requirements if the position adopted is to be reasonably arguable. This aspect, together with the proposed increase in penalties for larger entities (turnover exceeding $2 billion) as announced in the 2015-16 Federal Budget, means that properly documenting cross-border transactions and associate pricing policies is a business imperative.

**Taxation of financial arrangements (TOFA)**

Have you considered whether you meet the relevant threshold criteria to be subject to the TOFA rules in Division 230 of the Income Tax Assessment Act 1997? The TOFA regime broadly operates to recognise gains and losses from financial arrangements such as term deposits, financial securities and borrowings on an accruals basis. However for certain financial arrangements, such as hedges or foreign currency denominated arrangements, it may be the case that to secure assessable income/deductions, you need to realise or dispose of the financial arrangement to trigger a gain or loss on realisation or as a balancing adjustment. All June balancing companies preparing audited financial reports should also consider the implications of making any new tax-timing election(s) – retranslation, hedging, fair value or financial reports - by 30 June 2015 to have the election apply to all eligible financial arrangements that started to be held from 1 July 2014. Because any election that is made is irrevocable, and will apply to all relevant financial arrangements that the entity subsequently starts to have, the consequences of making any election should be carefully reviewed.
Small business companies

In addition to the accelerate depreciation measure noted earlier, small business companies should note and monitor the enactment of this year’s Federal Budget proposal to reduce the corporate tax rate from 30 per cent to 28.5 per cent with effect from 1 July 2015. A lower tax rate will produce after-tax cash savings and should be considered in the context of the time of derivation of assessable income (or time of assessable CGT events) and the time at which deductible expenditure is incurred.

General anti avoidance rule

Before undertaking any year-end tax planning, you should consider the general anti-avoidance provisions in Part IVA of the Income Tax Assessment Act 1936 including the changes to these provisions announced in the 2015-16 Federal Budget.

You should always discuss any tax planning options with your usual PwC adviser.

Let’s talk

For a deeper discussion of how these issues might affect your business, please contact:

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