Corporate Essentials

Tax Smart Australia

Issue
#0101

Tax Essentials
Tax Effective Shares & Property Investment

OCTOBER | 2019

THE NEWSLETTER
Recent Tax Developments

MICHAEL'S CORNER
Sick Leave For Employees Who Do Not Work A Standard 7.6-Hour Day
Article No. 001

SPECIAL BONUS ISSUE
Tax Effective Shares & Property Investment

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MICHAEL'S CORNER

SPECIAL BONUS ISSUE

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- The need for developers to re-consider instalment contracts for residential property after new GST withholding laws.
- "unsophisticated" share trader denied deductions – Hill v FC of T AATA 1723 8.7.2019.
- We have added commentary on the tax implications of renovating and then selling your principal place of residence.
- We have added commentary on common GST errors for developers – in particular for a change in creditable purposes from selling to renting.
- New ATO guidance capital/ revenue in property developments.

The Newsletter

RECENT TAX DEVELOPMENTS

RETIREMENT ANNOUNCEMENT

It is with warm wishes that we announce that after years of service, our dedicated and hard-working technical writer, Leigh Bernhardt, will be retiring from our publication. Leighs leaving marks the end of an era as his team have been with bO2 Corporate Essentials Pty Ltd since 2011.

Leigh developed many of the resources we now consider the backbone of our product line. We are indebted to his vision and commitment for propelling us to our present position in the industry. His work has assured our success.

We are very excited for Leigh; however, he will be greatly missed here at bO2. His positive attitude and abundance of energy have helped make our office a pleasant place to work. His co-workers also recognise Leigh for being an all -round really great bloke.

While Leigh's retirement is our loss, he is setting his sights on a well-deserved retirement and spending more time with his recently retired wife, Sandra and their family.

We cannot thank him enough for his contributions.

Leigh's Corner to become Michael's Corner…….

We're pleased to announce that we have appointed Michael Corrigan to take over the reins from Leigh as our new HR/IR and WHS specialist writer and advisor.

Michael is a truly exceptional find in this industry. Bringing decades of experience to bO2 and our members. As well as being a published writer he has an impressive and well-rounded record of over 20 years of human resource and industrial relations experience in public and private sector management, together with experience in the trade union movement. This gives him particular insight into varying and changing workplace issues.

Michael has dealt with a wide range of Industries and is able to provide specialist advice in the Public Sector, Architecture, Construction, Manufacturing, Transport, Hospitality, Retail, Telecommunications, Public and Private Hospitals, Finance, Airlines and Community based organisations.

With his vast amount of experience in Industrial Relations across Australia, Michael has appeared on behalf of clients in the NSW, Queensland, Australian Industrial Relations Commission, Anti-Discrimination Commissions and WorkCover reviews on a raft of issues. Matters appeared for on behalf of clients include but not limited to disputes, wages recoveries, unfair dismissals, award variations, negotiations, discrimination claims and WorkCover Claims.

Michael's appointment is a clear reflection of our company's current state; ready to take on the future and fired up after another strong year of growth and success.

Again, a warm welcome to Michael!

ATO RESPONDS TO GLENCORE DECISION

On 3.9.2019, the Federal Court issued a decision on whether dealings between Swiss-based Glencore International AG and an Australian subsidiary breached transfer pricing rules in relation to the sale and purchase of copper concentrate in the 2007 to 2009 years.

The case considers transfer pricing rules (Subdivision 815-A) the object of which is to ensure related Australian and non-resident entities are taxed consistent with the arm's length principle. The Commissioner had argued before the Court that amendments made to an agreement between Glencore International AG and its Australian subsidiary were not arm's length dealings. The Commissioner had issued Glencore with three sets of amended assessments that arose as a consequence of this.

The court rejected aspects of the Commissioner's interpretation of the relevant transfer pricing rules. In doing so the court found that the terms operating between the Australian copper mine and its Swiss trader parent to calculate the price at which the mine sold its entire copper concentrate production were within an arm's length range.

"The most significant issue in multinational taxation is ensuring that the Australian arms of companies have arm's length dealings with offshore related parties.

Transfer pricing rules ensure these transactions are priced fairly and that multinational companies do not underpay tax in Australia," Deputy Commissioner Jeremy Geale said.

The ATO will consider this decision and whether an appeal is appropriate.

You may recall that on 14.8.2019, the High Court rejected a move by Glencore to stop the ATO using leaked documents to assess its tax bill.

The High Court ruled unanimously that Glencore could not use "legal privilege" to prevent to ATO accessing key documents.

LOW INCOME EARNERS MAY NEED TO LODGE

If your taxable income is under the tax-free threshold of $18,200 (before offsets) they may still need to lodge a tax return. Common reasons for this include, if you:

- Had pay as you go (PAYG) withheld from payments received during the year.
- Had a reportable fringe benefits amount on their income statement or PAYG payment summary.
- Had reportable employer superannuation contributions on your income statement or PAYG payment summary.
- Made a loss or can claim a loss made in a previous year.
- Were an Australian resident for tax purposes and had exempt foreign employment income and $1 or more of other income.
- Were entitled to the private health insurance rebate but did not claim your correct entitlement as a premium reduction.
- Were a liable or recipient parent under a child support assessment unless both of the following applied:
  - You received one or more Australian Government allowances, pensions or payments (listed on the Individual tax return instructions 2019;
  - Your income was less than$25,038.

Burton v. Commissioner of Taxation (2019) FCAFC 140 22.8.2019

In an interesting case, the Full Federal Court unanimously held that Australian taxpayers entitled to the 50% capital gains tax (CGT) discount only receive a foreign income tax offset (FITO) in respect of half of the US tax paid in respect of gain. By majority, (Logan J dissenting) it decided that article 22(3) of the Australia-US tax treaty did not operate to alter this result.

The taxpayer, in the relevant years was an Australian tax resident. In the 2011- and 2012-income years, he was presently entitled to capital gains made by the trustee of a discretionary trust on the disposal of US assets. The entire gain was subject to US tax, at a concessional rate of 15%.

In Australia, the gain also was treated in a concessional manner, but the mechanics of the calculation differed to the US tax rules. Burton was subject to Australian tax on only half of the gain (due to the 50% CGT discount), which was then subject to Australian tax at normal marginal rates. In calculating the amount of Australian tax payable, Burton sought to apply a FITO for all US tax paid in respect of the underlying disposal of US assets. The ATO argued that he was only entitled to a FITO for half of the US tax paid, given only half of the gain was included in his Australian assessable income.

The court held that this followed from FITO rules that provide that a FITO is available where foreign tax was paid "in respect of an amount that is all or part of an amount included in his assessable income for the year."

Burton also advanced the argument that article 22 (Relief from double taxation) of the Australia-US tax treaty effectively required that Australia grant a credit for the full amount of US tax paid. As mentioned above on a 2-1 majority basis, the majority held that the reference to "income" in article 22 is to be construed with regard to domestic legislation. As such, because only 50% of the gain was assessable in Australia, article 22 only required Australia to allow a credit for half of the US taxes. As a result, there was no inconsistency between article 22 and the FITO rules.

Given this split decision on the treaty issue, Burton may consider seeking leave to appeal to the High Court, and we will keep you informed on developments.

AAT RULES AGAINST TRUST DISTRIBUTION

Ariss and Commissioner of Taxation (Taxation) [2019] AATA 2598

This case dealt with the following issues:

- Whether trust distributions are ordinary income and/or personal services income.
- Whether part IVA applies.
- Entitlement to income tax deductions.
- Whether applicant entitled to clerical deductions for income attributed to spouse.
- Whether deductions were an unreasonable amount paid to a related person.
- Whether applicant was entitled to deduction for payments made to an associate.
- Whether applicant was entitled to deductions for personal superannuation contributions.
- Entitlement to income tax deduction for travel expenses where reimbursement already made.
- Whether respondent was out of time to amend assessments.
- Limited amendment period.
- Whether applicant beneficiary under a trust.
- Whether any person entered into or carried out a scheme for the sole or dominant purpose of the individual obtaining a scheme benefit.

This case dealt with whether an I.T. consultant was entitled to receive income through a trust and then split it with his wife. Here we are dealing with the contentious personal services income (PSI) rules.

It is standard practice to set up a trust or company to structure business or professional affairs. The tax rate for small companies (27.5%) compares well with the top personal tax rate of 47 per cent (including Medicare levy).

Income from a trust or company may be distributed to different parties, who may also have lower tax rates.

However, the personal service income (PSI) rules, which are designed stop people diverting income from "personal services" through companies, partnerships or trusts need to be considered.

Broadly, income is classified as personal services income when more than 50% of the amount received under contract is for the individual's labour, skill or expertise. A number of other tests can be applied.

In the years ended 30 June 2010 to and 2013 inclusive, Mr Ariss provided services to Wesfarmers Coal Ltd, Fusion Applications, Wesfarmers Resources and Premier Coal.

In the relevant years, Mr Ariss and his wife lodged tax returns declaring distributions of trust income from Agency Resource Management Services (Global) Trust (ARMS). The distributions were the amount invoiced by ARMS to clients for Ariss's work which clearly, stated "for professional services rendered by Terence Ariss."

The income split was 70% to Mr Ariss and 30% to his wife.

In 2013, the tax returns were audited by the ATO with amended assessments issued attributing the trust distributions as solely assessable to Terence Ariss as salary and wage income.

Mr Ariss objected to the amended assessment and it and it was up to the AAT to determine how Mr Ariss's income was to be characterised. The AAT considered the nature of the business, the relationship between Ariss and ARMS and the role undertaken by Ariss's wife.

Mr Ariss worked on a daily rate which was not dependent on the completion of a project. If a project was not completed, the payments were still made.

The work was undertaken at home in a dedicated home office which had no other purpose.

While Mr Ariss acknowledged it was his work clients were paying for, it was contended he would not have been able to manage his client workload without his wife's involvement in managing his contacts and his schedule. Mr Ariss prepared documents, conducted research on Oracle software changes, and administered accounts rendered.

Mrs Ariss was given 30% of the income, irrespective of the hours worked during each payment period.

The AAT used the "results test" to assess Ariss's income. This stipulates income will not be personal services income if: the income is for producing a result; the individual is required to supply the plant and equipment, or tools of the trade, needed to perform the work; and the individual is liable for the cost of rectifying any defect.

The AAT determined Mr Ariss was paid for performing work and providing services, rather than producing a result meaning the results test was not met.

Mr Ariss also failed the “unrelated clients test”. This requires that an individual’s services are provided as a result of them making offers or invitations to the public at large to provide the service.

The “employment test”, which requires that an individual engages one or more people to perform work was also not met. The AAT tribunal ruled that Ariss had no formal employment arrangement with his wife and she was, in any case, an “associate” for the purposes of the test.

It ruled that Ariss was not able to establish that the ATO’s amended assessments were excessive or otherwise incorrect.

HIRING WORKING HOLIDAY MAKERS

This is an issue many employers face each year as approximately 100,000 working holiday makers are employed in Australia.

When a new employee ticks the box at question eight on their Tax file number declaration form declaring they’re a ‘working holiday maker’, you need to:

1. Register

Anyone can hire a working holiday maker but first you’ll need to register to apply the 15% working holiday maker tax rate and declare that you’re aware of your obligations. This includes checking your working holiday maker’s visa status and complying with the Fair Work Act 2009 (where applicable).

If you don’t register you must withhold tax at the foreign resident tax rates and may be subject to penalties.

If you require assistance contact us. Alternatively, or you can register yourself using the ATO Working holiday maker employer registration form online before you make your first payment to them. You’ll need your:

- Australian business number (ABN)/Withholding payer number (WPN);
- entity type;
- contact details.

2. Check visa

Confirm your working holiday maker has a valid visa (subclass 417 or 462) by using the Visa Entitlement Verification Online (VEVO) service.

Your employees can do this for you online, or via the myVEVO app, and send you an email verifying their details.

3. 15% working holiday maker tax rate and super

Once you’re registered you can withhold 15% from every dollar your working holiday maker earns up to $37,000. The tax rates change for amounts above this.

You also need to pay eligible super contributions as you normally would. Working holiday makers can claim these super payments back when they leave Australia.

ATO REVIEW OF ITS UNCLAIMED SUPERANNUATION MONEY PROTOCOL

In August the ATO commenced a review of its current Unclaimed Super Money (USM) protocol. The protocol provides guidance under the Superannuation (Unclaimed Money and Lost Members) Act 1999 (SUMLMA) in relation to unclaimed money, lost member accounts, inactive low balance accounts, superannuation accounts of former temporary residents and the associated reporting and payment obligations.

While this review will make it easier for affected parties to navigate the ATO website, it is also a timely reminder for all of us to check whether we have any unclaimed superannuation. While you are at it you may also wish to check ASIC’s register of unclaimed monies, if not for yourself but for other family members.

NO LOSS ON REPAYMENT OF FOREIGN CURRENCY DENOMINATED LOANS

Sole Luna Pty Ltd as Trustee for the PA Wade No.2 Settlement Trust (“The Trust”) v Commissioner of Taxation [2019] FCA 1195.

In this Federal Court case it was held that the above Trust, did not incur a deductible foreign exchange loss on repayment of multiple foreign currency denominated loans that were advanced to a wholly owned subsidiary which were made when they were both non-residents. The Court held that the Trust had not incurred a foreign exchange loss as there was no evidence that Australian dollars were used as their respective functional currency and that the taxpayer expected to be repaid in Australian dollars. The Court also held that the Trusts had not incurred a capital loss because of the forgiveness of the balance of the Australian dollar denominated loan.

BENEFICIARY ASSESSABLE ON CASH DISTRIBUTION FROM TRUST

Campbell v Commissioner of Taxation [2019] AATA 2043

In this AAT case it was held that the taxpayer, a beneficiary of a New Zealand trust, was assessable under s99B of ITAA 1936 on a cash distribution received from a trust and the amount was not the corpus of the trust. The AAT found that the taxpayer had not provided adequate evidence to discharge their onus of establishing that the issued assessments were excessive. The trust records provided were inconsistent and therefore unreliable and there was no evidence before the AAT to corroborate witness history of the establishment of the trust and the characterisation of the money held herein.

If you are receiving funds from an overseas trust consider requesting financial records from the controllers to establish the character of the payments, if you receive corpus payments (non-assessable capital) the onus of proof is on the taxpayer in the event of an ATO enquiry.

Telgrove Pty Ltd t/as P & E Francis Plant Hire v Commissioner of State Revenue [2019] QCAT 199

Given the uniform legislation across most state jurisdictions, this case is relevant elsewhere.

The QLD Civil and Administrative Tribunal set aside the QLD Commissioner of State Revenue's decision to refuse to make an exclusion order to exclude certain entities from a payroll group. The payroll tax and the penalty the taxpayer paid in full was refunded. The Tribunal took into account that matters favouring grouping (management control and commercial transactions) are significantly outweighed by matters favouring exclusion (lack of other material commercial transactions, lack of shared resources, facilities or services, different management structures, lack of financial interdependencies and lack of a connection between the nature of the businesses).

This case shows how far state jurisdictions can go with data matching to identify group entities which come to their attention. If you are close to the payroll tax threshold also consider that "salaries and wages" has a wide definition including super and fringe benefits. If you require any guidance in this area, please contact us.

$30,000 INSTANT ASSET WRITE-OFF

Businesses with a turnover up to $50 million are now eligible for the instant asset write-off. This applies to assets that cost up to $30,000 and were purchased and first used or installed ready for use from 7.30pm (AEDT) on 2 April 2019 to 30 June 2020.

Businesses may purchase and claim a deduction for each asset that cost less than the $30,000 threshold. For example, in the same financial year a business may purchase a new van worth $22,000 and then purchase new equipment at a cost of $14,000. The business can claim both of these as each of the assets are under the $30,000 threshold.

For assets over $30,000 the general depreciation rules apply.

THE ATO's COMMERCIAL DEAL OFFERING

This program aims to provide certainty on the tax consequences of a proposed transaction before it is entered into.

ATO has advised taxpayers, it may be approached for an opinion prior to the taxpayer committing to a commercial deal. This offer targets privately owned and wealthy groups.

A commercial deal is defined as any significant business transaction that has the potential to impact the structure of the business. Examples given by the ATO includes the following:

- Demergers
- Divesting
- Financial and refinancing
- Initial public offerings
- Mergers and acquisitions
- Private equity
- Restructures
- Sale of business (partial or complete) or business assets
- Sale of commercial property
- Share buybacks
- Takeovers

Ideally the approach should be made pre-deal to work through the tax implications of the proposed transaction.

Depending on timing factors it may be possible to provide practical certainty on the tax outcome prior to the proposed deal being completed.

The ATO may also be approached once a deal has been completed to determine how and when the transaction is reported for tax purposes. If an agreement is reached, the ATO will usually follow up the taxpayer to confirm that the transaction was reported as agreed. The aim is to eliminate penalties and interest that may have applied if the taxpayer had reported the tax consequences differently to the Commissioner's view.

Clearly the benefit of the program is the possibility of reaching mutual agreement concerning the tax consequences prior to lodgement of a tax return, thus enabling tax disputes, reviews and audits to be avoided post-lodgement.

However, a taxpayer should consider the possible consequences of engaging with the commercial deals program but failing to reach agreement on the tax treatment of the transaction.

According to the ATO, 90% of the taxpayers offered this program have taken up the opportunity and that agreement has been reached 80% of the time.

THE PAY-AS-YOU-GO (PAYG) INSTALMENT SYSTEM

If you received gross business/investment income (instalment income) of $4,000 or more during any given tax year, you will probably receive correspondence from the ATO advising that you have entered the Pay-As-You-Go (PAYG) instalment system.

The PAYG instalment system serves as a method of prepaying the taxes owing in relation to your 'instalment income' throughout the year as opposed to waiting until you lodge your tax return and paying the taxes on assessment.

The ATO determines whether you are required to enter the PAYG instalment by reviewing taxable income (excluding net capital gains) reported on the last tax return you lodged and calculating the notional tax liability owing. Tax credits for taxes you have already paid (e.g. PAYG withholding taxes on your salary and wages) are then applied to reduce this notional tax liability,

The ATO system then estimates the taxes you will owe for the year ahead based on that 'instalment income' disclosed on your last tax return.

The ATO's systems automatically issue PAYG instalment correspondence where sufficient levels of any Employee Share Scheme (ESS) income are disclosed on your Australian tax return. PAYG withholding is not deducted from ESS income.

You may choose to either pay the ATO calculated instalment or vary it to a more accurate amount or even to nil (if you are not expecting to receive any 'instalment income').

Note there are general interest charges and/or penalties which may apply where your variation is significantly incorrect.

bO2 READERS QUESTIONS AND ANSWERS.............

Question 1

I have a query in relation to Payment Summaries.

We made a back payment to a number of employees in February 2019 which related to the period FY18, 01/07/2017 to 30/06/2018.

We have classed this as a Gross Payment on the Payment Summary and have already posted all payment summaries and uploaded the file to the ATO.

My query is should this back pay be shown in Gross payment or Lump Sum E? And are we required to re issue all payment summaries?

We have contacted the ATO, but they didn't sound confident and therefore would appreciate your advice with this.

Answer

If a back payment of salary or wages that accrued in a period more than 12 months before the date of payment (February 2019) is made, the payment should be labeled at Lump Sum E.

The ATO may calculate a tax offset on these payments.

If the payment was for a period more than 12 months before the payment, payment summaries should be reissued.

Question 2

If a person works 100% from home (work for tech company) I can see that they can claim not only running expenses but also occupancy (they rent). BUT my question concerns their initial training. This involved them flying from Brisbane to Sydney to do intensive training in head office for a week. It was done at the employee's own expense and they stayed with family for the week. Flights were also paid for by the employee.

Answer

Rent may be claimed as home office occupancy expenses if your employer does not provide an office. It is important that you apportion the rent between work-related and private use. The apportionment is usually based on a floor area basis (Taxation Ruling 93/30).

You can claim the cost of attending the training sessions that are closely related to your work activities. You may have to apportion the travel expenses between work-related and private purpose.

Question 3

I have a query regarding an employee who was sacked this morning. He started on the 03/06/19, so he is still under his 3-month probation. He has displayed several instances of bad workmanship and he has been absent from work a lot. He didn't come to work Friday and Monday, his excuse being he was loading a horse into a trailer. He was not sick just didn't want to come to work. My boss rang him last night and when he found out why he didn't come to work he sacked him.

My question is: Does he need to be paid his 1-week notice? Also, as it was over the phone, will he still have to come in for a meeting.

Answer

Please see my comments below:

1. There is insufficient information to provide accurate advice on this matter.
2. Is the employee, casual, permanent part time or full time, on an employment contract, covered by a Modern Award or Enterprise Agreement.
3. What are the terms of employment and notice periods in the letter of offer?
4. Is there a disciplinary policy and/or termination policy in place, and if so, were all of the steps leading to termination followed, this includes warning the employee on probation that their employment may be in jeopardy if they fail to improve to the required standards?
5. Was the process of dismissal in accordance with the Fair Work Act or the Small Business Dismissal Code (whichever is applicable).
6. Was the employee afforded due process in the telephone dismissal, from the information provided it is unlikely.

These are serious matters, and failure to follow the correct procedure could result in Adverse Action or Unfair Dismissal claims, generally it is not recommended to terminate employment over the telephone unless there are mitigating or serious circumstances which can be proven beyond doubt.

Question 4

Re: Small Business Write off

A SMSF has a couple of commercial properties. Is registered for GST.

Net assets of $1,000,000.

They have purchased an asset to go onto the buildings of $19,990 (ex GST).

Is the SMSF able to claim the under $30k instant asset write off?

Answer

Self-managed super funds (SMSFs) are not prohibited from carrying on a business, but the business must be:

- allowed under the trust deed;
- operated for the sole purpose of providing retirement benefits for fund members.

It would come down to successfully making the argument that the SMSF is "in the business of" to be classified as a small business entity.

The sole purpose test is often the sticking point here, and we would advise against making the claim.

Question 5

We made a back payment to a number of employees in February 2019 which related to the period FY18, 01/07/2017 to 30/06/2018 and also in April 2019 which related to FY19, 01/07/2018 to 30/04/2019.

Should we be including the gross and the super for WorkCover to calculate our premium as it is based on the actual wages for the year even though these payments were one offs.

Answer

WorkCover rules are state based. We believe that you should report the back payments of wages and super on a cash basis (i.e. report in the year they were actually paid to the staff).

As far as forward premium estimates, you would only include payments that are reasonably expected to be incurred for that year.

Question 6

One of my clients, who is a pensioner with a disabled daughter has a taxable income of $22679 and has no tax to pay but has a bill of$112.43 being for excess private health insurance reduction. Is this correct that being a pensioner does not negate this?

Answer

The Government has cut its private health insurance rebate contribution (marginally) but it should not have made that much of a difference at year end.

Ask the client to check the basis their insurer is calculating the rebate as obviously it is not matching with the ATO's calculation.

Also, double check the codes used at the private health insurance section, remember the ATO assesses eligibility for the level of rebate based on Adjusted Taxable Income.

Question 7

A client purchased a block of land approx. ½ acre for his family home to be built on.

They were living in a rented home.

Marriage breakdown occurs and the block of land is sold.

The landowner/taxpayer is able to demonstrate that he intended to build on it with builders plans etc. Water, Gas and electricity are ready for connection upon construction.

Does the capital gain qualify for the main residence exemption?

I view that the intention to live on the land and that had they have built the planned house they would have claimed main residence exemption from the date the property was purchased if the property had been constructed.

The fact that the marriage breakdown occurs further adds to the property being thought of as the family main residence, (not being built yet) rather than an investment.

The ATO website says no main residence exemption for a vacant block. However, I think this is taken out of context, and should apply to a situation where a taxpayer has purchased a vacant block purely as a speculative investment and already has a main residence.

Your thoughts please.

Answer

Sorry to advise the main residence exemption will definitely not apply in this instance.

Question 8

Please advise on the following regarding payment of wages:

Where a husband is employed as a Sales Representative/ Manager and he is paid the relevant award wage or higher, is it acceptable to employ his wife on a Casual basis and pay her the sales commission or bonuses as a wage that would otherwise be payable to her husband ? The wife would not take an active role in the business other than being a home helper to the husband's role.

Could this be an ancillary agreement (i.e. an extra remuneration) made after the original employment agreement undertaken with the husband (or may be not?)

Answer

• (HR/IR) - frame of reference

Any employee is required to be paid the minimum award wages and conditions and also the conditions contained in the National Employment Standards (NES).

In the scenario supplied, the casual employee would need to be paid as a casual award employee with the 25% casual loading and a minimum payment per day or call in as a minimum.

The scenario proposed in my view would be in breach of the Fair Work Act and Award provisions.

The payment of sales commissions and their relativity to the applicable Modern Award and wages is complex and requires specific advice.

Any agreement made needs to meet the minimum award requirements and NES and be in the form of an Individual Flexibility Agreement (IFA) and meet the Better Off Overall Test (BOOT).

The Fair Work helpline may be able to assist.

• (Tax) - frame of reference

In practice this does occur but as a responsible publication we cannot advocate this as the bonus is solely the result of the husband's personal endeavour.

In the event of an ATO audit… if the payments could be clearly identified as the husband's bonus payments then there could be amended assessments.

If you were able to have the wife perform some genuine tasks… perhaps of a marketing nature, then the remuneration paid to her would be a matter for you to determine.

This could be an acceptable outcome for all concerned.

Question 9

My client "Mr C" owns a Pty Ltd company. (S Pty Ltd) He owns 1 Ord Class share.

He wants to give some equity in S Pty Ltd to his employees, (A & B) who are unrelated to him.

He will give them J Class shares – no voting rights but can get dividends, that were created solely for being given to these staff.

He will give A & B each 10 J Class shares with a face value of $10 each.

What will be the journal entry to record the shares being issued?

Dr Unpaid share capital $200

Cr Share Equity J Class Shares $200

Is the Dr entry a loan to employees, as they did not pay for them? Is it a Div 7a loan?

Answer

The journal you suggest is acceptable.

I really don't view this as an employee share plan question as the recipients receive nothing of real value.

A number of valuations have established that such shares are worthless.

The dividends the staff may or may not receive are entirely at the discretion of your client.

Arguably the shares may have some value on a members' voluntary liquidation but that would depend upon the underlying net assets and the company's constitution which would outline any such entitlements

This is a matter your client should carefully consider.

The uncalled capital on the shares has no Division 7A implications as the debit should be placed in the share equity accounts (not the assets) – in any case it is a paltry amount.

Question 10

Relating to CGT and a Property.

If a client initially lives in a house as principal place of residence and then moves out and it becomes a rental property, in determining the cost base for the property are the costs of owing the property (e.g. rates, interest on loan etc.) taken onto account for the period up to the date it becomes income producing ?

Answer

No… personal use assets cannot be eligible for third element cost base additions.

Land and buildings are excluded from the definition of personal use assets.

However, having overcome this we have another problem.

You are seeking third element cost base increases to an exempt asset which by definition (while it is exempt) does not have a cost base.

We refer you to ATO ID 2004/950 still technically valid but superseded by example 65 in the 2009 ATO publication "A guide to capital gains" with annual updates.

Effectively you can use the market value of the property as the cost base when it was first used to produce assessable income from:

- A qualified valuer
- Calculating a valuation based on reasonably objective and supportable data.

So, it would appear that you may still get the uplift to the cost of the home by using market value.

Question 11

One of the employees has retired. His remuneration package included company car. On his retirement he was allowed to retain the car with a market value of $34K as a gift. What is/are the right accounting/taxation treatment of this transaction? What is the correct treatment of the asset itself, do I write it off at the WDV or do I sell it?

Answer

Usually the transfer to an employee of an asset of the employer for less than market value will result in a transfer property benefit for FBT purposes.

Here the taxable value is market value less any employee contribution towards the transfer.

In the event the transfer is part of the employee's termination arrangements, the transfer is considered to be an eligible termination payment (ETP) by the ATO.

Subsection 27A(8) of ITTA 1936 provides that where a transfer has been made to a person for the purposes for making an ETP, the transfer is deemed to be payment of an amount equal to the value of the property immediately before the transfer.

Subsection 136(1) of the FBTAA defines 'fringe benefit' and specifically excludes ETPs (para K).

This means we have cleared the FBT issue.

However, PAYGW will be required from the "payment".

The time of the payment is when the car is transferred to the retiree.

Assuming he is over 55 then, then the ETP will be taxed at the maximum rate of 15% plus Medicare levy.

The ETP cap for 2019 FY is $210k.

Allowance must be made for this PAYGW by grossing up the value of the car to arrive at a gross ETP amount due to the employee such that the value of the car represents the 'net' amount of the ETP.

On the basis written down value equates to market value and in line with normal practices dispose of the asset in the books at WDV.

Effectively this is a sale as title will have to be transferred.

The debit side of the journal is an expense in the P&L being Termination Payment to Mr XYZ.

Question 12

Customer A issues a recipient created invoice to Supplier B. Does Supplier B include the gross sale amount and GST thereon in the relevant BAS and also include a credit for the GST paid by Customer A to ensure GST is not paid twice….

Answer

Yes, as the supplier, B has to declare and remit the GST to the ATO. This is the end of his involvement.

The input tax credit is then claimed by customer A. This is why A issued the recipient generated tax invoice in the first place.

The nature of GST is that it is the end user that ultimately pays to GST.

Question 13

I have tax essential premium subscription and have a question regarding my clients' pension from China (they hold a PR visa but not Australian citizens and are AUS tax residents). I don't report said pension as per ATO ID 2002/337 but noted that the ID has been withdrawn in Dec-2018 so I am wondering if the ATO has changed their view on Chinese pensions and now becoming assessable?

Answer

Between 2001 and 2016 thousands of interpretative decisions including ATO ID 2002/337 were issued.

In the last three years no more have been issued and the ATO has systematically been withdrawing IDs.

Usually the reason is because guidance is contained elsewhere on the ATO website.

If there has been a change in law or the ATO's interpretation of the law this is clearly stated on the reason for withdrawal.

This is not the case here and on the basis that tax is payable on the pension in China, then the double tax agreement still applies.

This means the pension should not be taxable in Australia.

Question 14

We are having a bit of an argument in our office over Truck Drivers overnight allowances and we are confused. We have read TD2019/11 and the ATO's Truck Drivers – Income and work-related deductions.

The scenario is:

My client is a long-distance truck drive that leaves on a Monday morning and returns the following Friday. His employer pays him an overnight travel allowance of $37.61 per night and he is away for 240 night which on his Payment Summary shows a total of $9,026.

As per the ATO Truck Drivers – Income and Work-related deductions he can claim $20 on Breakfast, $25 for Lunch & $45 on dinner and they are they are exclusive and can't be swapped.

My client does not keep any receipts as once a week his wife prepares all his meal herself when they do the normal shopping and he takes them with him. As he states, it's very difficult to get decent meals whist you are travelling, and he eats at all different time of the day.

My questions are:

If he keeps the number of meals that he is away for, Breakfast, Lunch and Dinner, can he just claim up to the allowance without keeping receipts?

Do we just claim back what he has been paid by his employer?

I don't understand why the ATO have these allowances and what they are used for as the TD & other ATO papers really don't give decent examples of what is acceptable with the ATO and only confuse the issue.

We also have this issue with some of our clients that receive an amount for domestic travel that is less than the ATO reasonable amounts. Once again can we just use the amounts the ATO have published?

Answer

To answer your questions.

1) He cannot claim the amounts outlined in para 23 of TD 2019/11 because he has not been paid the permitted full allowance to equal breakfast $25.20 Lunch $28.75 and Dinner $49.60. The amounts of these meals are separate and cannot be aggregated into a single day amount.

2) You may cautiously claim back the amount paid by the employer because it is below the above amounts being mindful the client may have to provide a reasonable

explanation of the expenses if required by the ATO. If he informs his wife gives him a "packed lunch" then the claims will be denied. See example 3 paras 27-29 of TD 2019/11. In this case a reasonable estimate of the cost of the "packed lunch" will have to be made.

3) We don't disagree with your comment regarding the confusion. However, we think TD 2019/11 (updated each year) is reasonable and attribute the confusion to a lot of misinformation out there in the marketplace and incorrect practices by tax agents. Everyone wants to make a claim but not everyone is paid the required allowance outlined in the relevant annual tax determination.

4) Regarding the domestic travel by clients – they can only claim the actual higher cost incurred less the amount paid by the employer. Otherwise cautiously claim the allowance amount paid by the employer.

Note, we have a different situation if the employee receives no allowance and instead incurs costs later fully reimbursed by the employer. In this instance the employee cannot not make any claim.

Question 15

I have question in relation to whether to charge GST on top of the facility fees when on-charging facilities bills such as emergency levy, water use & water excess fees and etc. onto our lessee who leases from council?

As all of those costs don't attract GST but, my understanding is when we are on charging our lessee for leasing council premises under an agency relationship we have to charge GST on top of the emergency levy & water bills, irrespective of whether the lessee is registered for GST or not.

Could you please advise from your experience on this matter and advise whether we have to charge GST on ESL & water bill on the basis of agency relationship as per GST laws?

At this stage we have come across a few lease agreements having a clause about GST, and some don't! Does the GST law under agency relationship change if the lease agreement is silent on GST?

Answer

You are correct and you should charge GST on the entire amount of the supply which includes the outgoings.

This is because the Council may have to pay GST on these outgoings.

We refer you to GSTD 2000/10 paras 8 to 10.

Question 16

Vehicle purchased 29 October 2012 for $71142. Only $57466 (80.77%) able to be depreciated under luxury car limit.

Balance of WDV written off in 2018 year under SBE immediate deduction with balance of this account then being NIL.

Vehicle sold July 2018 for $22910 (excl. GST).

Amount assessable calculated as $18,504 (ie.80.77% $22910). Is this correct?

Answer

Assuming GST was initially claimed on the basis this is a work vehicle, there are GST implications on disposal.

GST on the sale is 1/11th of $22,910 being $2,083 – note this is calculated on the full amount with no adjustment for the MV depreciation cost limit.

This leaves net proceeds of $20,827.

If there were no second element additions to the cost base of the car i.e. extras and/or improvements, then your 80.77% is correct.

Given the asset was completely written off, 80.77% of $20,827 i.e. $16,822 should be deducted from the balance of the small business asset pool.

If this leaves the pool is a negative amount, then it is this figure that is assessable income.

Michael's Corner

Article 001

Hi all, welcome to Michael's corner and firstly, it is a fantastic opportunity to be able to take over Leigh's role in writing articles for this fantastic publication. Unfortunately, my first piece is not a good news story if you have people working non-standard days. Moving forward we will bring articles of use to the business as well as articles of legislative changes no matter what they are. Once again, I would like to thank Leigh and the awesome team at bO2 Corporate Essentials.

SICK LEAVE FOR EMPLOYEES WHO DO NOT WORK A STANDARD 7.6-HOUR DAY

- A significant decision with regard to sick leave was handed down in the Federal Court on the 21st August 2019.
- The decision is known as Mondelez v Automotive, Food, Metals, Engineering, Printing and Kindred Industries Union known as the Australian Manufacturing Workers Union (AMWU) [2019] FCAFC 138.
- The decision has determined that the National Employment Standards (NES) provide employees with access to 10 working days personal/carer's leave for each year of service, regardless of the number of ordinary hours the employee would ordinarily work on those days.
- This is certainly a change from the introduction to National Minimum standards (including for personal/ carer's leave) when first implemented in 2006.
- From 2006 to 2009 personal/ carer's leave was talked about in hours and that was at 76 hours for a full-time employee, which equates to 10 days at the normal 7.6-hour day.
- The biggest issue that arises are employers' current leave accrual and payroll practices, does your payroll software work with non-standard rosters or hours of work?
- The effects on other forms or leave, including annual leave is unclear as the court did not deal with this issue.

Following is an example of the changes and how it can affect your payroll:

For employees who work ordinary hours greater than 7.6 per day, they will have accrue more hours.

John works 4 x 9.5-hour days each week (=38 hours per week) and Felicity works 5 x 7.6 hours per day (= 38 hours per week).

Both John and Felicity accrue 10 DAYS of sick/personal leave each year and if this is converted to hours, as most if not all payroll software accrues the entitlements in hours like annual leave.

Now with the above decision John accrues 95 hours per year and Felicity accrues 76 hours per year.

What happens if Mary worked 4 x 8-hour days and 1 x 6-hour day?

Mary takes an 8-hour day as personal leave; this is 1 Day. If Mary takes the 6-hour day as personal leave, this too is 1 Day. However, each day has a different number of hours.

If Mary was to take 10 days sick leave per year on her 8-hour days she would get 80 hours but is her took them on her 6-hour days she would get 60 hours.

Part-time employees are also entitled to 10 days per year. So, an employee working 4 x 8-hour days per week (32 hours) is also entitled to 10 days per year. This equates to 80 hours of sick leave.

What you need to do:

- If the decision is not reversed by the High Court or by legislative change, many employers will need whom are affected by the decision will need to undertake a major reconciliation of personal carer's leave accruals for at least the past six years. The Fair Work Act 2009 allows for claims for employees to go back six years.
- The result could highlight significant under and over accrual issues (and associated under and overpayments) for employees working non-standard hours of work
- Given the uncertainty associated with any High Court appeal and/or Parliamentary processes, it is recommended that your business commence and audit.

This case was initiated by the employer, Mondelez as some employees work 7.2 hours per day, five days per week. Others work three 12-hour shifts per week.

The Union contended that the NES entitlement instead covered absences on 10 calendar days for each year of service.

The majority's decision

A majority of the Full Federal Court (Bromberg and Rangiah JJ) decided that the NES provides employees with access to 10 working days personal/carer's leave for each year of service.

In a brief dissenting judgment, O'Callaghan J accepted the Minister's interpretation, citing the text of the Fair Work Act, the Explanatory Memorandum and the practical implications of any alternative interpretation.

The following is a link to the decision: https://www.judgments.fedcourt.gov.au/judgments/Judgments/fca/full/2019/2019fcafc0138

Please note that this is general advice for information only and any application of legislation and/or Industrial Relations or contractual requirements may require professional advice to suit your individual circumstances. If you have any questions for Michael's team send us an email info@bO2.com.au

Special Bonus Issue

TAX EFFECTIVE SHARES & PROPERTY INVESTMENT

WHAT'S NEW IN 2019?

- Tighter Laws for vacant land tax deductions.
- The need for developers to re-consider instalment contracts for residential property after new GST withholding laws.
- "unsophisticated" share trader denied deductions – Hill v FC of T AATA 1723 8.7.2019.
- We have added commentary on the tax implications of renovating and then selling your principal place of residence.
- We have added commentary on common GST errors for developers – in particular for a change in creditable purposes from selling to renting.
- New ATO guidance capital/ revenue in property developments.

DENIAL OF TAX DEDUCTION FOR VACANT LAND LEGISLATION RELEASED

In July 2019, the Federal Government introduced legislation to enact the May 2018 Federal Budget denial of tax deduction for vacant land integrity measures.

Property developers, property investors and primary producers should review the landholding usage, contractual arrangements and business plans to ensure tax deductions are not denied from 1.7. 2019.

These changes aimed to address concerns that deductions are being improperly claimed for expenses, such as interest costs, related to holding vacant land, where the land is not genuinely held for the purpose of earning assessable income. It will also reduce tax incentives for land banking, which deny the use of land for housing or other development. This measure applies from 1 July 2019.

Denied deductions will not be able to be carried forward for use in later income years. Expenses for which deductions will be denied that would ordinarily be a cost base element (such as borrowing expenses and council rates) may be included in the cost base of the asset for capital gains tax (CGT) purposes when sold. However, denied deductions for expenses that would not ordinarily be a cost base element would not be able to be included in the cost base of the asset for CGT purposes.

This measure will not apply to expenses associated with holding land that are incurred after:

- a property has been constructed on the land, it has received approval to be occupied and is available for rent; or

- the land is being used by the owner to carry on a business, including a business of primary production.

This measure will apply to land held for residential or commercial purposes. However, the 'carrying on a business' test will generally exclude land held for commercial development.

On 24.7. 2019, the Government introduced Treasury Laws Amendment (2019 Tax Integrity and Other Measures No. 1) Bill 2019 (Cth), which was referred to the Senate Economics Legislation Committee for a Report by 5 September 2019.

From 1.7.2019 income tax deductions to taxpayers (other than corporates, non-SMSF superfunds, MITs, or PUTs or their subsidiary unit trusts or partnerships) will be denied for losses and outgoings incurred in holding vacant land (without an independent substantial and permanent structure in use or available for use (ignoring lawfully occupied residential premises that are not leased/hired/licenced or available for lease/hire/licence)), regardless of when acquired, to the extent the land is not at the time of incurring the expense or outgoing (sec. 26-102 ITAA 1997):

1. used or held available for use by the entity in the course of carrying on a business in order to earn assessable income or;
2. used or held available for use in carrying on a business by:

- an affiliate, spouse or child of the taxpayer; or
- an entity that is connected with the taxpayer or of which the taxpayer is an affiliate.

Key points:

- Deductions are denied from 1.7. 2019 regardless of when the land was acquired (no grandfathering).
- The land is assessed on each separate title.
- Apportionment of deductions is required for mixed business use and vacant use land.
- The structure must be independent (separate and not incidental purpose to other structures), substantial (size, value or importance) and permanent (fixed and enduring).
- The structure must exist at the date the holding costs (rates, land tax, repairs) or expense (finance interest) is incurred or is referrable.
- A structure is not required where the land is used or held for use in carrying on a business (property development business or primary production business) by the owner or an affiliate or connected entity.
- Land is vacant until the structure is lawfully able to be occupied and used or available for use (e.g. no deduction during construction).
- Land is vacant if the structure is not actively leased/hired/licenced or available for lease/hire/licence.

It is possible that deductions may be denied for property developers where the land is recorded as capital or is not subject to a future development program because the land must be actively used or held ready for use in a property development business.

This affects land banking where a tract of land is held long term for development at a later date.

For property investors, deductions may be denied prior to construction, issue of the certificate of occupancy and the premises are listed for lease/hire/licence or subject to a lease/hire/licence or agreement for lease/hire/licence.

For primary producers, deductions may be denied where primary production activities (that do not constitute a primary production business) such as agistment, hobby/lifestyle farms or small-scale farms (and possibly share farming) are being conducted.

Property developers, property investors and primary producers need to review the landholding usage, contractual arrangements and business plans to ensure tax deductions are not denied from 1.7.2019.

LONG-TERM CONSTRUCTION CONTRACTS

In past issue we have mentioned IT 2450 which set out guidance on the recognition of income from long term construction contracts. This has now been superseded by T.R. 2018/3. In the past 31 years, a number of related tax determinations have been issued and new accounting standard AASB 15 revenue from contracts with customers has come into effect. TR2018/3 took effect from 1 January 2018.

Fundamentally this Ruling does not change the ATO's view. TR 2018/3 expands ATO guidance to cover the treatment of expenses and makes reference to new accounting standard AASB 15. The key difference for business now appear to be with the fundamental differences that can now exist between the income tax treatment and AASB 15.

Key points of the ruling include:

- 'Long-term' construction contracts are contracts where construction work extends beyond one year of income. Accordingly, a construction contract of less than twelve months may still be 'long term' if it straddles two income years.

- A deferral of the recognition of profits and losses until completion of the contract remains unacceptable.
- There continues to be two methods which may apply in recognising the income derived and expenses incurred under a long-term construction contract for income tax purposes – the basic approach and the estimated profits basis.
- Under the basic approach, all progress and final payments received in an income year are assessable with deductions allowed for expenses incurred and permitted under law. This may result in upfront payments being assessable in the year of receipt and differences from the accounting treatment adopted.
- Where taxpayers adopt the estimated profits basis, it is acceptable to recognise the ultimate profit or loss over the term of contract, provided the method of accounting for the long term construction contract is in accordance with accepted accounting practices and has the effect of allocating the profit or loss on a fair and reasonable basis. However, this does not necessarily mean the tax treatment will mirror the accounting treatment. Certain tax adjustments are still required under the estimated profits basis as AASB 15 does not necessarily bring into line the accounting recognition of revenue with tax law which requires income to have been derived. Similarly, expenses will only be deductible where they are identified as likely having been incurred over the period of the contract. Estimations of costs are likely to be required each year and estimations will need to be well documented.
- The allocation of notional taxable income adopted for a contract must reflect the progress of the contract and the particular method used will depend on the nature of the contract. The method adopted must be applied consistently for all years of the contract.

TAX IMPLICATIONS OF NEW AUSTRALIANS SELLING THEIR FORMER OVERSEAS PRINCIPAL PLACE OF RESIDENCE (PPR)

Case study

With high rates of immigration over the past 15 years this issue is quite common. Quite often migrants take some time to sell their PPR. For the obvious reason they may choose to return to their country of origin – sometimes for family reasons. When they do eventually sell a large sum of money is often involved which they usually want remitted to Australia.

They normally ask two questions:

1. Does the government have tax on money coming into the country?
2. Are there any other tax implications?

The first answer is... broadly no and the second answer is ... quite possibly yes.

Recently a British couple came and saw us – they had purchased a residence in 1986, came to Australia in 2006 and have just sold their former residence. There were a number of issues to consider.

Upon becoming Australian tax residents:

- They are deemed to have acquired their former PPR at market value. i.e. in November 2006.
- They mistakenly believed that if there was any tax issue, it would be in 2018/19 – however the contract for sale was signed before 30 June 2018. As we have stated in our tax tips – the crystallisation of the taxable capital gain occurs upon signing of the contract... not when the funds settle.
- Between November 2006 and the date of sale the dwelling had increased in value by AUD $175,000.
- There were net funds to remit of $500,000. The only responsible advice to give was that the capital gain be properly reported.
- We warn those not willing to do so, that the ATO may well question the source of the funds and that since 2017, O.E.C.D. revenue authorities have been sharing information.
- The fact in this case was that the wife's parents had lived in the dwelling for the entire period, meaning the following third element costs cover the past 12 years could be added to the cost base:

– Mortgage interest costs

– Insurance

– Rates and taxes

– Repairs and maintenance

– A small renovation

– Legitimate inspection costs (apportioned) prior to 1.7.2017

After adding these costs, then applying the 50% individual discount the amount of CGT payable was only $15,000.

ATO POSTS REVIEW FOR ONLINE RENTALS

The Australian Taxation Office (ATO) has launched an extensive data-matching program to identify taxpayers receiving income from short term rentals. Information from online platform sharing sites for around 190,000 Australians will be examined to identify taxpayers who have left out rental income and over-claimed deductions.

A & A Property Developers Pty Ltd v MCCA Asset Management Ltd

This case clearly shows how failure to clarify the GST issues that arise in relation to a conveyancing transaction before contractual relations are created can lead to substantial and costly disputes.

A potential GST liability of $290,000 was involved. While a detailed discussion of this case is beyond the scope of this publication, there is a clear take out… where GST is involved in a transaction do not skimp on legal advice – it is money well spent.

In past editions we covered the below property cases in some detail. These have been removed to our website.

- Commissioner of Taxation V MBI Properties Pty Ltd (2014) HCA 49
- Vidler V FCT: Residential Property
- Vacant Land and GST – A Tap Is Not Enough
- Corymbia Corporation Pty Ltd V Commissioner of Taxation (2010) AATA 401
- Sunchen Pty Ltd V Commissioner of Taxation (2010) FCA 21
- Commissioner of Taxation V Gloxinia Investments Ltd ATF Gloxinia Unit Trust
- A F C Holdings Pty Ltd V Shiprock Holdings Pty Ltd (2010) NSWSC 985
- Cyonara Snowfox Pty Ltd and Commissioner of Taxation (2011) AATA 124
- Aurora Developments Pty Ltd V Commissioner of Taxation (2011) FCA 232 15 August 2011
- ECC Southbank Pty Ltd as Trustee for Nest Southbank Unit Trust V Commissioner of Taxation (2012) FCA 795 31 July 2012
- Craddon and Commissioner of Taxation (2011) AATA 790
- Margin scheme and GST anti-avoidance – the Taxpayer and Commissioner of Taxation (2010) A.A.T.A. 497
- Share trader or investor – Hartley and Commissioner of Taxation (2013) AATA 601

NO DEDUCTION FOR TRAVEL EXPENSES

From 1 July 2017, the government disallowed deductions for travel expenses related to owning a residential investment property. This is an integrity measure to address concerns that such deductions are being abused.

This will rein in a high growth deduction item and improve taxpayer confidence in the negative gearing system.

RENOVATING PROPERTIES

Personal property investor

If you're considered a personal property investor, your net gain or loss from the renovation (proceeds from the sale of the property less the purchase and other costs associated with buying, renovating and selling it) is treated as a capital gain or capital loss respectively.

CGT concessions such as the CGT discount and the main residence exemption may reduce your capital gain.

You're not conducting an enterprise of property renovation for GST purposes and are not required to register for GST. But if you're registered in some other business capacity you don't pay GST on the proceeds from the sale of the property or claim GST credits for related purchases.

The following example illustrates the characteristics of personal property investing.

Example: Personal investor

Doug is a sales representative. He obtains an investment loan and purchases a property that he intends to rent out. He would not consider selling the property unless the price appreciated markedly.

The property requires renovation to attract desirable tenants. Doug renovates the property after work and on weekends. Over the period of the renovation, the real estate market booms and Doug decides to sell the property.

Doug would not be considered to be in the business of property renovation because:

- His intention when he bought the property was to gain rental income rather than make a profit from buying, renovating and selling it.
- Doug didn't rely on the income to meet regular expenses because he has income from his job.
- His renovation activities were not carried on in a business-like manner.

- Doug did not buy the property with a view to selling it at a profit and did not carry out a one-off profit-making activity.

So, Doug is regarded as a personal investor.

However, if Doug, because of his success with this renovation (either in his own right or with another or others) was to then undertake another renovation similar to the first with a view to achieving the same profit levels, he will be regarded as being in the business of property renovation.

Profit-making activity of property renovations

If you're carrying out a profit-making activity of property renovations also known as 'property flipping', you report in your income tax return your net profit or loss from the renovation (proceeds from the sale of the property less the purchase and other costs associated with buying, holding, renovating and selling it).

You're entitled to an Australian business number (ABN) and you may be required to register for GST if the renovations are substantial.

The following example illustrates the characteristics of a profit-making activity of property renovations:

Example: Renovation as a profit-making activity

Fred and Sally are married with two children. They renovated their home, substantially increasing its value. After watching many of the home improvement shows and seeing how other people have bought, renovated and sold properties for a significant profit, they decide to investigate the purchase of another property to renovate and make a profit.

They consider many properties, costing out the renovations, the costs of buying and selling and timeframes to complete the renovations. Their research shows that they could also make a significant profit.

Fred and Sally sell their current home and purchase a new property, which they move into while completing the renovations. They plan out the renovation in stages, including the costs and any contractors needed to complete the work. The renovation runs to schedule and, when completed, they list the property for sale, and it sells for a profit.

Because the property renovation activities were planned, organised and carried on in a business-like manner, the purpose of buying the property was to renovate it and make a profit, and the renovations were carried on in a similar manner to other property renovation businesses, Fred and Sally have entered into a one-off profit-making activity.

Business of renovating properties

If you're carrying on a business of renovating properties or 'flipping' properties, the purchased properties are regarded as trading stock (even if you live in one for a short period) and the costs associated with buying and renovating them form part of the cost of your trading stock until they're sold.

You calculate your business's annual profit or loss in the same way as any business with trading stock.

CGT doesn't apply to assets held as trading stock, and CGT concessions such as the CGT discount, small business concessions and main residence exemption don't apply to any income from the sale of the properties.

You're entitled to an Australian business number (ABN) and you may be required to register for GST if the renovations are substantial.

The following example illustrates the characteristics of a business of renovating properties.

Property renovating as a business or profit-making activity

Whether you are in the business of property renovating, property flipping or undertaking a profit-making activity in regard to property renovation, is a question of fact. The following information will help you work out if you are in a business or profit-making activity.

Some of the questions you need to ask about your property renovating activities, are:

- Are they regular and repetitive?
- What is their size and scale?
- Are they planned, organised and carried on in a business-like manner?
- Are they carried on for the purpose of making a profit?
- Do you rely on the income received to meet your and your dependents' regular expenses?
- Are they of a similar kind and carried on in a similar manner, to the activities of other property renovating businesses?

In reaching a conclusion, no single factor is necessarily decisive, and many may be interrelated with other factors. The importance given to each factor varies depending on individual circumstances.

However, you are likely to be entering into a profit-making activity if you acquire a property with the intention of renovating and selling it at a profit and go about it in a business-like way.

Example: Renovation business

Tony is a carpenter. After reading the Investors Club News, he decides to purchase a property. He thoroughly researches the real estate market, attends investment seminars and records the information he has found.

The property Tony purchases is in a good location, but he pays a reduced price because it needs extensive renovation. Using his knowledge and contacts within the building industry, Tony quickly completes the renovations.

He then sells the property and makes a generous profit.

Using the proceeds from the sale of the first property, Tony purchases two more houses that require renovation.

Tony sets up an office in one of the rooms in his house. He has a computer and access to the internet so he can monitor the property market. Tony's objective is to identify properties that will increase in value over a short time once he has improved them. He leaves his job so he can spend more time on his research and renovations.

Tony's activities show all the factors that would be expected from a person carrying on a business. His property renovating operation demonstrates a profit-making intention; and there is repetition and regularity to his activities. Tony's activities are also organised in a business-like manner.

Therefore, Tony is regarded as being in the business of property renovation.

This can be a lineball situation with the ATO having real difficulty in proving subjective intention. It is not wise to immediately place a home on the market, with an aggressive marketing campaign when renovations are complete then crow about it on social media. If it is a quick turnaround then you may be asking for trouble.

TIPS FOR DEVELOPERS EXPECTING LARGE GST REFUNDS

These can be held up by the ATO seeking documentation and verification of input tax credits.

- Be clear on your tax position and if in doubt seek expert advice – if you wrongly claim large credits, serious penalties may apply.
- If a large refund is expected, invariably the ATO will ask for supporting documentation.
- Anticipate this by placing this documentation on the tax agent's portal.
- If this is not possible have the documentation ready for forwarding to the ATO.

Recently the inspector of taxation found the ATO was doing a generally good job in forwarding GST refunds. However, some of us have had a very different experience and we advise developers not to expect the ATO, refund to be available in the normal cycle – it may well be held up and you should have contingency plans for this.

CHANGES TO DEPRECIATION ON SECONDHAND PROPERTIES ANNOUNCED

In the 2017 budget, the Government has confined plant and equipment depreciation deductions for items that can be easily removed, such as carpets and dishwashers and only to those expenses actually incurred by investors.

This no longer allows subsequent owners of property to claim deductions on items purchased by the previous owners of the property.

There was some concern that such assets were being depreciated in excess of their actual values by successive investors. In effect this is an integrity measure.

These changes apply on a prospective basis, with existing investments grandfathered. Plant and equipment forming part of residential investment properties as of 09/05/2017 will continue to give rise to deductions for depreciation until either the investor no longer owns the asset, or the asset reaches the end of its effective life.

Investors who purchase plant and equipment for their residential investment property after 09/05/2017 are able to claim a deduction over the effective life of the asset. However, subsequent owners of a property are unable to claim deductions for plant and equipment purchased by a previous owner of that property.

CHANGES TO CGT RULES FOR NON-RESIDENTS AND TEMPORARY RESIDENTS

The capital gains tax (CGT) rules have been changed to reduce the risk that foreign investors avoid paying CGT in Australia, including by no longer allowing foreign or temporary tax residents to claim the main residence CGT exemption, and by expanding the scope of the CGT withholding system for foreign residents;

TOP EIGHT TIPS FOR INVESTMENT PROPERTIES

Start thinking about these issues now not just prior to tax year end being 30 June.

The Importance of Good Records

Keep all documentation summaries of all your rental income and expenses.

This documentation should be kept for at least 5 years.

Depreciation

Generally, only registered quantity surveyors are authorised to prepare eligible depreciation schedules for purchases of new property. Builders and cost schedules are also allowable.

In the event you are doing a renovation a quantity surveyor can produce a scrapping schedule, which puts a value against all items to be discarded. Also refer to our article on demolitions. This value is expensed in the year of expenditure. The new items are then depreciated in a new depreciation schedule.

Also note that each investor has their own depreciation cost limit – currently $300 – see our article on pages 28 and 29.

This is relevant where properties are owned by more than one person.

Interest Expenses

Only interest expenses on borrowed funds used to invest in an asset that produces assessable income can be deductible. This is known as the 'use' test as consistently applied by the Courts.

A split line of credit should be considered when a loan is used for both investment and private purposes.

If capitalising interest on the investment line of credit, the ATO may require evidence of correct documentation and intention.

In this area you will need to seek specialist advice. However, split loans have their place to avoid the merging of personal (non-deductible) and investment (deductible) debt.

Pre-pay Expenses

If you have a geared investment, consider pre-paying next year's interest to gain an immediate tax deduction.

You could prepay insurance and bring forward expenditure.

Home Office

Consumables used as you work on your investment property may be a tax deduction. The ATO provides an hourly rate for energy costs. Also, you may claim a modest percentage of internet costs along with printing and stationery costs. Telephone calls relating to these activities are also deductible.

Apply for a PAYG Variation

If you have purchased a negatively geared investment you may have your PAYG deductions reduced to allow for the losses being incurred.

You can request the ATO to provide a PAYG variation certificate to give to your employer for reduced PAYG deductions. Alternatively, you will receive the refund of the additional tax paid on lodgement of your income tax return.

Minimise Capital Gains

Taxable capital gains realised during a tax year may be minimised by an offset against capital losses or trading losses incurred during that same tax year.

To reduce a capital gain generated on sale of property or other assets during the year, consider disposing assets which have lost value and have a bleak future.

The 50% discount on capital gains is available where an asset is held for longer than 12 months so carefully consider the timing of any sale, noting that relevant dates for calculating capital gains and eligibility for the discount is the contract date, not the settlement date.

Record those Capital Losses

Capital losses incurred in a given year may be indefinitely carried forward to future years if there are insufficient gains to absorb it in the current year.

Note however, capital losses may not be offset against normal income such as salary or business trading income. In the event you have made a capital gain, review your share and property portfolio to consider realising a capital loss to offset the gain.

Capital losses cannot be carried back to prior years. Refer to Issue #97 February 2019 tax tip #20 which outlines the importance of a CGT Asset Register.

Trusts

The use of a trust improves asset protection, estate planning and allows increased flexibility for property investors – see Issue #100 August 2019 pages 26-32.

Ensure the Trust has been formed correctly to ensure you do not lose interest deductibility, normally fully allowable by the ATO providing the requirements are met.

GST "CHANGE OF USE" ADJUSTMENT RULES RELEVANT TO PROPERTY DEVELOPERS

An adjustment is a change that increases or decreased your net GST liability for a reporting period. There are two types of adjustments:

- **Increasing adjustments** – these increase your net GST liability for a reporting period.
- **Decreasing adjustments** – these decrease your net GST liability for a reporting period.

You may need to make an adjustment on your activity statement in relation to GST credits you have previously claimed if you use your property differently from the way you originally planned – for example, if you have rented out a residential premises that you planned to sell. You would need to make an adjustment in these circumstances as the GST credits you have previously claimed in relation to the construction or development of the residential premises you may have been too much based on your actual use. You will also have an adjustment if you originally planned to rent but have sold residential premises that form part of your business or enterprise.

Information you need to work out change in use Adjustments

To be able to calculate change in use adjustments, you will need certain information including:

- When you made your purchase.
- The GST-exclusive market value of each of your purchases.
- What GST credits you claimed when you made the purchases.
- The tax period in which you claimed the GST credits on your purchases.
- Any previous adjustments you have made relating to the purchases.
- Any details of you holding or marketing the property for sale (for example the listing agreement with your real estate agent or advertising material).
- A reasonable estimation of the selling price (if the property has not sold).
- What you have used the residential property for, including the period for which you have rented the premises or used the premises for private purposes.
- The amount of any rent you received (if they have been rented).
- The date when you sold the property, and the amount you sold it for.

INCREASING ATO FOCUS ON PROPERTY DEVELOPERS

Recently the ATO has been using more ways of detecting goods and services tax (GST) avoidance on property sales, including property data matching from the Office of State Revenue and Land Titles Data. The ATO is also using data matching and analysis to ensure property developers are correctly reporting GST on property sales.

The ATO has made it clear that this activity continued throughout at 2018 and 2019 with increased focus on their enhanced data matching capacities.

PROPERTY DEVELOPERS – THRESHOLD ISSUES

We have covered "the Accidental Developer" elsewhere in this edition. On the issue of isolated transactions, both accountants and business owners register entities by overlooking section 188-25 of the GST Act i.e. transfer of capital assets and termination etc of an enterprise to be disregarded.

Example 3 in GSTR 2001/7 (Goods and Services Tax: Meaning of GST Turnover, including the effect of Section 188-25 on projected GST Turnover) explains this.

Example 3: Sample calculation of current GST turnover and projected GST turnover

Alan, a retiree, owns all three shops located next to a suburban railway station. Each of the shops is rented to tenants whose weekly tenancies are to terminate on 14 December 2001. The rent payable for each of the three shops is $200 per week. The railway department is planning an expansion of the station. Alan sells the shops with vacant possession to the railway department for $200,000. Alan's only enterprise is renting the shops. He is not registered for GST. He is not intending to carry on any other enterprise in the next 12 months. Settlement is to take place on 20 December 2001.

Alan's current GST turnover as calculated in December 2001 is the sum of the values of all the supplies that he has made or is likely to make during the 12 months ending on 31 December 2001. Alan has no supplies that are excluded under section 188-15 or 188-20 (such as input taxed supplies).

Alan's current GST turnover is 50 weeks rent of $600 per week (up to 14 December 2001) plus the $200,000 from the sale of the shops. That is, a total of $230,000. Alan's current GST turnover is above the registration turnover threshold.

Alan's projected GST turnover is the sum of the values of all the supplies that Alan has made or is likely to make in December 2001 and up to 30 November 2002. Alan has made or will make supplies of 2 weeks rent of $600 per week (up to 14 December 2001) plus the $200,000 from the sale of the shops. His projected GST turnover calculated under section 188-20 is $201,200.

In selling the shops, Alan will dispose of a capital asset in addition to ceasing to carry on his enterprise. Although the supply satisfies the conditions under both paragraph 188-25(a) and 188-25(b), those proceeds are excluded only once when calculating projected GST turnover. (Refer to paragraph 30.) Alan can disregard the $200,000 from the sale of the shops. Alan calculates his projected GST turnover as $1,200. As Alan has calculated his projected GST turnover on a reasonable basis to be below the registration turnover threshold, his GST turnover does not meet that particular turnover threshold. He is not required to register for GST.

However, we are still seeing accountants making registrations which are not necessary.

COMMON GST ERRORS FOR DEVELOPERS

In a typical development where full input tax credits are claimed we see four common mistakes.

A Failure to Adjust for a change in 'Creditable Purpose' from Selling to Renting

This is not an uncommon situation where the developer is not able to dispose of stock units at the desired price. A choice may be made to rent out some units.

Note income tax credits have been claimed on the basis the units were to be sold, refer to Division 129 of the Act.

The fundamental question Division 129 asks is 'was the GST position applied to earlier transactions reflective of how the acquisition was put to use.'

See above "change of use" adjustments on page 22.

Clearly adjustments will be required for premises that have for a period of time derived rent. More than ATO data matching techniques are increasingly identifying these situations.

This has become a topical issue with the glut of inner-city units that developments are finding hold to sell.

In the event an adjustment is made there is failure to consider a potential dual use application

Where Division 129 adjustments are made by the Taxpayer there is sometimes a failure to consider a dual use application. We refer you to GSTR 2009/4 and the formula outlined in Paragraph 83.

This could result in substantial savings.

In order to sustain a dual use intention a taxpayer must on an objective assessment of the facts and circumstances demonstrate that there was and still is a genuine intention that relevant properties be sold.

Paragraph 45 of GST 2009/4 outlines some relevant factors.

Incorrect Interpretation of the 5 year 'Residential Accommodation' use 'Carve Out' from the definition of New Residential Premises

If you have taken advantage of a dual use application to minimise the input tax credits clawed back, then you cannot expect to have your cake and eat it too.

Refer to section 40-75 (2) 'Meaning of New Residential Premises for the 5-year rule.' Once again GSTR 2009/4 provides guidance on the Commissioner's view which is where dual use premises are involved, then the premises will have been used for a purpose other than input taxed residential premises. The ATO view is that where the dual use of the premises continues, then the 5-year rule cannot apply.

A failure to take into account the Application of Division 135 to an Acquisition

Division 135 is an integrity measure which provides for an adjustment to ensure a proper accounting for GST that is in proportion to the private or input taxed use of the property that is acquired.

This may happen when a bundle of residential premises is acquired such as a residential complex (refer to MBI Properties).

Another example would be the acquisition of a retirement village.

The message here when claiming input tax credits on making adjustments is that big dollars equals big risk particularly where the accountant or the business owner enters unchartered waters – seek professional advice.

NEW RESIDENTIAL PREMISES AND GST

The ATO have advised that if you are registered for GST and have constructed new residential premises that you originally intended to sell but have since rented out, you may need to make an adjustment in your next Business Activity Statement.

If you constructed new residential premises which you intended to sell as part of your business, then the premises have been constructed for a creditable purpose – GST credits can generally be claimed on things which are acquired for a creditable purpose.

If your use of the property changes – for example, you rent instead of sell – so does the creditable purpose. The renting of the premises is input taxed and is not for a creditable purpose.

If you have a change in creditable purpose, you will need to make an adjustment to the amount of GST credits originally claimed. An increasing adjustment will increase your GST liability for the tax period, while a decreasing adjustment will reduce your GST liability.

Adjustments for the change in creditable purpose are often made over a number of years and are generally recorded in June activity statements.

If you find you have creditable purpose adjustment for property transactions that you didn't report, you should complete a Voluntary disclosure.

If you review your activity statements and report any mistakes voluntarily, you won't have to pay any shortfall penalties, and any general interest charges (GIC) will be reduced to the base rate.

VALUATIONS AND THE GST MARGIN SCHEME

In January 2012 the ATO published a "Valuation Issues Paper" in collaboration with the Australian Property Institute and the Australian Valuation Office. The current requirements for approved valuations for GST margin scheme calculations should be considered in the light of this issue paper.

There are several situations in which calculations of GST payable under the margin scheme for supplies of real property under Division 75 of the GST Act 1999 require an "approved valuation" of a property interest as a 1 July, 2000 or some a later date when a particular event occurs (e.g. the date of GST registration).

Section 75-35 allows the Commissioner to determine in writing the requirements for making such a valuation and has issued a number of legislative determinations in this regard – see MSV 2009/1 applying to sales or real property from 1 March 2010. Typically, a taxpayer will adopt Method 1 of engaging a professional valuer.

Paragraph 13 of MSV 2009/1 lists various requirements for a valuation by a professional valuer to be an approved valuation for the purposes of Division 75.

The decision of the Federal Court in the Brady King case is authority for the Commissioner being able to challenge margin scheme valuations (i.e. where the Commissioner considers the valuation is too high so the GST payable is too low) where the terms of the applicable legislative determination have not been complied with.

The message here is clear – if you are applying the margin scheme seek specialist advice which carefully considers the "valuation issues paper."

The ATO has also issued a number of legislative determinations along with a fact sheet which was last updated in May 2019.

In order to maximise the benefits of the margin scheme, the taxpayer has a clear incentive to receive a high valuation. The fact sheet also identifies "recurring issue" on valuations they believe to be deficient or flawed. In the event you are getting a valuation done, be mindful of this and make sure the exercise has real integrity.

FOREIGN RESIDENT CAPITAL GAINS TAX WITHHOLDING

Since 1 July 2016, the foreign resident capital gains tax withholding regime has been in force.

From 1 July 2017, the withholding rate that a buyer must pay to the Australian Tax Office on purchase of real estate assets from a foreign resident seller increased from 10 percent to 12.5 percent. The threshold values at which the laws apply have also reduced from $2 million to $750,000.

This regime impacts not only upon purchasers of real property but also purchasers of shares in non-listed property rich companies and purchases of units in unlisted property trusts.

The definition of property includes both residential and commercial real property, leasehold interests and mining, quarrying and prospecting rights.

Property acquisitions

If you are a purchaser of property for more than $750,000 then **you must withhold unless** the vendor shows you a **clearance certificate** or a **variation certificate**. An exemption is available where the vendor is in financial distress as defined (e.g. administration) but in such cases specialist advice should be sought.

Any **Australian Vendor** of property should apply online to the ATO to get a clearance certificate immediately a sale of relevant property is contemplated. The clearance certificate is not property specific and lasts 12 months.

Foreign vendors may apply to the ATO for a variation on the grounds that the tax they expect to pay on the gain (if any) will ultimately amount to less than 12.5% of the purchase price in order to reduce the withholding required to nil or some other amount. This could apply if the property is being sold for a loss, the vendor has carried forward tax losses or roll-over relief is available. Such a variation is property specific and should be applied for as early as possible as the application may take up to a month to process.

As this is a non-final withholding measure, the foreign vendor should file an Australian tax return disclosing any gain. The amount withheld by the purchaser is a tax credit to the amount otherwise payable by the vendor – so in the event withholding is made where the vendor has no tax liability, the vendor be entitled to a full refund on filing an Australian tax return.

If the purchaser fails to withhold then the ATO may impose a penalty of the amount of tax which would have been withheld.

Those purchasing shares or units may also have to withhold – but the procedure in order to escape withholding is different. In this case there is a declaration mechanism that can be used by both Australian and foreign vendors.

DEVELOPERS NEED TO RE-THINK INSTALMENT CONTRACTS FOR RESIDENTIAL PROPERTY AFTER NEW GST WITHHOLDING LAWS

While it is now over a year since the introduction of the GST withholding laws, property developers continue to struggle the new regime.

Developers should be mindful of GST withholding requirements when entering into instalment contracts for the purchase of residential property, or vacant greenfield land which can falls in the category of potential residential land. This is often transacted pursuant to a contract that provides for multiple instalment payments.

Vendors of residential property or potential residential land included in a property subdivision plan must provide the purchaser with notification prior to the date that payment of the first instalment (other than the deposit) is due stating whether the purchaser is required to withhold GST from the vendor and pay it directly to the ATO. The payment will be 1/11th of the contract price or if the margin scheme applies, 7% of the contract price. Where the contract does not require instalment payments, the vendor's notification will only be required prior to settlement.

To structure the deal on the basis of multiple payments is usually advantageous for both parties as the purchaser can negotiate a longer settlement date and the vendor usually receives a higher price.

However, before you enter into a contract of sale of new residential premises or potential residential land that requires multiple payments, both parties should, ascertain whether GST is payable on the supply and then carefully consider their agreed instalment regime. It's possible in some cases the GST that the Purchaser will be required to pay to the ATO on the first instalment date may be greater than the first instalment amount it had agreed to pay.

Failure by a purchaser to withhold GST and pay it to the ATO can give rise to administrative penalties, which may be significant resulting in the purchaser being unable to meet the instalment price required by the contract.

THE FOUR-YEAR CONSTRUCTION RULE

Extending the Main Residence Exemption

When a taxpayer builds a new home on land, or repairs or renovates an existing house, the main residence exemption will usually only apply from the date the completed dwelling becomes the taxpayer's main residence. It then follows when the house is eventually sold, only a partial main residence exemption will apply. In this case, the taxable portion of any capital gain is calculated under s.118-185.

However, there is relief under s.118-150 which allows a taxpayer to choose to treat the completed dwelling and the land as their main residence for a period of up to 4 years before it actually becomes the taxpayer's main residence. The taxpayer then applies the main residence exemption to the whole property during the period the dwelling is being constructed, repaired or renovated, for a period of up to 4 years.

This choice can **only** be made when the following conditions are met:

- The completed dwelling becomes the taxpayer's main residence as soon as practicable after it is completed; and
- The dwelling continues to be the taxpayer's main residence for at least 3 months.

Once the choice is made to apply s.118-150, no other dwelling can generally be the taxpayer's main residence during the same period.

The 4-year exemption under s.118-150 may be a very useful planning tool in maximising the main residence exemption for taxpayers who build a new home or repair or renovate an existing house that will become the taxpayer's home. When applying this concession, a distinction should be made between the following common categories of taxpayers:

- Those taxpayers who buy land and then either build a new home or repair or renovate an existing house on the land, before moving in;
- Those taxpayers who buy an existing house which is then occupied (e.g. by tenants) before either a new home is built, or the existing house is repaired or renovated; and
- Those taxpayers who demolish their existing main residence to build a new home.

The following case study may be helpful:

Purchase of vacant land to build new home

Tony acquired a block of land on 1 April 2000 and built a new house which was completed on 12 September 2002. Tony moved into the house on 15 September 2002 and lived there until the house was sold on 15 March 2009. The sale generated a capital gain of $180,000.

Tony's new house will be considered his main residence from the time he moved into it until it was sold (i.e. from 15 September 2002 to 15 March 2009). If Tony chooses to apply s.118-150, his house will also be considered his main residence from the time the land was acquired until it became his main residence (i.e. from 1 April 2000 to 14 September 2002).

If a dwelling is occupied by tenants for a period of time before it is re-built, repaired or renovated, the main residence exemption will not apply for this period.

Where an existing house is demolished to build a new home there are a number of scenarios and valuable guidance is contained in ATO ID's 2003/322, 20003/466 and 2006/185.

ENCROACHING SUBURBIA AND FARMLAND

ATO finds sale of farmland a 'mere realisation' ID 2002/700

With encroaching suburbia particularly in regional towns this may be very relevant.

Here the ATO considered whether the sale of farmland was assessable income under s.6-5.

In the 1970's the taxpayer purchased farming land. Several types of farming were attempted and found unprofitable over an extensive period. Due to the unprofitability of the farming business the taxpayer rezoned and subdivided the land.

Roads were constructed, underground power was installed, and trees were planted. Little of the subdivision work was planned by the taxpayer who relied on town planners, engineers, contractors and consultants to design, plan and sell the allotments.

The taxpayer had not conducted any other activities relating to property development.

Holding the profit derived from the subdivision was only a mere realisation, the ATO cited the following reasons:

- **Unprofitability of land** – the sale of the subdivided land was triggered by the land's unprofitability;
- **Initial purpose not land development** – the initial purpose of purchasing land was farming;
- **Land was farmed** – the land was used for farming purposes for a long period of time before subdivision;
- **Taxpayer outsourced subdivision** – the taxpayer only performed a small part of the subdivision. The taxpayer relied on town planners, engineers, contractors and consultants to design, plan and sell the allotments; and
- **Taxpayer was not a developer** – the taxpayer had no other business relating to property development.

TRUSTS MISCHARACTERISING PROPERTY DEVELOPMENT RECEIPTS AS CAPITAL GAINS

Taxpayer Alert 2014/1 released on 28.07.2014 describes arrangements where property developers use trusts to return the proceeds from property development as capital gains instead of income on revenue account.

This Taxpayer Alert describes an arrangement whereby a trust (commonly a special purpose or new trust) undertakes property development activities as part of its normal business. The developed property, which could be either commercial or residential in nature, is subsequently sold and the proceeds are returned on capital account, resulting in access to the general 50% capital gains discount.

The proceeds are not returned as ordinary income under section 6-5 of the Income Tax Assessment Act 1997 (ITAA 1997), either on a gross basis (as part of a business of property development, where the underlying property constitutes trading stock for the purposes of section 70-10 of the ITAA 1997) or on a net basis (as part of a profit making undertaking).

Description

This Taxpayer Alert applies to arrangements which display all or most of the following:

An entity with experience in either developing or selling property, or in the property and construction industry, establishes a new trust for the purpose of acquiring property for development and sale.

In some cases, the trust deed may expressly state that the purpose of the trust is to hold the developed property as a capital asset to generate rental income. In other cases, the trust deed may be silent as to its purpose.

Activity is then undertaken in a manner which is at odds with the stated purpose of treating the developed property as a capital asset. For example:

- Documents prepared in connection with obtaining finance for the development may indicate that the dwellings constructed on the land are to be sold within a certain timeframe and that the proceeds are to be used to repay the loan.
- Communication with local government authorities overseeing building approvals may describe the activity as being the development of property for sale.
- Real estate agents may be engaged early in the development process, and advertising to the general public may indicate that the dwellings/subdivided blocks of land are available to be purchased well in advance of the project's completion, including sales off the plan.

The property is sold soon after completion of the development, where the underlying property may have been held for as little as 13 months.

The trustee treats the sale proceeds as being on capital account, and because the trustee acquired the underlying property more than 12 months before the sale, it claims the general 50% capital gains tax discount (in other words, it treats the gain/profit in respect of each sale as a discounted capital gain).

The ATO considers that arrangements of this type give rise to various issues relevant to taxation laws, including whether:

- the underlying property constitutes trading stock for the purposes of section 70-10 of the ITAA 1997 on the basis that the trustee is carrying on a business of property development;
- the gross proceeds from sale constitute ordinary income under section 6-5 of the ITAA 1997 on the basis that the trustee is carrying on a business of property development;
- the net profit from sale is ordinary income under section 6-5 of the ITAA 1997 on the basis that, although the trustee is not carrying on a business of property development, it is nevertheless involved in a profit-making undertaking.

The ATO has commenced a number of audits and has made adjustments to increase the net income of a number of trusts. Audit activity will continue.

If you have entered into a similar arrangement to that described in this alert, you may wish to seek independent professional advice. If you would like to correct something in your tax return, more information is available on the ATO website ato.gov.au and search for Correcting your tax return or activity statement.

CAPITAL V INCOME "INVESTORS" BEWARE!

August - V - Commissioner of Taxation (2013) FCAFC 85

This case confirms the importance of property investors seeking advice at the time of acquiring a property and also making their intentions clear if they wish to remain on 'capital account' and within the CGT regime.

This was an interlocutory application to adduce further evidence prior to hearing of a further Appeal to the Full Federal Court following the decision of Nicholas J in August v Commissioner of Taxation (2012) FCA 682. In rejecting the application Siopis, Besanko and McKerracher JJ have set out in detail the Nicholas J findings and firmly rejected the challenge to the conclusions "of the trial judge" on evidentiary issues.

The Full Court confirmed the ATO view that the sales of the relevant properties were not on capital account and formed part of ordinary income under Section 6-5. This effectively denied the 50% discount that would have been available under the CGT provisions.

In the absence of any contemporaneous documents evidencing the Augusts' purposes or intentions when the shops were acquired, the Full Federal Court held that whether or not the properties had been purchased for the purpose of engaging in a scheme of profit-making by sale must be determined with regard to all the surrounding circumstances and the parties evidence as to their own purposes and intentions.

The Full Federal Court upheld the decision of the judge at the first instance that the acquisitions by the Augusts' investment trust were to be treated as part of a profit-making scheme rather than as long-term investments.

The reason for the Court's conclusion was that the circumstances surrounding the acquisitions showed that the shops had been purchased with the intention or purpose of developing and tenanting them and selling them for a profit. The development and tenanting of properties and their subsequent sale was regarded by the Court as a scheme or commercial transaction.

It is essential property investors obtain professional legal, financial and taxation advice when making property acquisitions. It is vital to keep sound records, particularly if they wish to have favourable tax treatment of capital gains. In assessing the tax implications of a particular property transaction, the ATO and courts will consider not only an investor's evidence as to their intentions at the time of the purchase but will also look to evidence such as contemporaneous records and take into account the circumstances surrounding the transaction (e.g. finance methods, whether any improvements are made to the property and the existence of any tenancies).

Be warned! This is definitely on the ATO's radar as our discussion of Taxpayer Alert 2014/1 reveals.

August – Ongoing Implications

What lessons can be learned from Taxpayer Alert 2014/1 and the August case?

Advisers and clients alike need to be clearly aware of the dangers of believing because they have a special purpose trust, set up for one enterprise, that they can automatically access the CGT 50% individual discount if they have held at asset for more than 12 months.

In our Capital Gains Tax bonus edition #098, we dealt with the "Accidental Developer" but here the situation is often very different.

One scenario is business savvy principals of a trust who through their own or associated entities are actively engaged in property development. However, the premise used to access the CGT discount is that the trust is an investor with their adviser's confining their analysis to the CGT provisions of the Income Tax Assessment Act 1997 (ITAA).

However, as the August case clearly shows, it is not necessary for the entity to be conducting a business. Rather, if a profit-making intention can be adduced, then the ATO will take the view it is income according to normal concepts.

Here it is crucial to objectively review the manner in which the taxpayer acquired, dealt with and then subsequently disposed of the property in question – refer to the above in August.

In any cycle of the property market there is plenty of this going on for both residential and commercial. The ATO is likely to take the view that activities which are highly commercial in nature, resulting in renovations, new leases/tenancies and relatively quick turnover are fully assessable in under section

Don't just look at the CGT provisions, consider the following:

- scale of operations;
- background of participants;
- evidence pointing to their 'subjective intention';
- whether a profit-making intention can be adduced.

As mentioned in the past these can fall either side of the line.

MAXIMISING DEPRECIATION CLAIMS ON RENTAL PROPERTIES

From 1 July 2001 the immediate deduction for depreciating assets costing $300 or less has been restricted to assets in use to produce assessable income from activities that do not amount to carrying on a business. This of course includes rental properties.

So, when applying the $300 immediate write-off we should consider owned rental property assets. Here each joint owner's interest in the asset is effectively treated as a separate asset for depreciation purposes under S. 40-35.

This means where the cost of a joint owner's interest in an asset is not more than $300, an immediate write-off can be claimed by the joint owner under S. 40-82(2) (if all other conditions are met), even if the overall cost of the asset exceeds $300.

For example, if a rental property is jointly owned by two or more persons, an asset costing up to $600 where the property is owned by two people may be written-off in the year of purchase under S. 40-80(2).

Therefore, the $300 immediate write-off concession will generate better initial cash flow benefits for jointly owned properties compared with rental properties which have only the one owner.

Many tax accountants miss this concession. An asset in a jointly owned property that has an overall cost of more than $300 - but no more than $300 for each individual joint owner will mean the asset can still be written-off in the year of purchase providing the other conditions in S. 40-80(2) are met. In comparison, the same asset in a rental property that is owned by one person must be depreciated over the asset's effective life (subject to the low-value pool method of depreciation – see over).

In similar fashion to the $300 write off, the advantages of allocating jointly owned assets to a low-value pool are often overlooked where properties held in joint names.

Under the low-value pool rules (refer to S. 40-425 to S. 40-460), a landlord can generally choose to depreciate the following two categories of assets as part of a low-value pool:

- a low-cost asset – this is an asset acquired during the current year, costing less than $1,000 (except an asset that is eligible for the $300 immediate write-off concession noted above); and
- a low-value asset – this includes an existing asset already written down to less than $1,000 under the diminishing value (DV) method.

In a low-value pool, all assets are usually depreciated using a DV rate of 37.5%. The only exception is for low-cost assets which are depreciated using a DV rate of 8.75% (i.e. half the full rate of 37.5%) in their first year.

Once a choice has been made to set up a low-value pool, all low-cost assets acquired in that year and in later income years must be allocated to the pool. However, it's possible to allocate low-value assets at the taxpayer's discretion under S. 40-430.

COMMON RENTAL PROPERTY MISTAKES

According to the ATO, some common errors made by rental property owners include:

- claiming rental deductions for properties not genuinely available for rent;
- incorrectly claiming deductions for properties only available for rent part of the year such as a holiday home;
- incorrectly claiming structural improvement costs as repairs when they are capital works deductions, such as re-modelling a bathroom or building a pergola; and
- overstating deduction claims for the interest on loans taken out to purchase, renovate or maintain a rental property.

ATO Crackdown on Rental Property Tax Claims

Recently the ATO announced it was targeting taxpayers who rent out their holiday homes for only a few weeks during the year but claim a full year's worth of deductions returns.

The ATO will pay close attention to rental property owners, especially those who own a holiday home who incorrectly claim these deductions. Taxpayers who have recently acquired rental properties will also be targeted.

Homeowners should be aware that it is not just holiday homes that are under focus by the ATO.

A common mistake that has risen among rental property owners is claiming for deductions for initial repairs to rectify damage, defects or deterioration that exists at the time of purchasing the property.

Taxpayers should be aware they are not entitled to claim a deduction for any repairs made to their rental property for issues that exist at the time of purchase even if the repairs were carried out to make the property suitable for rent. The cost of these repairs should be capitalised.

CASH FLOW BENEFITS FOR JOINTLY OWNED ASSETS IN A LOW-VALUE POOL

There are two cash flow benefits arising when depreciating a rental property asset as part of low-value pool, compared with depreciating the same asset over its effective life, as follows:

1. **Depreciation for low-cost asset in first year** – in the first year (i.e. the year of purchase), low-cost assets are depreciated at a flat DV rate of 18.75% for the full year, regardless of when the asset is purchased during the year – there is no requirement to apportion the asset's depreciating claim on a day in the year basis.

   This means a low-cost asset can be purchased on the last day of an income year and still be depreciated at 18.75% for that income year. However, if the same asset was being depreciated over its effective life and not as part of a low-value pool it could only be effectively depreciated for one day in the income year which would result in a negligible tax deduction.

   Clearly for low-cost assets that are acquired towards the end of the income year; there are significant cash flow benefits of depreciating these assets as part of a low-value pool rather than depreciating them separately over their effective life in the first income year (i.e. the year of purchase).

2. **Depreciation for pooled assets after first year** – In general, depreciation claims for an asset (in its earlier years) will be greater in a low-value pool (compared with depreciating the same asset over its effective life), where the asset has an effective life of more than 4 years. Invariably this is usually the case with rental property fixtures, fittings and furnishings.

Joint owners of a rental property can gain greater access to the potential cash flow benefits of using a low-value pool. This is because the low-value pool rules are applied to each joint owner's interest in the asset, and not to the asset as a whole. This means if the cost of a joint owner's interest in an asset is less than $1,000, the joint owner's interest will qualify as a low-cost asset and can be allocated to a low-value pool even if the overall cost of the asset is more than $1,000.

For example, if a rental property is jointly owned by two individuals, an asset costing up to less than $2,000 could be depreciated as part of a low-value pool.

Joint owners of a rental property will therefore have a greater number of assets that are eligible to be depreciated as part of a low-value pool compared with taxpayers who own a rental property solely in their name. Consequently, the potential cash flow benefits of using a low-value pool will generally be greater in respect of a jointly owned rental property, compared with a rental property that is owned only by one person.

Be mindful however, that depreciation is only one expense and there may well be sound overall tax reasons for having the negatively geared property in the name of only one high income earning spouse. The above two examples are included to maximise claims in the event the property is held in joint names.

INVESTMENT IN RESIDENTIAL PROPERTY – SAVING ON GST

The leasing of residential premises is input taxed under the GST law unless the premises have the character of commercial residential premises.

It follows that a lessor of residential premises would not be entitled to obtain an input tax credit for an acquisition made in respect of residential premises, whereas the lessor of commercial residential premises would generally be (subject to the long-term accommodation exception), entitled to obtain input tax credits for such expenses.

If an investor acquires residential premises which are leased to another entity that leases similar premises from other owners and provides such premises to the general public for short-term accommodation, then the initial lease should be structured so as to impose an obligation upon the lessee entity to bear all costs associated with the maintenance and management of the premises and accept a lower rent. In essence, structure the lease in the same way as commercial leases operate – such leases impose an obligation upon the lessee to bear the costs of all expenses associated with the maintenance of the premises.

TAX SMART SELLING: PROPERTY

The message is clear and simple: get professional tax advice – this could save you thousands of dollars. After the event, it is usually too late for opportunities to generate tax savings. If at all possible, a desired outcome is to generate tax savings by increasing the taxable capital gain on the sale of a property and simultaneously create revenue deductions. The after-tax benefit of deductions for an individual (at 47%) more than offset the additional tax burden arising from an increased gain (at 23.5%). In other cases, the same strategy used by a company allows capital gains to be generated for use against capital losses with a corresponding decrease in taxable income.

Example - Standard sale

Toby has owned his factory and the surrounding property since 2003. He acquired the property (including the factory) for $3.2 million. By 2015, Toby's business has outgrown the factory, which he sells to a property developer who intends to knock down the factory and build town houses for resale. Since acquiring the factory Toby has claimed $200,000 in capital works deductions.

Toby sells the property to the property developer outright for $4 million, the $1,000,000 capital gain (on a $3.2 million cost base, reduced by the $200,000 Division 43 deductions clawed back) will give rise to a net tax liability of $235,000 (after applying the CGT 50% discount).

DIY Sale

Alternatively, assume Toby sells the property to the property developer under a contract stipulating that the vendor will demolish the factory. The sale price is adjusted by $100,000 to reflect the additional cost to Toby demolishing the factory. At this point the factory has residual 'undeducted construction expenditure' of $600,000.

In this scenario, the tax outcome is far more advantageous for Toby.

Under the capital works tax amortisation provisions, Toby is able to claim $600,000 revenue deduction in respect of the undeducted construction expenditure. This produces a tax saving of $282,000 (at the 47% tax rate).

From a capital gains tax perspective, the capital works deduction gives rises to a costs base adjustment for the property sold. Under the CGT rules, as the property was first acquired by Toby after 13 May 1997, the cost base is reduced by the $200,000 in capital works deductions claimed by Toby in the past and the $600,000 capital works deduction on demolition of the factory. As a result, the cost base is reduced to $2.4 million.

Toby's cost base for the property is increased to reflect the demolition costs he has incurred in demolishing the factory (say $100,000), bringing the cost base of the property to $2,500,000. With capital proceeds of $4,100,000 on the sale of the property, Toby's total taxable capital gain under this alternative is $1,600,000 resulting in tax on the capital gain of $376,000 (after applying the 50% capital gains discount). Taking into account the capital works deduction (giving rise to a tax saving of $282,000), Toby's net tax liability is $94,000. This represents a tax saving of $141,000 (being $235,000 - $94,000) compared to the scenario in which Toby sells the property without first demolishing the factory.

Pre 13 May 1997 property

Had the property been acquired before 13 May 1997, the benefit derived by Toby in this scenario would have been further increased. For properties acquired prior to this date, the cost base reduction to reflect Division 43 capital works deductions, are required above, would not have been necessary under the CGT rules. This would have resulted in a higher cost base and a smaller taxable capital gain.

Interest Deductions after a Rental Property Has Been Sold

In a property market under stress this issue is becoming more common.

Sale proceeds of a rental property will usually be applied against any outstanding loan. In the event a property is sold for less than the outstanding loan balance there will be a shortfall amount. The issue that then arises is whether a tax deduction can still be claimed for interest incurred on the loan shortfall amount.

The decisions in FCT – v – Brown (1999) FCA 721 (Brown) and FCT – v – Jones (2002) FCA 204 (Jones) clearly indicate that a taxpayer should be entitled to a tax deduction for interest on a loan shortfall amount arising from the sale of an income producing asset.

Taxation Ruling TR 2004/4 sets out the Commissioner's view following those decisions.

It should be noted that although Brown and Jones both dealt with taxpayer's carrying on a business, the courts and the ATO have indicated that the same principles can equally apply to non-business taxpayers (TD 95/27) including rental property owners.

Based on these decisions the below factors must be considered before making a claim for interest on a loan shortfall:

- If the entire proceeds from the property's disposal are applied to the loan, then the interest will continue to be deductible.
- In the event there is a legal entitlement to pay the loan early and the taxpayer has sufficient assets to repay the loan, then this could affect the deductibility of interest subsequent to the sale of the rental property.
- Where a fixed term loan is refinanced at a lower rate after the rental property is sold this generally would not affect the deductibility of interest.
- The length of time elapsing since the sale of the rental property should not be an issue as long as the taxpayer does not have the capacity to repay the loan.

For example, in Guest – v – FCT FCA 193 interest deductions were allowed for 10 years after the business had ceased.

TAX TIP – INCREASING YOUR COST BASE ON FORMER PRINCIPAL PLACE OF RESIDENCE

Increasing your cost base

You can obtain uplift in the cost base of your house by having it deemed to have been acquired at market value on the day your home is first rented out. The following conditions must be satisfied:

1. The home is rented out for more than 6 years (and no other property is treated as a 'main residence');
2. The home has been rented out after 20 August 1996; and
3. The full main residence exemption would have been available if the house was sold just before it was rented out.

To determine the market value of the house for CGT purposes, a person has the option of:

1. Obtaining a valuation from a qualified valuer; or
2. Calculating their own valuation based on reasonably objective and supportable data.

Generally, if significant amounts are involved, it will be prudent to obtain a valuation from a qualified valuer, particularly if there is also any doubt about the market value of the property.

For further guidance see Law Administration Practice Statement PS LA 2005/8-Market Valuations.

Example 1 - Susan purchased a property in Melbourne in 2003 for $300,000 and occupied it as her main residence for 5 years. In 2008, she moved to Sydney for work and rented out her house. A qualified valuer values the market value of her house to be $650,000 at that time. In 2015 Susan decides to stay in Sydney and sells her house for $1,350,000 (i.e. 7 years after it is first rented out).

Capital Gains Tax Implications

Given that Susan meets all the above requirements, she can be deemed to have acquired her Melbourne home for its market value at $650,000 in 2008 (the date that the property was first used for income producing purposes).

When Susan sells the apartment, the capital gain (or loss) is calculated as follows:

Amount received:	$1,350,000
Less: Market value cost base of house in 2008	$ 650,000
Capital gain (loss)	**$ 700,000**

The taxable capital gain is then worked out as:

$$\text{Capital gain (or loss)} \times \frac{\text{Non-main residence days}}{\text{Days of ownership}}$$

$$= \frac{\$700{,}000 \times 365}{2{,}555}$$

$$= \$100{,}000$$

Susan can then apply the 50% CGT discount (given that she has also held the property for more than 12 months). The capital gain on the sale of the Melbourne home will only be $50,000.

A great tax outcome

The reason Susan pays negligible tax of $23,500 on her profit of $700,000 is that she can BOTH revalue her house at 2008 (when she first rented it out) AND still partially claim the main residence exemption.

CO-OWNERSHIP OF RENTAL PROPERTY

The way that rental income and expenses are divided between co-owners varies depending on whether the co-owners are joint tenants or tenants in common or there is a partnership carrying on a rental property business.

Co-owners of an investment property – not in business

A person who simply co-owns an investment property or several investment properties is usually regarded as an investor who is not carrying on a rental property business, either alone or with the other co-owners. This is because of the limited scope of the rental property activities and the limited degree to which a co-owner actively participates in rental property activities.

Dividing income and expenses according to legal interest

Co-owners who are not carrying on a rental property business must divide the income and expenses for the rental property in line with their legal interest in the property. If they are:

- Joint tenants, they each hold an equal interest in the property;
- Tenants in common, they may hold unequal interests in the property – for example, one may hold a 20% interest and the other an 80% interest.

Rental income and expenses must be attributed to each co-owner according to their legal interest in the property, despite any agreement between co-owners, either oral or in writing, stating otherwise.

Example: Joint Tenants

Mr and Mrs Hitchman are joint tenants in an investment rental property. Their activity is insufficient for them to be characterised as carrying on a rental property business. In the relevant year, Mrs Hitchman phones the Tax Office and asks if she can claim 80% of the rental loss. Mrs Hitchman says she is earning $67,000 a year, and Mr Hitchman is earning $31,000. Therefore, it would be better if she claimed most of the rental loss, as she would save more tax. Mrs Hitchman thought it was fair that she claimed a bigger loss because most of the expenses were paid out of her wages. Under a partnership agreement drawn up by the Hitchmans, Mrs Hitchman is supposed to claim 80% of any rental loss.

Mrs Hitchman was told that where two people are joint tenants in a rental property, the net rental loss must be shared in line with their legal interest in the property. Therefore, the Hitchmans must each include half of the total income and expenses in their tax returns.

Any agreement that the Hitchmans might draw up to divide the income and expenses in proportions other than equal shares has no effect for income tax purposes. Therefore, even is Mrs Hitchman paid most of the bills associated with the rental property; she would not be able to claim more of the rental property deductions than Mr Hitchman.

Example: Tenants in common

In the preceding example, if the Hitchmans held their property interest as tenants in common in equal shares, Mrs Hitchman would still be able to claim only 50% of the total property deductions.

However, if Mrs Hitchman's legal interest was 75% and Mr Hitchman's legal interest was 25%, Mrs Hitchman would have to include 75% of the income and expenses on her tax return and Mr Hitchman would have to include 25% of the income and expenses on his tax return.

Note: Interest on money borrowed by only one of the co-owners which is exclusively used to acquire that person's interest in the rental property does not need to be divided between all of the co-owners.

If you do not know whether you hold your legal interest as a joint tenant or a tenant in common, read the Title Deed for the rental property.

Non-commercial rental

If you let a property or part of a property at less than normal commercial rates, this may limit the amount of deductions you can claim.

Renting to a family member

This issue arises frequently, and the following example provides guidance:

Mr and Mrs Hitchman were charging their previous Queensland tenants the normal commercial rate of rent - $180.00 per week. They allowed their son, Tim, to live in the property at a nominal rent of $40.00 per week. Tim lived in the property for four weeks. When he moved out, the Hitchman's advertised for tenants.

Although Tim was paying rent to the Hitchman's, the arrangement was not based on normal commercial rates. As a result, the Hitchman's could not claim a deduction for the total rental property expenses for the period Tim was living in the property. Generally, a deduction can be claimed for rental property expenses up to the amount of rental income received from this type of non-commercial arrangement.

Assuming that during the four weeks of Tim's residence, the Hitchman's incurred rental expenses of more than $160, these deductions would be limited to $160 in total, that is, $40 x 4 weeks.

If Tim had been living in the house rent free, the Hitchman's would not have been able to claim any deductions for the time he was living in the property.

Claiming Prepaid Expenses for 30 June 2020

If you prepay a rental property expense, such as insurance of interest on money borrowed, that covers a period of 12 months or less AND the period ends on or before 30 June 2021, you can claim an immediate deduction. A prepayment that does not meet their criteria AND is $1,000 or more may have to be spread over two or more years. This is also the case if you carry on your rental activity as a business and have not elected to be taxed under the simplified tax system for small businesses.

Common mistakes

Avoid these common mistakes when making claims or preparing schedules for your accountant:

- Incorrectly claiming the cost of the land as a capital works deduction, that is, as part of the cost of constructing or renovating the rental property.
- Incorrectly claiming the cost of improvements such as remodelling bathrooms or kitchens or adding a deck or pergola as repairs. These are capital improvements and should be claimed as capital works deductions.
- Overstating claims for deductions on the interest on the loan taken out to purchase, renovate or maintain the property. A loan may be taken out for both income-producing and private purposes, such as to purchase motor vehicles or other goods or services. The interest on this private portion of the loan is not deductible and should not be claimed.
- Claiming deductions for properties which are not genuinely available for rent.
- Incorrectly claiming deductions when properties are only available for rent for part of the year. If a holiday home or unit is used by you, your friends or your relatives free of charge for part of the year, you are not entitled to a deduction for costs incurred during those periods.
- Claiming deductions for items incorrectly classified as depreciating assets.
- If you financed the purchase of your rental property using a split loan facility, you cannot claim a deduction for the extra capitalised interest expense imposed under that facility.

CHECKLIST FOR EXPENSES FOR WHICH YOU MAY CLAIM AN IMMEDIATE DEDUCTION

Expenses for which you may be entitled to an immediate deduction in the income year you incur the expense include:

- Advertising for tenants
- Bank charges
- Body corporate fees and charges
- Cleaning
- Council rates

- Electricity and gas
- Gardening and lawn mowing
- In-house audio / video service charges
- Insurance:
  > Building
  > Contents
  > Public liability
- Interest on loans
- Land tax
- Lease document expenses
  > Preparation
  > Registration
  > Stamp duty
- Legal expenses
- Mortgage discharge expenses
- Pest control
- Property agent's fees and commission
- Quantity surveyor's fees
- Accounting fees
- Repairs and maintenance
- Secretarial and bookkeeping fees
- Security patrol fees
- Servicing costs – for example, servicing a water heater
- Stationery and postage
- Telephone calls and rental
- Tax-related expenses
- Water charges

ATO INCREASES FOCUS ON RENTAL PROPERTY DEDUCTIONS

The ATO has an increased focus on rental property deductions this tax time and is encouraging rental owners to double-check their claims are correct before lodging their tax return.

In particular, the ATO is paying close attention to:

- Excessive deductions claimed for holiday homes;
- Husbands and wives splitting rental income and deductions for jointly owned properties that is not supported;
- Claims for repairs and maintenance shortly after the property was purchased; and
- Interest deductions claimed for the private proportion of loans.

While the ATO will be paying close attention to these issues, it will also be actively educating rental property owners about what they can and cannot claim.

For example, the ATO will be writing to rental property owners in popular holiday locations, reminding them to only claim the deductions they are entitled to, for the periods the property is rented out or is genuinely available for rent.

Getting rental property deductions right

There are a few simple rules rental property owners should follow to avoid making mistakes on their tax return.

First, it is important for all property owners to keep accurate records. This helps to ensure they declare the right amount of rental income and they have evidence for claims made.

Secondly, rental property owners should only claim deductions for the periods the property is rented out or is genuinely available for rent. If a property is rented at below market rates, for example to family or friends, deduction claims must be limited to the income earned while rented.

Finally, costs to repair damage, defects or deterioration existing on purchase, or renovation costs, can't be claimed as an immediate deduction. These costs are deductible over a number of years.

Case studies

Holiday Homes

The ATO recently amended a taxpayer's return to disallow deductions claimed for a holiday home after discovering that:

- The taxpayer rented the home to family and friends during the year at less than market rate.
- Besides a brochure which was only available at the taxpayers' business premises, there were no realistic efforts to let the property.
- The nightly rent advertised was much higher than that of surrounding properties.
- The pattern of income did not match the advertised rate, or the requirement for a five-night minimum stay.

The ATO ruled that the property was mainly used for the taxpayer's personal use, and deductions were limited to the amount earned from family and friends. The end result was that the taxpayer had to pay more tax and a penalty was imposed.

Husband and wives

The ATO has seen instances where a husband and wife jointly own a property but split the income and deductions unequally to get a tax advantage for the highest income earner. Some people have even included the income in the low-income earner's returns and the deductions in the high-income earner's returns. These types of arrangements attract higher penalties where they have been done deliberately.

Refinancing

The ATO recently addressed a situation where a property was refinanced by a taxpayer to pay for their daughters' wedding and an overseas holiday. The taxpayer claimed the whole interest amount but should have only claimed the portion of interest that relates to the rental property.

Repairs and Maintenance

A taxpayer recently claimed repairs and maintenance for a newly acquired rental property which was significantly improved upon purchase. The taxpayer provided an invoice from an interior developer for the "refurbishment" of the property. Further, documentation detailed the scope of the refurbishment which included completely stripping the property and replacing old fixtures and fittings with new. The large repairs and maintenance claim was disallowed because initial repairs and improvements to a property are not deductible.

Rebuilding

A husband and wife demolished their existing rental property and built a new dwelling. In their income tax return, they claimed an immediate deduction for their share of the entire cost of the building as repairs and maintenance. While the cost of constructing the new dwelling for rental purposes is permitted, the correct treatment is to spread the cost over 40 years, claiming 2.5 per cent of eligible construction costs as a capital works deduction. The repairs and maintenance claim was disallowed.

INTEREST ON LOANS

If you take out a loan to purchase a rental property, you can claim the interest charged on that loan, or a portion of the interest, as a deduction. However, the property must be rented, or available for rental, in the income year for which you claim a deduction. If you start to use the property for private purposes, you cannot claim any interest expenses you incur after you start using the property for private purposes.

Similarly, if you take out a loan to purchase land on which to build a rental property or to finance renovations to a property you intend to rent out, the interest on the loan will be deductible from the time you took the loan out. However, if your intention changes, for example, you decide to use the property for private purposes and you no longer intend to use it to produce rent or other income you cannot claim the interest after your intention changes.

While the property is rented, or available for rent, you may also claim interest charged on loans taken out:

- to purchase depreciating assets;
- for repairs; or
- for renovations.

Banks and other lending institutions offer a range of financial products which can be used to acquire a rental property. Many of these products permit flexible repayment and redraw facilities. As a consequence, a loan might be obtained to purchase both a rental property and a private car. In cases of this type, the interest on the loan must be apportioned into deductible and non-deductible parts according to the amounts borrowed for the rental property and for private purposes.

If you have a loan account that has a fluctuating balance due to a variety of deposits and withdrawals and it is used for both private purposes and for rental property purposes, you must keep accurate records to enable you to calculate the interest that applies to the rental property portion of the loan; that is, you must separate the interest that related to the rental property from any interest that relates to the private use of the funds.

If you have difficulty calculating your deduction for interest, contact your qualified tax adviser or the Tax Office.

Some rental property owners borrow money to buy a new home and then rent out their previous home. If there is an outstanding loan on the old home and the property is used to produce income, the interest outstanding on the loan, or part of the interest, will be deductible. However, an interest deduction cannot be claimed on the loan used to buy the new home because it is not used to produce income. This is so whether or not the loan for the new home is secured against the former home.

CAPITAL ALLOWANCE AND DECLINE IN VALUE

Capital expenditure incurred in constructing buildings and structural improvements may be tax deductible at either 2.5% or 4% of the eligible construction expenditure, depending on when construction commenced and how the building is used.

The deduction generally commences from the time the building is used to produce income. Ideally, upon purchasing a property you should be given a copy of the construction expenditure costing. In practice, this often is not available. In these circumstances, obtain a report prepared by a Quantity Surveyor, (Q.S.), which can then be used to determine the amount of your claim.

Note that the Q.S. will also separately identify fixture, fittings and furnishings eligible for much higher decline in value depreciated claims. Any costs paid to the Q.S. in relation to the reports' preparation are tax deductible.

Often Q.S. reports cost between $400 and $500, but usually this proves to be money well spent as thousands of dollars of tax is saved.

NEGATIVE GEARING

Negative gearing may be explained as paying more interest and other outgoings than you receive in income from your investment. There are other (non-cash outgoings) such as depreciation that are also tax deductible.

At first negative gearing may seem unwise, but the following example may make the position clearer in the context of our current tax rules. Geared investments (shares, rental property or units' trusts financed by borrowings) provide a tax deduction if the interest and other costs of the investment exceed the income earned. This is called negative gearing.

If you purchase a house as an investment for $300,000 and borrow the entire amount at 7.5% pa interest, your annual interest repayments would total $22,500. You rent the house out for $350 per week, giving you an annual rental income of $18,200. The cost of rates, home maintenance, insurance, agent's fees and so on, total $6,000. The total tax deductions for this investment amount to $34,500 ($22,500 in interest, $6,000 in running costs and $6,000 in depreciation), but income is only $18,200.

The shortfall of $16,300 is wholly tax deductible – it is deducted from your gross income in assessing your taxable income. This is a considerable tax saving while you hold the investment. The investment, however, is making capital gains and you should eventually have a 50% CGT discount when the building is sold. If the investment property keeps pace with inflation, the running expenses are fully covered by the capital increase, but you have a tax deduction for the expenses.

CAPITALISATION OF INTEREST

In Hart v Federal Commissioner of Taxation (2002) it was held that compound interest, as with ordinary interest, derives its character from the use of the original borrowings.

In this case the compound interest was incurred on funds borrowed, under the split loan facility, to acquire property B which was used solely for income producing purposes. As such, the compound interest was incurred in earning assessable income and is an allowable deduction under section 8-1 of the ITAA 1997.

However, we stress the Commissioner will apply his discretion under Part IVA of the ITAA 1936 to disallow the deduction. A full and detailed explanation of the reasons for the application of Part IVA may be found in Taxation Ruling TR 98/22. We consider that the ATO holds a similar view on split lines of credit where the circumstances are similar to the above scenario in ID 2006/297.

However, we would stress that no two cases are the same and some interesting rulings are contained in the Register of Binding Financial Rulings on the ATO's website www.ato.gov.au.

We would point out the ATO appears to be increasing its focus in this area.

On 7 March 2012 Taxation Determination TD 2012/1 was released in relation to split loans structures described as 'investment loan interest payment' arrangements.

SELLING THE MAIN RESIDENCE

In 1998, Tony and Alison purchased a luxury house in Surfers Paradise.

In 2015, their children left home and the empty nesters are struggling with upkeep of the house and adjacent tennis court.

An option is to sell off the tennis court. If this occurs, they have been advised capital gains tax will be payable.

Let's consider the following:

Tony and Alison decide to demolish the existing house, subdivide the land into 2 titles, construct a new smaller house on each title, and sell both houses.

Income Tax - Are Tony and Alison merely realising their family home in most advantageous way or do their activities amount to a business venture: McCurry (1998).

Although they are selling the property, they have held for over 16 years, it could be argued they are doing far more simply then selling the family home in most profitable manner.

At first sight, MT 2006/1, which deals with entitlements to an ABN, supports the argument that this is a business-type venture.

MT 2006/1 contains the example of Prakash and Indira, who have lived in the same house on a large block of land for a number of years. Prakash and Indira have decided to move out from the area and, to maximise sale proceeds, demolish their house, subdivide land into 2 blocks and a build new house on each block (which they sell).

MT 2006/1 tales the position that Prakash and Indira are entitled to an ABN in respect of the subdivision on the basis their activities go beyond minimal activities needed to sell subdivided land.

We should consider whether MT 2006/1 (in essence a GST ruling) is relevant for income tax purposes?

If income tax applies, Tony and Alison's assessable income would include:

Sale proceeds – (value of blocks in 2006 + demolition costs + building costs + agent's fees).

CGT - If the transaction is on capital account, are Tony and Alison entitled to benefit of main residence exemption?

In respect of which dwelling? Tony and Alison do not appear to have used either dwelling as their main residence.

Does (should) the position change if Tony and Alison move back into 1 of the units before the sale? Is their use of the dwelling merely transitory?

GST - Per MT 2006/1, the ATO is likely to take position that Tony and Alison carrying on enterprise, and therefore required to register for GST.

Our second scenario is that alternatively, Tony and Alison don't wish to move out of the area but do want to scale down. They demolish the existing house, subdividing the land into 2 titles to build new houses one each title, then sell 1 house and retain and live in the other.

Income Tax - Could Tony and Alison argue that they didn't purchase family residence for resale at profit and have lived in the dwelling for 16 years? Further that the main reason for redeveloping was to 'scale down', living in a smaller, 'low maintenance' dwelling and to achieve this they had to sell part of their existing property. As such any gain would be on capital account.

However, the ATO could take the view that Tony and Alison have obtained Council approval, created 2 separate titles, built new houses, with their activities resulting in any profit on sale being assessable and not arising from a mere realisation of assets.

CGT - Tony and Alison are not entitled to main residence exemption on the sale of the separate house.

Consider also TD 2000/14 ("If you buy land and dwelling A, live in dwelling A, subdivide into 2 blocks and build dwelling B, and then sell dwellings A and B, is main residence exemption available for both dwellings?").

GST - MT 2006/1 doesn't provide a clear answer as to whether Tony and Alison are carrying on an enterprise, and therefore required to register as none of the examples given in the ruling match their circumstances. They may consider seeking a Private Ruling from the ATO.

Our third scenario is that Tony and Alison construct a dwelling on the tennis court, move into that new house for 6 months and rent out the old house. They then sell the new house before moving back into the old house.

Income Tax - As per above, are Tony and Alison just realising their family home in the most advantageous way or do their activities amount to a business venture: McCurry (1998).

CGT - Can Tony and Alison claim main residence exemption for gain on sale of new house? That is, can Tony and Alison choose that the new house is their "main residence" if they only live there 6 months before selling?

The following provides guidance:

- TD 51 ("What factors are taken into account in determining whether or not a dwelling is a taxpayer's main residence?"). Note, that TD 51 has been withdrawn.
- TD 92/135 ("Is the main residence exemption relevant when the proceeds of sale of a dwelling are treated as income under ordinary concepts?).

TAX SMART FINANCING STRATEGIES

1. Maximise the percentage borrowing against your rental property (if you have equity in your residential home, the bank will often be flexible).
2. Repay your residential loan as quickly as you can (use all your excess cash to repay this loan).
3. Consider asking the bank if you can defer repayments on your rental property loan as long as possible. Note it is best to have some separate levels of minimum repayment in respect of both your residential loan and your rental property loan.
4. If permitted, increase your rental property borrowings to pay for all the costs related to your rental property. Maintain a separate (flexible) overdraft facility to cover all the costs of your rental property, such as repairs, agent's fees, capital improvements, advertising, council rates, land tax etc.
5. Use an interest offset deposit account as your everyday account (i.e. your wages can be paid into this account), with the interest otherwise payable on the deposit account reducing the interest payable on your residential loan.
6. Consider the possibility of intra-marriage transfers. For example, if you are looking to rent out your longstanding jointly owned residence and purchase a new home, consider transferring your old residence wholly into the name of one spouse (who would borrow to make the acquisition). The new residence could perhaps be acquired by the other spouse. Stamp duty costs will have to be considered.
7. You will put yourself in a difficult position if you mistakenly increase your rental property loan for a private purpose and then, on discovering your "mistake" try to refinance this cost. It is vital to get your borrowings and repayments right the first time.

Ineffective Strategies

1. Do not use two separate loans which are completely linked in terms of having just the one joint credit limit and one joint minimum monthly repayment. Ensure that there are separate limits and separate repayment levels for each loan.

   Avoid a facility offered by a bank or other financial institution which promotes the "tax savings" in its marketing materials.
2. Avoid a split loan borrowing facility (i.e. one loan with two notional sub-accounts for separate borrowing purposes). This is unacceptable to the ATO.
3. Do not enter an arrangement which provides you with a tax saving, but which comes at a real commercial cost, such as payment of a higher interest rate or other charges.
4. Do not enter an arrangement with a bank which provides "unusual" terms – such as an indefinite deferral of repayment on one part of the borrowing.
5. Do not redraw amounts for private purposes from your rental property loan as this will mix the purposes and reduce the deductible element.

SMSFs – making loans

It is important for funds to keep in mind that high returns general equate with high risk and hence funds should obtain independent advice on investment decisions where possible. The fund's investment strategy should also be referenced and the reasons for making the loans clearly documented.

ATO GUIDANCE ON CAPITAL/REVENUE IN PROPERTY DEVELOPMENTS

In July 2019, the ATO released the Draft Property and Construction Website Guidance providing guidance in relation to the ATO position on property development and whether relevant property is held by the taxpayer on capital or revenue account.

The ATO says the Guidelines are to "facilitate consultation between the [ATO] ..., tax professionals, industry associations and taxpayers engaged in property transactions. The guidance aims to provide insight and transparency into our decision making on a range of property development scenarios that we are seeing."

Some of the factors outlined by the ATO in the Guidelines include whether:

- the landowner has held the land for a considerable period prior to the development and sale;
- the landowner has conducted farming, or other non-development business activities, on the land prior to beginning the process of developing and selling the land;
- the landowner originally bought the property as an investment, such as for long term capital appreciation or to derive rental income;
- the property has recently been rezoned and whether the landowner actively sought rezoning;
- a potential buyer of the property made an offer to the landowner before the landowner entered into a development arrangement;

- the landowner applies for rezoning and planning approvals around the time or sometime after acquisition of the property, but before undertaking further steps that might lead to a profitable sale or entering into development arrangements;
- the landowner has registered for GST on the basis that they are carrying on an enterprise in relation to developing the land;
- whether the landowner and developer are related entities;
- the level of financial risk borne by the landowner and the level of control of the landowner over the development; and
- the landowner has a history of buying and profitably selling developed land or land for development.

In the Guidelines the ATO indicates that where a taxpayer owns property on capital account and there is a change to revenue account then, depending on the facts and circumstances, that change could be a change of purpose to a profit-making undertaking or plan or the commencement of a business -this brings CGT event C4 into play.

The guidelines contain 12 worked examples that cover everything from large greenfield developments to smaller suburban land subdivisions.

We would urge anyone who wants to put gains on capital account (with the possible 50% CGT discount) to carefully review this guidance.

Isolated Transactions: Taxation Ruling TR 92/3

TR 92/3 is significant because the treatment of profits as assessable income can result from low scale developments.

In McCurry v FCT (1998), the Federal Court held that the profit made by 2 brothers on the purchase of land, the construction of 3 townhouses and the subsequent sale thereof, was a business operation or commercial transaction for the purpose of profit-making. The profit was therefore assessable as ordinary income, rather than as a capital gain.

In Taxation Ruling TR 92/3, the ATO sets out the following factors which may be relevant in determining whether an isolated transaction amounts to a business operation or commercial transaction:

- the nature of the entity undertaking the operation or transaction;
- the nature and scale of other activities undertaken by the taxpayer;
- the amount of money involved in the operation or transaction and the magnitude of the profit sought or obtained;
- the nature, scale and complexity of the operation or transaction;
- the manner in which the operation or transaction was entered into or carried out;
- the nature of any connection between the relevant taxpayer and any other party to the operation or transaction;
- if the transaction involves the acquisition and disposal of property, the nature of that property; and
- The timing of the transaction or the various steps in the transaction.

Although the above factors provide guidance, the Commissioner and taxpayers will often disagree as to how they should be applied in any given situation. In particular, there may well be arguments about whether the taxpayer has taken more steps than are necessary to effect a “mere realisation”.

What is clear is the need for specialist advice before embarking on any course of action.

IS AN ENTITY CARRYING ON A BUSINESS FOR GST PURPOSES?

GST Registration is required for taxpayers carrying on a business. For those “accidental developers” considerable care needs to be taken. Indeed, this is an issue that a lot of people will face. Although it is possible to argue that GST Registration is not necessary, due to realisation of a capital asset, the position is far from clear. The ATO may pursue the argument that the accidental developer’s activities are in the form of an adventure or concern in the nature of trade.

Note that the ATO can come in with the benefit of hindsight and form the view that an entity was carrying on a business for GST purposes. This can result in unsuspecting taxpayers suddenly having a large GST liability to deal with.

Under the GST Act, one of the requirements of a taxable supply is that the supply is made in course or furtherance of an enterprise. Note that ‘in the course or furtherance of an enterprise’ is not defined in the GST Act. However, the term ‘enterprise’ has a wide definition as an activity or series of activities done:

- In the form of a business;
- In the form of an adventure or concern in the nature of trade – see 'isolated transactions' overleaf.

Other items included in the definition are not relevant to this discussion.

For guidance on what is considered to be an enterprise, see MT 2006/1 mentioned above.

GST THE MARGIN SCHEME

When a taxable supply is made by a registered entity, it is liable for GST on the supply. The amount of GST is usually 1/11th of the sale price. However, when such an entity sells real property and is liable for GST on the sale of the property, it may elect to use the margin scheme to calculate its GST liability. Note however, it is not possible to use the margin scheme if the entity acquired the property through a taxable supply on which the GST was worked out without using the margin scheme.

Under the margin scheme the amount of the GST liability is 1/11th of the MARGIN (which is usually the sale price less cost of acquisition).

If the margin scheme is used, the purchaser will NOT be entitled to input tax credits on the acquisition – more on this later.

Example - Builder Pty Ltd purchases land from Wealthland for $1.1 million. When the transaction occurred, the margin scheme was used to calculate vendor Wealthland's GST and both entities are registered for GST.

Builder now sells the land to Smithers for $1.32 million. Builder is eligible to use the margin scheme to calculate its GST liability on the transaction. This is because the original purchase of the land from Wealthland constituted a taxable supply to Builder and the GST on that sale by the vendor was calculated using the margin scheme. If Builder uses the margin scheme, with the prior written consent of Smithers, its GST liability will be $20,000 (1/11th x ($1,320,000 - $1,100,000)).

Note however that Smithers will not be eligible to claim any input tax credit on the acquisition. If the margin scheme were not used, Builder's GST liability would be $120,000 (1/11th x $1,320,000). In that case Smithers would be able to claim input tax credits on the acquisition.

If the margin scheme had NOT been used in the original transaction (Wealthland to Builder) and GST had been calculated using the normal method, then Builder would not be allowed to use the margin scheme when it sold to Smithers.

In the event Wealthland was not a GST registered entity at the time it sold to Builder and not required to be registered, it would not be liable to pay any GST on the transaction. In that case Builder would still be entitled to use the margin scheme when it sells the land to Smithers. Note the only time an entity is disqualified from using the margin scheme is when it acquires a property through a taxable supply on which the GST was calculated without using the margin scheme.

Business Activity Statements

Recent updates have dealt with tax cases where taxpayers filling out B.A.S. have incorrectly claimed input tax credits where the margin scheme was applied on the purchase of real property. The ATO have shown little leniency when applying penalties and real care needs to be taken.

Cases

AAT Case (2009) AATA 805, YXFP and FCT – Supply of property not GST-free; no deduction for trading stock

The AAT has confirmed that the sale of a property by a property developer was not a GST-free supply by a going concern because the taxpayer had not satisfied that the supplier and recipient agree in writing that the supply is of a going concern.

Also, the AAT considered whether an amount of $220,000 was considered legitimate trading stock and as such tax deductible.

However, the AAT determined that the $220,000 was in fact more in the nature of a capital contribution or loan to another property developing entity. Although the taxpayer may have been genuine in his belief that there had been an acquisition of trading stock, the AAT clearly thought otherwise, rejecting the tax deduction. So, developers beware, if the matter is not clear cut or there are unusual circumstances involved (particularly other entities), be very careful before making a claim for trading stock.

SMSF AND PROPERTY DEVELOPMENT

Property Development as opposed to passive investment means an entity is engaged in business

This issue comes up time and time again and a common misconception is that superannuation funds cannot carry on a business.

A review of SISA, the SISR and the Tax Acts finds no provision that prevents a SMSF from operating a business.

Further confirmation exists:

- The national tax liaison group sub-committee minutes of 28.10.2005.
- Various ATO publications.

However, this does **not** give SMSF trustees carte blanch to engage in these activities.

There is too much at stake here and you must take specialist advice.

Broader Superannuation Industry (Supervision) Act 1993 (SISA) considerations include:

- Prohibition against acquiring assets from related parties' section 66;
- The in-house asset rules Part 8 SISA;
- Prohibition against providing financial assistance to members section 65;
- The prohibition against borrowing section 67 but, note the exception for limited recourse borrowing arrangements (LRBA)...however these loans can only be taken out to purchase completed property;
- The sole purchase test – section 62;
- Investment strategy – section 52(B)...here any property development activities must be consistent with this;
- Trustees must not allow assets owned by SMSF to be encumbered by a mortgage view or other security – Reg 13.14 SISR;
- Trustee remuneration – section 17A – if a SMSF remuneration should not be paid.

These are only some of the considerations and we will expand on these and some trust structures in our forthcoming superannuation bonus issue.

HOLDING SHARES OR ACTIVELY TRADING: WHAT IS THE DIFFERENCE?

Until recently the Australian share market had enjoyed an extended period of growth, with prices at historically high levels and solid dividends being paid.

Taxpayers who have bought or sold shares as part of their investment strategy will need to determine their tax liability. An important part of that process involves deciding whether they are a share trader or shareholder.

While the Tax Office considers each case on its individual features, in summary, a share trader is someone who carries out business activities for the purpose of earning income from buying and selling shares. A shareholder, on the other hand, is someone who holds shares for the purpose of earning income from dividends and similar receipts.

Relevant matters include nature, regularity, volume and repetition of the share activity; the amount of capital employed; and the extent to which there is organisation in a business-like manner, through the keeping of books or records and the use of a system.

For a **share trader**:

- receipts from the sale of shares are income;
- purchased shares would be regarded as trading stock;
- costs incurred in buying or selling shares are an allowable deduction in the year in which they are incurred; and
- dividends and other similar receipts are included in assessable income.

In the case of **shareholder**:

- the cost of purchase of shares is not an allowable deduction – it is a capital cost;
- receipts from the sale of shares are not assessable income – however, any net profit is subject to capital gains tax;
- a net loss from sale of shares may not be offset against income from other sources, but may be carried forward to offset against future capital gains made from the sale of shares;
- costs incurred in buying or selling shares are not an allowable deduction in the year in which they are incurred, but are taken into account in determining the amount of any capital gain;
- dividends and other similar receipts are included in assessable income; and
- costs incurred in earning dividend income – such as interest on borrowed money – are an allowable deduction at the time they are incurred.

These practical examples supplied by the Tax Office could be helpful:

Carrying on a business of share trading

A 'business' for tax purposes includes 'any profession, trade, employment, vocation or calling, but does not include occupation as an employee.' This definition would include a business of share trading.

The question of whether a person is a share trader, or a shareholder is determined in each individual case. This is done by considering the following factors that have been used in court cases:

1. the nature of the activities, particularly whether they have the purpose of profit making;
2. the repetition, volume and regularity of the activities, and the similarity to other businesses in your industry;
3. the keeping of books of accounts and records of trading stock, business premises, licences or qualifications, a registered business name and an Australian business number;
4. the volume of the operations;
5. the amount of capital employed.

Nature of activity and purpose of profit making

The intention to make a profit is not, on its own, sufficient to establish that a business is being carried on.

A share trader is someone who carries out business activities for the purpose of earning income and buying and selling shares.

Shares may be held for either investment or trading purposes, and profits on sale are earned in either case. A person who invests in shares as a shareholder (rather than a share trader) does so with the intention of earning income from dividends and receipts but is not carrying on business activities. It is necessary for you to consider not only your intention to make a profit, but also the facts of your situation. This would include details of how the activity has actually been carried out or a business plan of how the activities will be conducted.

A business plan might show, for example:

- an analysis of each potential investment;
- analysis of the current market and various segments of the market;
- research to show when or where a profit may arise.

Share trader

Sally is an electrical engineer. After seeing a television program, Sally decides to start share trading. She sets up an office in one of the rooms in her house. She has a computer and access to the internet.

Sally has $100,000 of her own funds available to purchase shares and, in addition, she has access to a $50,000 borrowing facility through her bank.

She conducts daily analysis and assessment of developments in equity markets, using financial newspapers, investment magazines and stock market reports. Sally's objective is to identify stocks that will increase in value in the short term to enable her to sell at a profit after holding them for a brief period.

In the year ended 30 June 2006, Sally conducted 60 share transactions: 35 buying and 25 selling. The average buying transaction involved 500 shares and the average cost was $1000. The average selling transaction involved 750 shares and the average selling prices was $1800. All transactions were conducted through stock broking facilities on the internet. The average time that shares were held before selling was twelve weeks. Sally's activities resulted in a loss of $5000 after expenses.

Sally's activities show all the factors that would be expected from a person carrying on a business. Her share trading operation demonstrates a profit-making intention even though a loss has resulted. There is a repetition and regularity to her activities. Her activities are organised in a business-like manner. The volume of shares turned over is high and Sally has injected a large amount of capital into the operation.

Shareholder

Cecil is an accountant. He has bought 20,000 shares in twenty 'blue chip' companies over several years. His total portfolio costs $500,000. Cecil bought the shares because of consistently high dividends. He would not consider selling shares unless their price appreciated markedly before selling them. In the year ended 30 June 2006, he sold 2,000 shares over the year for a gain of $30,000.

Although Cecil has made a large gain on the shares, he would not be considered to be carrying on a business of share trading. He has purchased his shares for the purpose of gaining dividend income rather than making profit.

TAX-SMART, INVESTING IN SHARES

If you own shares you will have tax entitlements and obligations. Don't pay more tax than you need to.

Acquisition	Ownership	Disposal
You can acquire shares: • By buying • By inheriting • As a gift • On the breakdown of your marriage • Through employee share schemes • Through a conversion of notes to shares • Through demutualisation • Through bonus share schemes • Through dividend reinvestment plans • Through mergers, takeovers and demergers	The following activities can affect your tax: • Receiving dividends • Dividend reinvestment plans • Bonus share schemes • Call payments on bonus share schemes • Receiving non-assessable payments • Mergers, takeovers and demergers.	Disposing of your shares can affect your tax. You can dispose of your shares: • By selling • By giving them away • On the breakdown of your marriage • Through company liquidation • Through share buy-backs • Through mergers, takeovers and demergers.
What you do during each stage of the life of your shares can affect your tax for years to come.		

BUYING Did you know?	OWING Did you know?	SELLING Did you know?
• Generally, the names you put on the purchase order determine who must declare the dividends and can claim the expenses.	• You need to declare all of your dividend income on your tax return, even if you use your dividend to purchase more shares (for example through a dividend reinvestment plan).	• When you dispose of your shares you may make a capital gain or capital loss.
• If you hold a policy in an insurance company that demutualises, you may be subject to capital gains tax either at the time of the demutualisation or when you sell your shares.	• Tax deductions on shares can include management fees, specialist journals and interest on monies borrowed to buy them.	• Your capital gain is the difference between your 'cost base' (costs of ownership) and your 'capital proceeds' (what you receive when you sell your shares).
• Even if you did not pay anything for your shares you should find out the market value at the time your acquired them.	• Receiving bonus shares can alter the capital gains tax cost base (costs of ownership) of both your original and bonus shares.	
• In some circumstances, you may be the owner of shares purchased in your child's name.	• You may choose to roll over any capital gain or capital loss you make under an eligible demerger.	• The law has been changed so that an administrator as well as a liquidator can declare that a company's shares are worthless.
• Costs associated with buying your shares such as brokerage fees and stamp duty are not deductible, however they form part of the cost base (costs of ownership) for capital gains tax purposes.	• The ATO produces an information fact sheet for each major takeover, merger or demerger.	• If you have owned your shares for more than 12 months, you may be able to reduce your capital gains by the tax discount of 50%.
• Payments or other benefits you obtain from a private company in which you are a shareholder may be treated as if they were a taxable dividend paid to you.	• Simply transferring your shares into someone else's name may mean you have to pay capital gains tax.	

Cases:

Greig V Commissioner of Taxation (2018) FCA 1084: Revenue Vs Capital and Lessons for Investors

This case highlights the uncertainty in respect of the revenue and capital implications of some share sales and was an appeal by the taxpayer against a decision by the Commissioner of Taxation's disallowance of deductions under section 8-1 ITAA1997 of share losses and litigation costs totalling $12.35m.

The taxpayer argued he had an intention to make short-term profits from the purchase of shares on the ASX. However, the taxpayer's appeal was disallowed because the Court held that he was not in a business operation or commercial transaction of purchasing shares and was not carrying on a business of dealing in shares.

The taxpayer had a diverse portfolio of shares and made regular investments. With the help of his financial adviser, the Taxpayer bought $11.85m worth of shares in Nexus Energy Limited **(Nexus)** over a period of 25 months in 2013 and 2014. The taxpayer's investment approach - was to generate profits over a short-term period from investments in the mining, energy, and resource sectors. The taxpayer made gains and losses from his share portfolio and treated those losses as being on capital account (on this basis, the capital gains tax (CGT) rules applied.

Nexus went into voluntary administration in June 2014 and the taxpayer made a $11.85m share loss on his Nexus shares in December 2014 and incurred a further $0.5m in legal fees due to the legal action he took against Nexus and its voluntary administration.

The taxpayer's contention was that the share loss and legal fees should be deductible under section 8-1 (revenue account) relying on the principle in the Myer Emporium case because he had a profit-making intention at the time of purchasing the Nexus shares and he conducted a business of buying and selling Nexus shares.

The Myer Emporium principle is that an isolated transaction is ordinary income if the intention or purpose of the taxpayer in entering into the transaction was to make a profit or gain and the transaction was entered into, and the profit was made, in the course of carrying on a business or in carrying out a business operation or commercial transaction.

Thawley J agreed that the taxpayer had a profit-making intention when buying the Nexus shares. However, the case turned on the whether the taxpayer bought the Nexus shares as part of a "business operation or commercial transaction" or whether the taxpayer was in the business in "dealing" in Nexus shares.

On this point, the taxpayer could not lead sufficient evidence that his actions were different to that of investors who purchase shares with the intention of deriving dividends or hoping the share price would increase or both. The taxpayer's arguments that he researched extensively into the Nexus shares and the continuous acquisition of the shares did not amount to actions constituting a "business operation or a commercial transaction".

Accordingly, Thawley J held that the taxpayer was not in the business of dealing in Nexus shares and the $12.35m of share losses and litigation costs were not deductible under section 8-1.

Executor for the Late J.E. Osborne V FC of T (2014) AATA 128

This is an interesting case decided in favour of the taxpayer, i.e. that the trading in shares constituted a business. This has implications for persons managing a share portfolio under a power of attorney and also is the management of a deceased estate.

Decision Impact Statement - Mehta and Commissioner of Taxation

The taxpayer was in full time employment at all times during the income years under review. On 26 June 2007, the taxpayer made an application for a margin lending facility and soon thereafter made his first purchase of shares.

During the income tax year ended 30 June 2008, the taxpayer made a total of 32 purchases and 3 sales. The taxpayer did not regard himself to be in a business of share trading for the year ended 30 June 2008.

During the income year ended 30 June 2009, the taxpayer carried out a total of 22 purchases and 27 sales of shares. He contributed $150,000 of his own capital to purchase shares and borrowed another $500,000 from BT Australia. The taxpayer also established a dedicated office for the share trading business in his home.

In his income tax return for the year ended 30 June 2009, the taxpayer claimed a loss of $125,293.

The Commissioner disallowed the claim on the basis that the taxpayer was not carrying on a business of share trading. The taxpayer objected and then applied to the Administrative Appeals Tribunal for review of the objection decision which affirmed the original decision.

The Tribunal found that the taxpayer was in the business of carrying on a business of share trading in the 2009 income year.

The ATO took the view that the case was decided on its facts and will not have any impact on any existing or future litigation proceedings.

Devi and Commissioner of Taxation (Taxation) (2016) AATA 67 (9 February 2016)

In this case the AAT found that a taxpayer was not carrying on a business of share trading. As such the taxpayer was not entitled to claim $20,000 loss resulting from share transactions in the 2011 income year. At the relevant time the taxpayer was paid around $40,000 per annum as a childcare worker.

In July 2010, the taxpayer commenced substantial share trading. In the 2010/11 year, the taxpayer engaged in 108 share transactions which included 71 purchases valued at approximately $380,000 and 37 sales valued at approximately $215,000. These transactions were in the main carried out in the first six months of the year with only 10 transactions, to a value of around $70,000, taking place in the second half of the year. Twenty different companies were involved, and the taxpayer claimed to have spent between 15 and 25 hours per week on these activities.

Key extracts from judgement:

"In this case, the factors which favour Ms Devi carrying on business as a share trader are as followers:

- The turnover was substantial, particularly having regard to Ms Devi's wages; and
- Ms Devi maintained a home office for the purpose of undertaking the share transactions.

The factors which do not favour Ms Devi carrying on business are as follows:

- The share transactions were not regularly and systematically carried out throughout the 2011 income year – there were only 10 share transactions in the second half of the income year;
- The activities were very basic and lacked sophistication to constitute a share trading business;
- There was no demonstrated pattern of trading although I accept there was a business plan even before the written document was later produced; and
- She had no skills or experience or interest in shares.

In my view, the specific share trading factors weigh heavily against Ms Devi carrying on a share trading business.

Having regard to the evidence and to all the factors set out above, Ms Devi was not carrying on business as a share trader. Her activities were very basic and lacked sophistication to constitute a share trading business particularly as there was no demonstrated pattern of trading."

This case serves as a warning to advisers and taxpayers alike. Do not assume that because you start off with a flurry of activity that you are automatically a share trader.

In giving her evidence, it was clear the Taxpayer lacked detailed knowledge of the ASX and the shares she had invested in. Also, expect ATO scrutiny, where "share trading" losses cause losses resulting in large refunds on PAYG employment income.

UNSOPHISTICATED SHARE TRADING ACTIVITIES NOT A "BUSINESS"

Hill V FC of T [2019] AATA 1723, P Britten – Jones (Deputy President) and S Griffiths (Member), Adelaide, 8 July 2019.

In similar fashion to Devi, it was held that a taxpayer's share trading activities were not a "business" as they were unsophisticated and not carried out in a business-like manner. As a result, the taxpayer was not entitled to claim or carry forward existing losses in the income years in question.

The taxpayer worked in the aviation industry and also traded shares on the ASX. Orders were usually placed on his days off with most transactions placed using a computer in a home office set up for trading. For research, the taxpayer used the internet generally. He did not consult a stockbroker or financial advisor. His share trading plan was to obtain retirement income. The "business plan" was a half-page document with few records of trading kept. Following an audit, the Commissioner determined that the taxpayer's share trading activities were not a "business", resulting in revenue and carried forward loses being denied in the 2015, 2016- and 2017-income years. After the Commissioner disallowed his objection, the taxpayer applied to the AAT for a review of the objection decision.

The AAT said the taxpayer's share trading was infrequent and characterised by numerous periods of no trading. There was also no established system and the trading was irregular. This pointed to the taxpayer being involved in a series of individual transactions on a speculative basis rather than as a share trader conducting a business. As the taxpayer was working full-time in the aviation industry for the majority of the relevant period, the overall impression was that the share trading activities were very much a side issue which did not occupy a significant amount of the taxpayer's time except for a limited period when trading became more frequent and extensive.

In addition, the AAT found the taxpayer did not arrange his share trading activities in a business-like manner; he did not incorporate a trading vehicle or register a business name and there were few records kept of the trading or other associated activities. Further, the taxpayer did not engage professional assistance from a stockbroker or financial planner despite having no qualifications in these areas. His written business plan was unsophisticated and contained very little detail.

Key points in ruling

- The share trades were infrequent and there were many periods of no trading with no established system and irregular trading.
- This indicated a series of individual transactions on an irregular basis – not a genuine share trader carrying on a business.
- Given the taxpayer's full-time occupation in the aviation industry for most of the period in question, this pointed to the share trading being a side issue except for a limited time of frequent trades.
- Further the taxpayer did not incorporate a trading vehicle or register a business name and few records were kept. There were no budgets of intended expenditure or expected revenue.
- As stated, he did not engage any professionals, undertake extensive research or seek specialist advice. Given he had no qualifications in the area, the applicant would have sought professional assistance from a broker, bookkeeper or accountant if his intention was to operate a business of share trading.
- His written business plan was unsophisticated and contained very little detail. Stating an intention to invest in shares to receive dividends and capital growth in the medium to long term is not indicative of an intention to carry out a share trading business.

TAX IMPLICATIONS FOR VARIOUS SECURITIES

Tax time is a confusing time of year for most investors. The ASX assembled the following table to help identify the tax implications of the various products traded on ASX.

Instalment Warrants	Holders will need to consider dividends and associated franking credits (subject to 45 day holding period rule). Some Holders may be entitled to deductions for interest paid. Remember, some instalment transactions involving shares and warrants may not trigger a capital gains tax event.
Exchange Traded Options	Tax assessment is dependent on individual's classification as a trader, a speculator, or as a hedger. Selling options for premiums is treated as income subject to the individual's classification (as above). Buying an option and then exercising into the underlying share adds to the cost base for CGT purposes. The length of time shares are held for will determine the CGT rate, and remember the holding period rule in relation to dividends.
Listed Investment Companies (LICs)	Dividend payments are typically fully franked and capital gains are managed by the fund manager to minimise cost to investors.
Equities (shares)	Shareholders need to keep a record of the date and value of share parcels they acquire. When shares are sold, they are generally subject to capital gains tax (CGT). The length of time shares are held for will affect the CGT rate applicable. Shareholders can receive franked dividends. These carry imputation credits that may potentially reduce tax payable on dividend income. Shareholders should consult their taxation adviser regarding the deductibility of interest on margin loans.
Bonds and Hybrids	The sale or redemption of bonds is generally not subject to CGT but is assessable for income tax. However, there are CGT considerations following disposal of shares that are received from convertible notes. It is important to note that there are distinctions in the taxation treatment for convertible notes issued after 14 May 2002.
International Shares via ASX World Link®	ASX World Link® service provides dividend and transaction information in Australian dollars to help in preparation of tax returns. Investors may be able to claim a foreign tax credit in respect of all or part of the dividend withholding tax amount.
Infrastructure funds	A portion of the income (distributions) is typically tax deferred until the holder sells their units. Property trusts a portion of the income (distributions) is typically tax deferred until the holder sells their units.
Pooled development funds (PDFs)	These funds display some unique taxation characteristics and investors are advised to seek professional advice. Generally, capital gains and dividends are tax-free. The PDF only pays 15% corporate tax rate. Dividends carry franking credits at the 30% rate.
Exchange Traded Funds (EFTs)	Dividends from EFTs typically have franking credits attached to them. Capital gains are managed by the fund manager in order to minimise costs to investors. Low portfolio turnover means Indexed EFTs have low capital gains tax consequences.
Absolute Return funds	Capital gains are managed by the fund's manager to minimise cost to investor. Dividends may be fully franked.

Investors' Disposal of Shares

If you have sold or given away shares you may have a capital gain or capital loss to take into account when completing your tax return for the income year in which you sold or gave them away.

Acquisitions and Disposals

You acquire shares when you become their owner. The most common way of acquiring your shares is by buying them. However, there are other ways such as receiving them:

- As bonus shares;
- On the breakdown of your marriage;
- Through a conversion of notes to shares;
- Through employee share schemes;
- Through demutualisation;
- Through a merger, takeover or demerger;
- Through dividend reinvestment plans; and
- As an inheritance or as a gift.

Simply, you dispose of your shares when you stop being their owner. The most common way of disposing of your shares is by selling them. Other ways include disposal through a merger, takeover or demerger, or through a share buy-back. You may also dispose of the shares by giving them away or through your will upon death.

What happens when you sell or give away shares?

Disposing of shares is a capital gains tax event (CGT event). When a CGT event happens, you need to know whether you have made a capital gain or a capital loss to determine whether you need to pay tax on your capital gain or claim a capital loss on your tax return. Sometimes a rollover may apply which enables the capital gain to be deferred or disregarded until a later CGT event happens.

You can only offset your capital losses against capital gains you make on other assets, reducing the overall amount of tax you must pay. You can use these losses in the financial year you made them, with unused capital losses carried forward for use in a future year.

To work out your capital gain or capital loss – and therefore ensure you do not pay more tax than you need to – you need to know how much you spent on your shares when you first acquired them and while you owned them. This means making sure you keep records.

If you give away shares or your shares were given to you as a gift, you use the stock exchange closing price on the date of the gift in your calculation. If the company is not quoted on the exchange – for example, it is a private company, you will need an independent accounts valuation to demonstrate the share value.

Why should you keep records?

You will generally either pay tax on any capital gain or claim a capital loss on what you make on your shares when you sell them or give them away. You will need to have records to work out whether you can claim a capital loss or record a capital gain when you complete your yearly tax return.

Although CGT on shares transferred under a Will is usually disregarded, your beneficiaries may need your records to work out the cost base of your shares.

You need to keep evidence of all you've spent, from the beginning, to ensure you (and your beneficiaries) do not pay more tax than needed.

What records should you have?

Most of the records you will need would have been given to you by the company that issued the shares, your stockbroker or online share trading provider and your financial institution (if you took out a loan). It is important for you to have kept everything they gave you in relation to your shares.

You should have records of:

- The date of purchase;
- The date of sale;
- The amount paid to purchase the shares;
- Any commissions paid to brokers when you acquired or disposed of them;
- Any stamp duty paid; and
- The amount received upon sale.

You may (if applicable) also need records of:

- Details of any non-assessable payments made to you during the time you owned the shares;

- The date and amount of any calls, if the shares were partly paid;
- The date and number of shares purchased through a dividend reinvestment plan;
- The treatment of your shares during a merger, takeover or demerger; and
- The amount of any loans taken out to purchase your shares.

What do you do if you don't have records?

If you do not have the relevant records, you may be able to reconstruct them by obtaining copies, or details from:

- The company;
- Your stockbroker or investment adviser;
- Your bank statements;
- The Australian Stock Exchange (ASX);
- The share registry administering the shares;
- Your online share trading provider; or
- Your financial institution.

The main thing is to get as many relevant details as possible. In particular, each record should show:

- The date of the transaction / event;
- The parties involved; and
- How it is relevant to working out your capital gain or capital loss (that is, what the receipt or record is for).

How long should you keep records?

You must keep records of everything that affects your capital gains and capital losses for at least five years after the relevant CGT event (such as the sale of the shares).

Is there an easier way for you to keep records?

Yes. An easier way to keep your records is to set up a capital gains tax (CGT) asset register. It is comparatively easy and once you have entered your information into the register you may be able to discard records much sooner than would otherwise be the case.

If you have a taxable capital gain on the disposal of an asset such as shares, carefully consider whether you have purchased an eligible asset that has gone down in value. Prior to 30 June each year, consideration should be given to crystallising capital losses. This means in effect, creating a capital gains tax event disposal by selling an underperforming asset to offset taxable capital gains with taxable capital losses.

SHARE INVESTORS

"Wash Sales" and Part IVA

Taxable ruling (TR2008/03) deals with the "Application of Part IVA to 'wash sale' arrangements."

Generally speaking, the term 'wash sale' refers to an arrangement under which a taxpayer sells an asset to realise a capital loss on the sale, and then offsets this against a capital gain that they have made elsewhere.

The ATO will examine transactions where there is effectively no change in beneficial ownership of the asset, because the taxpayer either buys the asset back at the lower cost base or sells it to a related party.

The message here is don't make it obvious that the disposal is a wash sale.

SHARE TRADERS

At year end, when reviewing share trading profitability and other assessable income, carefully consider closing stock valuations for ASX listed shares. Effectively you have a choice to value each individual parcel of shares at purchase cost or listed market value. This could enable you to defer tax or better utilise lower marginal tax rates over a number of years.

TAXATION DETERMINATION TD 2011/22

TD 2011/22 released in August 2011 determines that Part IVA of the Income Tax Assessment Act 1936 can apply to a scheme designed to convert otherwise assessable interest income into non-assessable non-exempt dividends.

Be very cautious about entering into such arrangements.

DISCLAIMER

The information statement and opinions expressed in this publication are only intended as a guide to some of the important considerations to be taken into account relating to taxation matters. Although we believe that the statements are correct, and every effort has been made to ensure that they are correct, they should not be taken to represent taxation advice and you must obtain your own independent taxation advice. Neither the authors, nor the publisher or any people involved in the preparation of this publication give any guarantees about its contents or accept any liability for any loss, damage or other consequences which may arise as a result of any person acting on or using the information and opinions contained in this publication.

Readers seeking taxation advice should obtain their own independent advice and make their own enquiries about the correctness of the information set out in this publication and its accuracy in relation to their own particular circumstances.

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