Corporate Essentials

Tax Smart Australia

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#0089

Tax Essentials - Tax Effective Shares & Property Investment

OCTOBER 2017

THE NEWSLETTER
Recent Tax Developments

LEIGH'S CORNER
New Legislation to Protect Vulnerable Workers

Article No.37

SPECIAL BONUS ISSUE
Tax Effective Shares & Property Investment

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The Newsletter

Recent Tax Developments

MORE TIME TO LODGE AND PAY YOUR ACTIVITY STATEMENT

You may qualify for an extra two extra weeks to lodge and pay your quarterly activity statement if you lodge it online:

- using the ATO online services for sole traders (you will need a myGov account)
- through the A.T.O. Business Portal
- directly from your Standard Business Reporting enabled software.

Lodging online is easy, quick and secure making it faster to complete future activity statements.

By lodging your activity statement online you can avoid any delay in getting your refund as you will be prompted to correct simple errors while lodging. Remember to enter amounts as whole dollars – you shouldn't include cents.

If you can't pay on time, the A.T.O. can help you. Make sure you lodge your statement by the due date and phone them on 13 11 42 to discuss your circumstances. You can also set up an automated payment plan online.

TERMS AND CONDITIONS – TWO WEEK DEFERRAL OFFER

If you lodge your quarterly activity statements online, you may qualify for a two week deferral of your activity statement due date. This offer is ongoing and is subject to the following terms and conditions.

This offer applies to most activity statements for the standard quarters ending 30 September, 31 March and 30 June which have an original due date of the 28th of the month, following the end of the quarter – that is, quarters 1, 3 and 4 (quarter 2 activity statement lodgers already have eight weeks to lodge).

This offer does not apply to:

- monthly activity statements
- monthly GST payers with quarterly PAYG instalments (or other quarterly roles) –this includes businesses that are required to or elect to report on a monthly basis
- quarterly PAYG instalments for head companies of consolidated groups
- entities with substituted accounting periods that are classified as a large business client (see note below)
- any other clients who do not have an original due date of the 28th
- quarterly instalment notices, for example forms
  - R *(Quarterly PAYG instalment Notice)*
  - S *(Quarterly GST instalment Notice)*
  - T *(Quarterly GST & PAYG instalment Notice)*.

A large business client is defined as a client with:

- annual total income in excess of $10 million
- GST turnover of $20 million or more
- annual withholding payments in excess of $1 million, or an entity in a group of companies where at least one member of that group has an annual total income in excess of $10 million.

CHECKLIST TAX CHANGES THAT APPLY FROM 1.7.2017

SMALL BUSINESS

1) From 1.7.2017, Simplified BAS reporting is applies to small business entities.
2) The corporate tax rate for base rate entities is 27.5% from 1 July 2017. A company is a base rate entity if it carries on business and has an aggregated turnover for the year that is less than $25m.
3) From 1.7.2017, The A.T.O. is able to disclose to Credit Reporting Bureaus the tax debt information of businesses that have not effectively engaged with the A.T.O. to manage these debts.

CAPITAL GAINS TAX

1) The C.G.T. main residence exemption is no longer available to foreign and temporary tax residents from 7.30 pm (AEST) on 9.5.2017.
2) From 1.7.2017, C.G.T. event E4 will not arise where a trust receives a tax-free gain under the early stage innovation company provisions.

3) The C.G.T. foreign resident withholding rate is 12.5% from 1.7.2017 (previously 10%) and the threshold at which the C.G.T. withholding obligation applies to Australian real property has been reduced to $750,000 (previously $2m).

FRINGE BENEFITS TAX

1) For the F.B.T. year commencing 1.4.2017, the F.B.T. rate is 47%.
2) As such concessional tax treatment thresholds for certain employers revert back to $30,000 and $17,000 respectively.

GOODS AND SERVICES TAX

1) G.S.T. reporting and record-keeping has been simplified form 1.7.2017 for small businesses with a turnover of less than $10m.
2) The definition of "financial supply" has been extended to include the supply of bank accounts and superannuation interests by foreign financial institutions from 1.7.2017.
3) The G.S.T. treatment of digital currency such as bitcoin will be aligned with that of money from 1.7.2017 to avoid potential double taxation.
4) G.S.T. extends to cross-border supplies of services and intangibles, such as digital products, to Australian consumers from 1.7.2017.

RENTAL PROPERTY

1) Travel expenses related to inspecting, maintaining or collecting rent for a residential rental property have been disallowed effective 1.7.2017.
2) From 1.7.2017, eligibility for deductions for depreciating plant and equipment in a residential rental property will be limited to the taxpayer that actually incurred the outlay to purchase the plant and equipment and not to successive investors in the property.

INTERNATIONAL

1) The Foreign investment framework will be clarified and simplified with effect from 1.7.2017 to make foreign investor obligations clearer.
2) The diverted profits tax (DPT) applies to tax benefits under a relevant scheme derived in income years commencing on or after 1.7.2017.
3) Failure-to-disclose penalties have been increased for significant global entities.

SUPERANNUATION

1) The low income superannuation contribution scheme is abolished from 2017/18; a low income superannuation tax offset will be available for 2017/18 and later years.
2) The annual cap on concessional contributions has been reduced to $25,000 from 1.7.2017 for all individuals regardless of their age.
3) The threshold at which high income earners are liable for Division 293 tax has been lowered from $300,000 to $250,000 from 1.7.2017.
4) The restriction on funds accepting fund-capped contributions has been abolished from 1.7.2017.
5) A $1.6m transfer balance cap applies to the total amount of accumulated superannuation an individual can transfer into the tax-free retirement phase from 1.7.2017.
6) From 1.7.2017, the annual non-concessional contributions cap has been reduced to $100,000; individuals with a superannuation balance of more than $1.6m are not eligible to make non-concessional contributions from 1.7.2017.
7) Eligibility for the spouse contributions tax offset has been extended to individuals whose spouses earn up to $40,000 from 1.7.2017.
8) The 10% test to determine an individual's eligibility for deductions for personal superannuation contributions has been removed from 1.7.2017; contributions to certain prescribed funds are not tax-deductible.
9) A superannuation transfer balance cap will limit the total amount of accumulated superannuation that an individual can transfer into the tax-free retirement phrase from 1.7.2017; excess transfer balance tax is payable for exceeding the cap.
10) An individual's total superannuation balance concept is used to determine eligibility for various tax concessions from 1.7.2017.
11) Transitional C.G.T. relief applies for assets transfers in connection with changes to the tax treatment transition to retirement income streams and compliance with the superannuation transfer cap.
12) The tax exemption for income derived from assets has been changed to apply only to income streams in the retirement phase. Individuals can not treat superannuation income stream payments as lump sum superannuation benefits for tax purposes from 1.7.2017.

13) The anti-detriment provision, which allows superannuation funds to claim a tax deduction for a portion of the death benefits paid to eligible dependants, has been removed effective 1.7.2017.

14) The tax on working holiday makers' superannuation payments when they leave Australia is 65% effective 1.7.2017.

CONFUSION OVER SMALL BUSINESS COMPANY TAX CUTS

In our last issue #88, we indicated that given recent A.T.O. comments there was a possibility that the small business company tax cuts could apply to passive investment companies.

On 4.7.2017, The Minister for Revenue and Financial Services issued a media release in response to this. The Minister indicated that the policy decision made by the Government to cut the tax rate for small companies was not meant to apply to passive investment companies.

GUIDANCE ON PROPOSED SIMILAR BUSINESS TEST FOR ACCESSING LOSSES

The A.T.O. released Draft Law Companion Guideline LGG 2017/D6 on 21 July 2017, which provides guidance on the new similar business test currently proposed by *Treasury Laws Amendment (2017 Enterprise Incentives No.1) Bill 2017.*

Under this new test, a company will be able to utilise tax losses made from carrying on a business against income derived from carrying on a similar business following a change in ownership or control.

The Draft Guideline provides guidance on what carrying on a similar business means and includes various examples to demonstrate the approach the A.T.O. will take in assessing whether a company satisfies the similar business test and by reference to the four legislative factors to be taken into account. In summary, the Draft Guideline indicates that it will be more difficult to satisfy the similar business test if substantial new business activities and transactions do not evolve from, and complement, the business carried on before the test time.

This is contrasted with the case where a company might develop a new product or function from the business activities already carried on, and this development opens up a new business opportunity or allows the company to fill an existing gap in the market.

CASE AGAINST SELF-PROCLAIMED HUTT RIVER 'ROYALS' COSTS TAXPAYERS $80,000

In our last issue we covered this case; The A.T.O. has spent more than $80,000 in its latest legal fight against the self-proclaimed royal family of an invented principality in W.A.'s wheat fields.

In June the founders of the Hutt River Province, self-proclaimed former sovereign Prince Leonard Casley and his son Arthur, lost legal action against the Australian Taxation Office over the payment of eight years' of income tax, worth more than $3 million.

A.T.O. legal cost summaries, released under freedom of information laws, show two cases against the 91-year-old Prince Leonard, who abdicated from the throne he established for himself nearly 50 years ago, and his son, Arthur Wayne Casley, have cost taxpayers $81,865.91 to date. And of course the A.T.O. had no choice but to pursue this course of action; we would expect nothing less.

GREATER REPORTING OBLIGATIONS FOR GROUPS WITH TURNOVER ABOVE $250 MILLION

The A.T.O. will extend the obligation to lodge the reportable tax position (RTP) schedule to companies in economic groups with a turnover greater than $250million.

The RTP schedule is a schedule to the company income tax return that requires large businesses to disclose their most contestable and material tax positions. The obligation to lodge the schedule only arises once the A.T.O. has notified the company they are required to lodge an RTP schedule.

The A.T.O. currently targets companies that fall within its 'higher risk' or 'key player' categories. For income years ending on or after 30.6.2018, the obligation to lodge the RTP schedule will also apply to companies in economic groups with a turnover greater than $250 million. The A.T.O. will notify taxpayers that are affected by these changes of their RTP obligations.

Taxpayers will need to use the Guide to reportable tax position 2018 to complete their RTP schedule which will be available from 1.7. 2018.

TOBACCO DUTY HARMONISATION

On 10.8.2017, Parliament passed legislation to ensure that manufactured cigarettes and roll your own (loose leaf) tobacco receives comparable taxation treatment.

Currently, there is a disparity in the duty applied to cigarettes and loose leaf tobacco. The disparity occurs because the duty on cigarettes is a set amount per cigarette stick – an assumed 0.8 grams of tobacco. The duty on loose leaf tobacco is applied by reference to weight, at a rate per kilogram. As the average stick cigarette contains less than 0.8 grams of tobacco, the current rate of duty on loose leaf tobacco is a lower effective rate than for stick cigarettes.

To correct the disparity, the per kilogram tobacco duty rate will be based on the new assumption that the average cigarette contains 0.7 grams of tobacco and not 0.8 grams of tobacco as applies under the current rate.

This measure is estimated to deliver $360 million to the Budget over the forward estimates period, and additional G.S.T. revenue of $35 million which will be paid to the States and Territories to fund essential services.

The adjustment will increase the duty imposed on roll your own tobacco over four years. The first adjustment will occur on 1 September 2017, with further increases on 1 September 2018, September 2019, and 1 September 2020.

The Federal Government is also boosting efforts to combat trade in illicit tobacco. The 2016-17 announced additional funding of $7.7 million to expand the Tobacco Strike Team. The Government is developing legislation to enhance penalties for illicit tobacco offences.

NEW ZEALAND JOINS AUSTRALIA IN MULTINATIONAL TAX CRACKDOWN

New Zealand's decision to join Australia in tackling multinational tax avoidance has been welcomed by the Federal Government.

Australia has been a strong advocate for all jurisdictions to adopt these measures.

New Zealand will take action against multinationals that use artificial arrangements to avoid having a taxable presence in New Zealand.

In Australia, the Turnbull Government introduced legislation in 2015, the Multinational Anti-avoidance law (MAAL), that similarly attacks the artificial commercial structures used by multinationals to escape paying tax here.

Australia has one of the toughest, if not the toughest, anti-avoidance tax regimes in the world.

The Australian people expect all corporations to pay the right amount of tax and this includes multinational companies. Over 30 corporate groups are currently restructuring, with more to follow. Restructures completed so far have resulted in around $6.5 billion in income per annum now being included in our tax base.

The A.T.O.'s Tax Avoidance Taskforce estimates this will lead to an additional $100 million in income tax being paid in the first year and over $300 million overall in the first four years after the MAAL came into effect. Notably, the restructuring in response to the MAAL also has had a significant impact of around $240 million in G.S.T. revenue to the end of 2016/17, to be received by the States and Territories.

The Taskforce has strengthened the A.T.O.'s capacity to identify and crack down on not only tax avoidance by large corporates and multinationals, but also private groups and high wealth individuals. The Taskforce is estimated to generate a $3.7 billion gain to revenue over the 2016-17/2019-20 forward estimates period.

New Zealand has also announced a measure which makes it easier for tax authorities to deal with companies that do not cooperate with requests for information, which the Turnbull Government's Diverted Profits Tax achieves by putting the onus on the multinational to justify its international tax arrangements.

A.A.T. REJECTS TAXPAYER'S CLAIM FOR INPUT TAX CREDITS

GH1 Pty Ltd (in Liquidation) v FCT [2017] AATA 1063

The A.A.T. has affirmed the Commissioner of Taxation's decision to disallow input tax credits (ITCs) totalling $817,207 for bulk earthwork services provided in relation to a development project.

The Taxpayer was unable to discharge its burden of proving, on the balance of probabilities, that the Commissioner's assessment was excessive.

The A.A.T. found:

- the purported 'tax invoices' were not evidence of any actual taxable supplies made – the mere existence of a 'tax invoice' is not, by itself, sufficient to establish that a "taxable supply" (under section 9-5 GST Act 1999) and corresponding 'creditable acquisition' (under section 11-5 GST Act 1999), has, in fact, occurred and

- There was evidence to demonstrate the relevant stages of development works had been completed prior to the dates of the purported invoices, and that ITCs in respect of the work were likely to have already been claimed in an earlier income year.

Where supplier loan accounts exist, it is crucial to maintain contemporaneous records sufficient to support ITC claims in circumstances where there has been no physical payment for supplies. Here consistent and clear record keeping is the key and remember the onus of proof is on the taxpayer.

CLEARANCE CERTIFICATES

In the May Federal Budget we saw changes to the threshold at which a clearance certificate is required and the amount to be remitted to the A.T.O. if no certificate is produced.

Developers should note the clearance certificate is valid for any property sold in the 12 months from date of issue. In the event that a project is delayed an updated certificate will be required.

The changes apply from 1.7.2017, for the prior 12 months the Federal Government had a regime whereby vendors of real estate in excess of $2 million had to provide purchasers with a clearance certificate on or prior to settlement or purchasers are mandated to retain and remit to the (A.T.O.) 10% of the price.

The key changes from 1.7.2017 are:

- the threshold at which a certificate is required has been reduced to $750,000
- the amount to be retained if a certificate is not produced and remitted to the A.T.O. is now 12.5% of the price

It should be noted foreign resident capital gains withholding clearance certificate application is not property specific.

For developers who have multiple property holdings, the A.T.O. has confirmed that an application can be made on behalf of an entity with an anticipated settlement date for any property. Once the clearance certificate has issued, the certificate is valid for 12 months for all properties sold in that 12 month period.

WHAT IS 'DOMINANT USE' IN REGARD TO THE PRIMARY PRODUCTION LAND TAX EXEMPTION

Redmadi Pty Ltd v Chief Commissioner of State Revenue [2017] NSWCATAD 231

In this N.S.W. case, the Civil and Administrative Tribunal (Tribunal) dismissed the application and affirmed the Chief Commissioner for State Revenue's (Commissioner) decision to deny a primary production land tax exemption to a taxpayer on the basis that it was not satisfied that land was used for the dominant purpose of primary production within the meaning of section 10 AA of the Land Tax Management Act 1956 (Act).

Taxpayers using rural land for multiple purposes should carefully consider the position. If the dominant use of the land is for primary production activities, they will be entitled to a full land tax exemption. However, if there is another dominant use of the land, the taxpayer will not be entitled to a partial exemption for primary production activities.

The taxpayer owned land on which it ran a farm stay accommodation business and also maintained and bred alpacas, goats and some chickens.

The Taxpayer contended that the land was used during the relevant year for the 'dominant purpose of the maintenance and breeding of animals for the purpose of selling them or their natural increase or bodily produce' (being the alpaca fleece). The Taxpayer argued that the use of the land as a home stay accommodation business was a non-dominant purpose.

In reaching its decision the Tribunal considered the following factors which supported the view that the land was not for the dominant use of primary production:

- when the land was purchased it was used for the purposes of, and widely advertised as, a farm stay accommodation business and that has continued throughout the Relevant Years
- in the employment contracts of the managers of the accommodation and livestock business, there was no 'substantial reference' in relation to duties to maintain or care for the animals
- the goats were sold for relatively insignificant amounts and no reliance is place on the sale of chickens or eggs to support the exemption claim and
- the tax returns of the Taxpayer for the 2011-2015 Years inclusive show a far greater revenue of activities on the accommodation operations as opposed to livestock operations ($1.15 million of revenue compared to $46,000 from sales of alpacas and fleece)

Accordingly the Tribunal concluded that this land was not exempt from land tax. As the exemption requires that the dominant use of the land is for primary production, the Taxpayer was unable to claim a partial exemption for the portion of the land that was used for primary production activities.

CASH AND THE HIDDEN ECONOMY

Recently the A.T.O. published a fact sheet in which they outlined their sophisticated benchmarking and data matching activities. The following examples are instructive:

Example: Unrealistic personal income leads to unreported millions

The income reported on their personal income tax returns indicated that a couple operating a property development company didn't seem to have sufficient income to cover their living expenses.

The A.T.O. found their company had failed to report millions of dollars from the sale of properties over a number of years. A large portion of unreported income had been lost through gambling and significant funds had been sent to an overseas bank account. The couple and their related companies had evaded paying tax of more than $4.5 million.

They had to pay the correct amount of tax based on their income and all their related companies. They also incurred a variety of penalties, including:

- administrative penalties (from the tax assessed on the returns that hadn't been lodged – a minimum of 75% of the tax assessed)
- false and misleading statement penalties (because of their intentional disregard of their tax obligations and lack of cooperation during the audit – up to 75% of the shortfall of tax on the returns adjusted to their true income).

Example: Data matching uncovers hidden income

A Melbourne restaurant owner was found to have discrepancies between the business's reported income and the data the A.T.O. received from their bank.

The owner was given the opportunity to let the A.T.O. know if they had made any errors before they started an audit. They consulted their bank and tax agent and advised that the business had failed to report their entire turnover.

Following discussions, the business owner made a voluntary disclosure correcting the business's tax returns for three financial years, resulting in unpaid tax of over $750,000. The A.T.O. accepted this as reasonable because, based on the small business benchmarks; it was equivalent to other businesses in the same industry with the same turnover range.

Example: Failing to report online sales

A Nowra court convicted the owner of a computer sales and repair business on eight charges of understating the business's G.S.T. and income tax liabilities.

The A.T.O. investigated discrepancies between income reported by the business and amounts deposited in the business owner's bank accounts. They found the business failed to report income from online sales.

The court ordered the business owner to pay over $36,000 in unreported tax and more than $18,400 in penalties. The owner was also fined $4,000 and now has a criminal conviction.

Example: Benchmarks used to calculate default assessments

A retail butcher shop was significantly outside the benchmark range for the industry.

When reviewing their records, it was clear the owners had failed to maintain the appropriate records as required by law. A number of errors were identified, including:

- not keeping cash register rolls or point-of-sale system printouts
- not showing evidence of regular till reconciliations to support daily sales records
- inaccurate and incomplete sales records for business income, such as missing sales records for significant trade periods.

The owners weren't able to explain how the income reported in their business tax returns was calculated. They didn't have the records to support their reported income.

The A.T.O. used the benchmarks to recalculate the business's income, then adjusted its tax return and the owners' personal returns based on the recalculated income. The A.T.O. subsequently issued the business and both owners default tax assessments.

The business owners had to pay tax based on the more accurate income calculated in the default assessments.

They also incurred penalties for failing to take reasonable care to meet their legal requirement to maintain accurate records.

A.T.O. – FOCUS ON CASH ECONOMY

Recently the A.T.O. published a fact sheet titled "Protecting honest business". As part of their damp down on the black economy the A.T.O. will focus on businesses that:

- operate and advertise as 'cash only'
- data matching suggests they don't take electronic payments
- are part of an industry where cash payments are common
- indicate unrealistic income relative to the assets and lifestyle of the business and owner
- fail to register for G.S.T. or lodge activity statements or tax returns
- under-report transactions and income according to third-party data
- fail to meet super or employer obligations
- operate outside the normal small business benchmarks for their industry
- are reported to them by the community for potential tax evasion – the number of reports the A.T.O. receives indicated that the community is less tolerant of unfair practices in these industries.

A.T.O. data analysis indicates that there are more businesses in some industries that have an unfair advantage.

Example 1: Failing to lodge and not reporting cash income

A licensed carpenter failed to lodge tax returns for a number of years. The A.T.O. demanded lodgment and when the tax returns were lodged, it was clear that income from cash jobs weren't included.

The A.T.O. conducted an audit for the 2006 to 2013 financial years and found the taxpayer had over-claimed input tax credits in addition to not declaring cash income. Their record keeping was very poor and they couldn't explain how some materials and vehicles were funded.

The audit resulted in the taxpayer owing additional tax and penalties of over $190,000.

Example 2: Failing to report cash income

The A.T.O. identified a company in the building and construction industry that hadn't reported over $970,000 in cash sales over a two-year period. The omitted income had been transferred into nine personal bank accounts as employee payments, including the company director. The nine employees also didn't report this income in their personal income tax returns.

This resulted in over $90,000 G.S.T. payable by the company with failure to withhold penalties of over $200,000 on the wages provided to its employees.

The total shortfall of income tax payable by the individuals was $277,000 and penalties of over $175,000.

The A.T.O. is visiting businesses across Australia as part of their ongoing focus on the cash and hidden economy. They are focusing on businesses advertising 'cash-only' or dealing mainly in cash.

The A.T.O. will work with business and industry associations along with local authorities like Chambers of Commerce and councils.

The A.T.O. will be talking to them about:

- why they are focusing on cash
- the benefits of electronic payment and record keeping facilities
- community expectations of paying by card
- their tools and demonstrating how to use them, including online lodgment
- making sure they're registered correctly
- ensuring all businesses pay the correct amount of tax and super by declaring all their income and knowing what expenses they can claim
- lodging their tax returns and activity statements
- meeting their obligations if they are struggling, taking into account specific circumstances, and helping them get back on track
- any other help they may need.

If a business is deliberately doing the wrong thing, the A.T.O. has an obligation to do something about it; possibly resulting in an audit or even prosecution.

Hair and beauty industry

Recent A.T.O. activities have resulted in:

- an increase of around 4% in timely lodgement of activity statements compared to the 2015 financial year
- an increase in G.S.T. registrations being corrected
- more timely payments of income tax and activity statement liabilities

- a reduction in outstanding payment obligations
- business owners being supported and educated to make informed decisions about their tax obligations.

Here are some examples of how the A.T.O. has dealt with businesses that have not met their obligations.

Example 1: Business owner's lifestyle didn't match their reported income

A nail salon business with a number of outlets was selected when data matching indicated anomalies. The initial investigation confirmed that the owner kept incomplete records and declared income that didn't support their lifestyle and assets.

The A.T.O. uncovered more than $2 million of undeclared income.

After imposing penalties for reckless behaviour of over $241,000, the total amount of G.S.T., income tax and penalties payable by the owner was more than $728,000.

Example 2: Poor record keeping leads to penalties

Acting on concerns from a member of the public, the A.T.O. investigated a hairdresser and found that the business owner couldn't account for all of their expenses.

The owner informed they didn't know how to keep good records and had never sought advice about how to do this from a tax professional.

G.S.T. and penalties on over-claimed expenses payable by the owner were over $50,000.

Restaurant, cafe, takeaway and catering industry

Recent activities have resulted in:

- an increase of over 6% in timely lodgement of activity statements compared to the 2015 financial year
- corrections to G.S.T. registrations
- an increase in timely payments of income tax and activity statement liabilities
- business owners being supported and educated to make informed decisions about their tax obligations.

Here are some examples of how the A.T.O. has dealt with businesses that have not met their obligations.

Example 1: Undeclared income and inflated expenses

When visiting one business, A.T.O. staff noticed the Australian business number (ABN) quoted on cash register sales receipts varied. When asked about this, the owner made voluntary disclosures about over-claimed expenses.

During the audit, the A.T.O. also found further unreported income and more over-claimed expenses. This led to adjustments of more than $1.1 million. Penalties imposed on the tax shortfall were reduced by just over $12,000 because of the disclosures.

G.S.T., income tax and penalties payable exceeded $211,000.

Example 2: Tracking cash payments

During a visit to a restaurant, it was apparent to the A.T.O. that the owner needed to improve their record keeping practices as cash was kept in a cardboard shoe box.

Profiling work showed five merchant IDs, which the taxpayer stated belonged to five different restaurants operating under this entity. All had the same poor record keeping processes in place.

A.T.O. analysis identified several bank accounts, and third party information identified deposits in excess of $300,000 for 2014 and 2015. The A.T.O. identified $1.3 million of understated income for 2014 and $1.5 million for 2015. The A.T.O. calculated cash not deposited by developing a 'cash deposit timeline' for each restaurant.

It turned out that no cash had been reported to the A.T.O., and only eftpos income had been included in tax returns and activity statements.

Building and construction industry

Recent activities have resulted in:

- an increase of around 5% in the timely lodgement of activity statements compared to the 2015 financial year
- over 760 businesses in the building and construction industry have been shown the A.T.O. range of online tools and services since July 2016.

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

QUESTION 1

Question 1.1

Hi, I have a client that has a question surrounding Australian Tax Residency. His circumstances are as follows:

- Had been an Australian resident since birth
- In 2007 he moved to Indonesia permanently with his spouse & 2 children

- They rented out their Principal Place of Residence for 2 years & then sold it
- In 2012 he split with his wife. His wife & 2 kinds then moved back to Australia
- In 2014 he had a child to his new partner in Indonesia
- In 2016 he started a company in Singapore. (While still living in Indonesia)
- In 2016 he purchased a property in Australia to use when he returns to spend time with family & kids
- In 2017 his Singaporean company obtained some contracts in Australia, which sees him returning to Australia more frequently (But less than 183 days per year).

My questions are: is he an Australian Tax Resident? – If so, at what point? –If not, other than physically moving back to Australia, what would cause him to become a tax resident?

Thanks

Answer

The key is the residence he purchased in Australia – is it solely for his use?

Also the number of days he spends in Australia will be instructive.

In the event the taxpayer maintains a permanent residence in both jurisdictions, then it is likely he will be resident of the nation where his "dominant economic interests" are.

Question 1.2

Am I right in assuming that as:

- The residence he purchased in Australia is solely for personal use; and
- He is in Australia for less than 183 days per year; and
- His dominant economic interest lies in his business overseas,

That he would be considered a non-resident?

Answer

You would need to clearly demonstrate his dominant economic interest is in the relevant jurisdiction in $$$ terms, further that he maintains a permanent residence in Indonesia and that he properly fulfils his tax obligations there.

In the event he has a business in Singapore, a permanent residence in Indonesia and assets in Australia (including a dwelling) this may not be clear out.

Your application of the "183 days test" is misconstrued. The AAT has confirmed that this test is only used to determine whether a taxpayer is a resident of Australia. It cannot be used to support the argument that he is not a resident of Australia.

Due to the complications involved you should seek a private ruling.

QUESTION 2

Hello. I refer to October 2014, Tax Smart magazine, issue number 0071, example 1, on page 29. This is where Susan purchased a property in Melbourne for $300,000 and occupied it as her main residence for 5 years.

She moved to Sydney for work in 2000, and rented out her Melbourne house. A qualified valuer, valued the MV of her house at $650,000 at that time.

In 2007 she stays in Sydney and sells her house for 1.35 mills. (I.e. 7 years it was rented out).

The cost base becomes $650,000 and she only pays capital gains tax on the difference.

Our query is this:

If Susan rented her house for less than 6 years, however also bought a new house in Sydney during this time, can she still claim her Melbourne house as her main residence or would she have to treat her new house in Sydney as her main residence form the time she bought it?

I.e. does renting versus buying a house in Sydney affect the Melbourne main residence status?

Answer

It is only one principal place of residence at one time. If you are in the process of buying/selling, then there can be an overlap of up to six months.

If Susan moves back in within 6 years, the 6 years gets "freshened up" again.

Susan can still effectively elect which house is her main residence for the relevant six year temporary absence.

QUESTION 3

In 1984 we bought a small grocery store unable to pay its lease commitment, from that we grew and expanded. We bought land and built a 700sq m building in 2003 and started trading in the new building in 2004. We transferred the existing business to the new building, for family reasons we sold the business paid the loan on the building, formed a family trust and a Company to operate the trust. The lessees paid lease payments into the trust which distributed its funds in accordance with the trust deed. The trust owes the wife and myself approximately 1 Million $. We did not claim or have received interest payments on the money. Our financial situation has changed considerably early this year.

The lessee went very badly, we exercised the landlord's right, re-entered the building, spent our funds and borrowed money, and our time without pay to re-establish the business and sold the business to new lessees on the 28-08-2017 on a 10 years lease.

We repaid borrowings to the bank. Because of our changed finances, can the family trust repay part or all the money owing to us without us having to pay tax on that money?

Asset protection issue 0088 on page 9, question 5 you address a similar case, our accountant does not share that opinion. Your answer and direction will be most appreciated.

Answer

I think you and the Accountant may be taking at cross purposes.

Let's apply the answer (in italics) in issue 88 to your circumstances.

"The advance (and subsequent return) of loan funds is on capital account and will not affect your taxable income."

This applies to you…in the meantime…

"However taxable income needs to be distributed to the beneficiaries"

The fact that a loan can be repaid to you tax free does not stop the trust having a taxable income.

To have been able to sell the rejuvenated business at a capital gain, it is clear the business made a profit.

Just because you are able to identify the cash taken out of the trust as a loan repayment does not stop the trust having a taxable income.

To avoid trustee tax (47%) this taxable income has to be distributed to beneficiaries.

QUESTION 4

A new client has contacted us.

They have brought to our attention their self-managed superannuation fund. The SMSF had a trustee company "something Pty Ltd". "Something Pty Ltd" was an operating company that ran a shop. The "something Pty Ltd" went into liquidation and was liquidated. Has been wound up quite some time ago circa 4 years.

The superannuation fund has a property in it. 500 acres of farm land. Worth $650,000. There is no debt and the members pay the rates on the property each quarter. The trust deed is unable to be located. Where should we start in remedying this situation? Given that the SMSF has no trustee.

Answer

Given there are property title and potential conveyancing issues along with trust law and SISA compliance issues, there is no quick fix.

The services of a reputable law firm with expertise in all of the above areas will be required.

Clearly the SMSF is well behind in its lodgements – otherwise the independent auditor would have picked this up… along with missing deed.

A new trustee will need to be chosen by the members and a corporate trustee is recommended.

A trust deed of variation will need to be done for the SMSF… trust deed or no trust deed – you could check with the bank and/or last known SMSF auditor to see if they have a copy.

We suspect a raft of compliance issues will come into play when the SMSF's compliance obligations are being updated.

These will not be limited to:

- The trustee issue
- Possible investment standards
- In-house/personal use assets
- Sole purpose test

Steps need to be taken to get this SMSF into compliance mode as soon as possible and it cannot be done on the cheap – some professional fees will be involved.

QUESTION 5

Hello, I just wanted clarification on the latest company tax rate changes down from 30% to 27.5%. In relation the franking account do we now have to go back and re-calculated the company's franking account as we had to do many years ago when the company tax rate had gone down from 34% to 30%?

I am not too sure if the Legislation is retro or just effects the franking account from 1 July 2016. Could you please clarify? Thank you.

Answer

We refer you to draft Practical Compliance Guideline PCG 2017/D7 published by the ATO. Nothing contained therein indicates that the franking account balances need to be altered.

The key change is that since 1.7.2016 dividends are only allowed to be franked to 27.5% for small business companies.

In the event shareholders of small companies (less than $10 million) have received dividend statements since 1 July 2016, then they need to be sent amended advices, advising that their dividends are only franked to 27.5%.

QUESTION 6

Dear Sir/Madam,

I write as a member of your subscription service.

My query is when making a distribution of profits from a Discretionary Family Trust to beneficiaries, if the profits consist of rental income and Franked Dividends, must the Franked Dividends and imputation credits be distributed to each beneficiary by the same percentage?

Or can you mix and match the split up between the Franked Dividend and imputation credit as to how you want?

Assuming all other streaming conditions are met and are permitted by the Trust Deed.

My example is as follows:

Rental income	$35,000
Franked Dividend	$10,000
Imputation credit	$4,285
Total income	$49285

Can beneficiary 1 be distributed income of $20,000 and imputation credit of $2,000?

Can beneficiary 2 be distributed income of $20,000 and imputation credit of $2,000?

Can beneficiary 2 be distributed income of $9,285 and imputation credit of $285?

Thanking you kindly

Answer

As a general comment the imputation credits are attached to the franked dividend and income retains its character as it flows through a trust. The franking credits cannot be separately dealt with.

The judgement in Thomas v Full Commissioner of Taxation 2015 FCA 968 certainly backs this up.

The judgement of Bamford case provides that a discretionary trust could only stream franked dividends and capital gains to specified beneficiaries, other trust income must be distributed to beneficiary on a proportionate basis. The proposed distribution in your example is workable.

Leigh's Corner

ARTICLE NO.37 -

NEW LEGISLATION TO PROTECT VULNERABLE WORKERS

The *Fair Work Amendment (Protecting Vulnerable Workers) Bill 2017* successfully passed through the Senate on September 4th, 2017 with some minor amendments in relation to the investigative powers of the Fair Work Ombudsman when gathering evidence.

Once these minor amendments are made and the Bill is returned to Parliament this legislation will become law.

The reasons provided by the Government for this legislation were that underpayment of wages remains a significant problem in Australia.

This assertion is based on a number of high profile cases involving large organisations and franchise companies underpaying staff by deliberately ignoring award and penalty rates, misuse of contractors (sham contracting) and threats to cancel work visas and withhold wages and/or require the wages to be paid back to the employer.

The largest of these breaches was the 7 Eleven case which has discovered millions of dollars of underpaid wages to employees who were mainly immigrant or work visa employees in a vulnerable position and the government while acknowledging that the majority of employers abide by the relevant wages and conditions prescribed in the modern award system have found that some organisations and particularly franchise companies have deliberately flouted the laws.

The new laws will apply in conjunction with the existing Fair Work Act and the powers of the Fair Work Ombudsman but will provide significant new penalties for employers who breach the laws with penalties increased up to ten times the existing penalty framework.

When the Bill becomes law, the main changes will be:

- The introduction of a higher scale of penalties **(up to 10 times the current amount)** for a new category of 'serious contraventions' of prescribed workplace laws.
- To prohibit employers from unreasonably requiring employees to make payments (i.e. 'cash-back' arrangements or threats to cancel visa arrangements or termination of employment)
- To strengthen the evidence-gathering powers of the Fair Work Ombudsman (FWO) to ensure that the exploitation of vulnerable workers can be properly investigated and
- To introduce stronger provisions to make franchisors and holding companies responsible for breaches of the Fair Work Act where they deliberately set out to contravene or avoid paying the correct wages and penalty rates to employees

The Office of the Fair Work Ombudsman will have increased powers in relation to the gathering of evidence and compliance under these laws.

If an official investigation into an employer's payment of wages and conditions commences the onus of proof under these new laws will be on the employer, which means the innocent until proven guilty rule will no longer apply in these cases.

The employer must prove that the correct payments are being made to employees and failure to keep proper payslips or appropriate electronic records may result in significant fines and possible back payments to staff.

The Office of the Fair Work Ombudsman is actively out in the community conducting investigations into claims of underpayment of wages and misuse of contractors and has been successful with some large penalties being applied to employers in the last 12-18 months.

This legislation will mean more investigations and scrutiny on employers and will possibly mean an increase in claims made by employees.

It is crucial that employers closely examine their wage structures, use of contractors and workplace agreements to ensure that they are compliant and correct and it would be prudent to get advice where appropriate to ensure that you do not become a test case for the new laws.

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 question for Leigh's team send us an email info@bo2.com.au.

Bonus Issue

2017 TAX EFFECTIVE SHARES & PROPERTY INVESTMENT

WHAT'S NEW IN 2017?

Property Investors

- No deduction for travel/inspection expenses
- Changes to depreciation deductions

– Temporary residents lose C.G.T. main residence exemption

– Annual charge on foreign owners who leave properties unoccupied

– Assisting first home buyers build a deposit inside superannuation

– Expanding scope of C.G.T. withholding for foreign residents

– Government to encourage investment in affordable rental accommodation

– Purchasers of new properties or land subdivisions to remit G.S.T. directly to A.T.O.

– Further commentary on land tax and stamp duty, primary production and the land tax exemption

In our last edition 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 G.S.T. – 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

NO DEDUCTION FOR TRAVEL EXPENSES

From 1 July 2017, the government will disallow 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.

CHANGES TO DEPRECIATION ON SECOND HAND PROPERTIES

The Government will also confine 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.

Here the plan is to no longer allow 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 are to 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 will be able to claim a deduction over the effective life of the asset. However, subsequent owners of a property will be unable to claim deductions for plant and equipment purchased by a previous owner of that property.

CHANGES TO C.G.T. RULES FOR NON RESIDENTS AND TEMPORARY RESIDENTS

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

Safeguarding the opportunity for Australian buyers to purchase in new developments by introducing a 50 per cent cap on pre-approved foreign ownership in new developments;

CHANGE ON FOREIGN OWNERS

Foreign owners of residential real estate will be encouraged to rent their properties out by applying an annual charge of at least $5,000 (reflecting the original application fee) to foreign owners who leave their properties unoccupied or not available for rent for 6 months or more each year.

FIRST HOME OWNER SAVINGS SCHEME

From 1 July 2017, individuals can make voluntary contributions of up to $15,000 per year and $30,000 in total, to their superannuation account to purchase a first home.

These contributions, which are taxed at 15 per cent along with deemed earnings, can be withdrawn for a deposit. Withdrawals will be taxed at marginal tax rates less a 30 per cent offset and allowed from 1 July 2018.

While the measures are designed to help individuals save for a home, it may also have the unintended consequences of encouraging younger taxpayers to be more engaged with their superannuation fund. Hopefully we'll see focus on the investment return and fees charges, instead of the usual approach of ignoring superannuation because the benefits are many decades away.

Also the change to superannuation to allow access to funds to buy housing will see changes to the sole purpose test and preservation rules in the Superannuation Law. Close attention should be paid to how these changes are implemented.

Example: Louise earns $60,000 a year and wants to buy her first home.

Using salary sacrifice, she annually directs $10,000 of pre-tax income into her superannuation account, increasing her balance by $8,500 after the contributions tax has been paid by her fund. After three years, she is able to withdraw $27,380 of contributions and the deemed earnings on those contributions, after withdrawal tax, she has $25,760 that she can use for her deposit. By using this scheme, Louise has saved around $6,240 more for a deposit that if she had saved in a standard deposit account.

SUPERANNUATION CONCESSION FOR DOWNSIZERS

From 1 July 2018, people aged 65 and over will be able to make a non-concessional (post-tax) contribution into their superannuation of up to $300,000 from the proceeds of selling their home.

This measure will apply to a principal place of residence held for a minimum of 10 years. Both members of a couple will be able to take advantage of this measure for the same home, meaning $600,000 per couple can be contributed to superannuation through the downsizing cap. These new contributions will be in addition to any other voluntary contributions that people are able to make under the existing contribution rules and concessional and non –concessional caps.

Example: George and Jane, both retired and aged 76 and 69, sell their home to move into more appropriate accommodation.

The proceeds of the sale are $1.2 million. They can both make a non-concessional contribution into superannuation of $300,000 from the sale proceeds ($600,000 in total); even though Jane no longer satisfies the standard contribution work test and George is over 75. They can make these special contributions regardless of how much they already have in their superannuation accounts.

FOREIGN INVESTMENT REGIME CHANGES

The Budget includes measures that appear to be intent on increasing the supply of new residential housing available to Australian residents by:

- placing a 50 per cent cap on foreign ownership in new developments (applied through conditions imposed on New Dwelling Exemption Certificates); and

- charging foreign resident owners of residential properties an annual charge if the property is not occupied or available to rent for at least six months each year.

The latter change has the benefit of either deriving revenue from the annual charge or revenue from income tax on forced rental of Australian investment properties. A win-win for the revenue.

PROPOSED CHANGES TO IMPACT DEVELOPER CASH FLOW AND LENDER SECURITY

The May 2017 Federal Budget contained a proposal to shift the responsibility of remitting G.S.T. on new residential sales from property developers to purchasers.

From 1 July 2018 purchases will be liable to pay the G.S.T. on the sale directly to A.T.O.

It is obvious the change will have an adverse impact on developers' cash flows. Depending on the date of settlement this could be felt for up to 50 days.

Lenders will be impacted as well

Current situation

- Developers claim G.S.T. input tax credits on expenses during the course of a development.
- They then pay G.S.T. on sales settled, under the Ordinary Method or the Margin Scheme (the most common method).
- The entity that completes the sale is responsible for remitting the G.S.T.
- A secured lender enforces its security on default as mortgagee in possession or through a Receiver; it then has the liability for G.S.T. payable on sales.

Currently, where developers have financial difficulties, the lenders preferred position is to maintain a watching brief. This leaves the developer to settle as many sales as possible while the lender insists on full net proceeds of sales in reduction of the secured debt. Payment of the G.S.T. liability is deferred and a secured lender will then reduce the loan to value ratio (LVR) to the full extent possible.

If the secured lender is repaid, the distressed developer still has an incentive to defer the payment of G.S.T. on sales preferring other unsecured creditors. For example, the directors of the development entity may have personal guarantees to some creditors or they may prioritise repayments on related party loans, or pay builders and consultants rather than the A.T.O.

If a developer then suffers an external appointment, the A.T.O. will rank equally with other unsecured creditors, for the developer's G.S.T. liability. Any 'preferred' creditors (i.e. those that received payment ahead of the A.T.O.) may be exposed to a preference recovery action by a subsequently appointed liquidator.

The changes announced in the Budget prevent this, allowing the A.T.O. a super-priority above all other creditors, even those lenders that have security over the development.

These changes will hurt developers' cash flow placing increased pressure on struggling developers to enter into external administration.

The incentive for a secured lender to adopt a watching brief over a struggling developer will effectively disappear. As sponsor risk is such a key risk in property development, lenders may choose to "appoint" earlier in the workout phase to avoid further risk.

Properly developers will need to be very circumspect in their dealings with lenders and will need to take specialist advice.

It is essential for developers to work closely with their secured lenders and resolve any questions of ongoing viability in a transparent manner.

And Government Affordable Housing

The Government will encourage private investment in affordable rental accommodation for low to moderate income households through a range of new incentives.

Private investors will be encouraged to invest in new and existing affordable housing. From 1/01/2018, investors, in qualifying for affordable housing, will be entitled to a 60 per cent discount on capital gains if they hold the investment for a minimum of three years in aggregate.

To qualify for the discount, housing must be provided at below market rent, and made available for tenants on low to moderate incomes and be managed by a registered community housing provider, From 1 July 2017, Managed Investment Trusts will be able to be set up to acquire, construct or redevelop property to hold as affordable housing. This will incentivise foreign and domestic investors to invest in affordable housing.

A new National Housing Finance and Investment Corporation (NHFIC) will be established by 1 July next year to provide long term, low cost finance to community housing providers for affordable housing projects. This will also assist in attracting large scale investors, including superannuation funds, into the affordable rental sector.

The Government will enable direct deduction of rent from welfare payments of tenants in public and community housing of States and Territories, and will provide greater income certainty for investors in this type of rental accommodation.

These measures will also support State, Territory and local governments imposing inclusionary zoning requirements on new development sites.

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 page 28.

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 A.T.O. 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 A.T.O. 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 A.T.O. 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 #85 February 2017 tax tip #17 which outlines the importance of a C.G.T. Asset Register.

Trusts

The use of a trust improves asset protection, estate planning and allows increased flexibility for property investors – see Issue #88 August 2017 pages 19-25.

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

G.S.T. "CHANGE OF USE" ADJUSTMENT RULES RELEVANT TO PROPERTY DEVELOPERS

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

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

You may need to make an adjustment on your activity statement in relation to G.S.T. credits you have previously claimed if you use your property differently from the way you originally planned – for example, if you have rented a residential premises that you planned to sell. You would need to make an adjustment in these circumstances as the G.S.T. 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 G.S.T.-exclusive market value of each of your purchases
- What G.S.T. credits you claimed when you made the purchases
- The tax period in which you claimed the G.S.T. 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 A.T.O. FOCUS ON PROPERTY DEVELOPERS

Recently the A.T.O. has been using more ways of detecting goods and services tax (G.S.T.) avoidance on property sales, including property data matching from the Office of State Revenue and Land Titles Data.

The A.T.O. is also using data matching and analysis to ensure property developers are correctly reporting G.S.T. on property sales.

The A.T.O. has made it clear that this activity will continue in 2017 with increased focus on their enhanced data matching capacities.

Property developers who try to avoid declaring G.S.T. on the sale of property are more likely than ever to be contacted by the A.T.O.

The A.T.O. has increased their focus on property developers who intentionally avoid their G.S.T. obligations, or claim G.S.T. credits on properties they purchase and avoid lodging an activity statement after they later sell them.

In a recent case, a property developer purchased rural farmland and subdivided it into residential lots for the purpose of sale.

Through the data matching activities, the A.T.O. identified over 100 sales that were made by the same developer.

The main issues in this case were:

- omitted G.S.T. income of approximately $1 million
- default assessments (due to non-lodgement) of $5 million
- overstated G.S.T. credits of $200,000.

The developer was found to have not reported the property sales and the A.T.O. charged the highest penalty applicable, amounting to approximately $4.5 million.

Every property transaction may have a tax consequence you need to report.

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 G.S.T. 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 G.S.T. Turnover, including the effect of Section 188-25 on projected G.S.T. Turnover) explains this.

Example 3: Sample calculation of current G.S.T. turnover and projected G.S.T. 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 G.S.T. 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 G.S.T. 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 G.S.T. 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 G.S.T. turnover is above the registration turnover threshold.

Alan's projected G.S.T. 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 G.S.T. 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 G.S.T. turnover. (Refer to paragraph 30.) Alan can disregard the $200,000 from the sale of the shops. Alan calculates his projected G.S.T. turnover as $1,200. As Alan has calculated his projected G.S.T. turnover on a reasonable basis to be below the registration turnover threshold, his G.S.T. turnover does not meet that particular turnover threshold. He is not required to register for G.S.T.

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

COMMON G.S.T. 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 I.T.Cs 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 G.S.T. position applied to earlier transactions reflective of how the acquisition was put to use.'

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

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 A.T.O. 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 G.S.T. 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 are acquired such as 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 G.S.T.

The A.T.O. have advised that if you are registered for G.S.T. 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 – G.S.T. 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 G.S.T. credits originally claimed. An increasing adjustment will increase your G.S.T. liability for the tax period, while a decreasing adjustment will reduce your G.S.T. 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 G.S.T. MARGIN SCHEME

In January 2012 the A.T.O. published a "Valuation Issues Paper" in collaboration with the Australian Property Institute and the Australian Valuation Office.

The current requirements for approved valuations for G.S.T. margin scheme calculations should be considered in the light of this issues paper.

There are several situations in which calculations of G.S.T. 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 G.S.T. 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 G.S.T. 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."

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.

The legislation makes it clear that the clearance certificate should be valid for a period which covers the date of contract. It must also be valid at the date it is provided to the purchaser.

At this time however, the A.T.O. maintains they can't issue a retrospective clearance. This is an issue where the clearance certificate is applied for after the date of contract. This issue will be resolved in the next six months but in the meantime the A.T.O. will accept a clearance certificate if it is current when given to the buyer and it predates the settlement date.

Any **Australian Vendor** of property should apply online to the A.T.O. 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 A.T.O. 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 A.T.O. 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.

FOREIGN PROPERTY INVESTORS HIT WITH ADDITIONAL CHARGES AT STATE LEVEL

As these only have limited application to our subscribers, we will be brief.

The Federal Capital Gains Withholding Regime has already been covered. These changes have occurred in recent state budgets for Foreign Investors.

The Victorian stamp duty surcharge for foreign investors will increase from 3% to 7%, for contracts signed on or after 1 July 2016. This would bring the total duty rate payable by foreign purchasers to 12.5% for properties with a purchase price of more than $960,000.

This also applies to an indirect acquisition of land, through the acquisition of an interest in a landholder company or trust.

NSW introduced a foreign investor surcharge on stamp duty (4%) and a land tax surcharge (0.75%) on the acquisition of interests in residential real estate.

From 1.10.2016, a 3% duty surcharge applies to direct and indirect acquisitions of specified residential property in Queensland by foreign acquirers. This surcharge will apply in addition to transfer duty, landholder duty and corporate trustee duty and will be imposed at a rate of 3%.

For properties over $1,000,000, the transfer duty payable, including the "additional foreign acquirer duty" will be as high as 8.75%.

A.T.O. HUNTS 32 YEARS OF PROPERTY SALE RECORDS

In December 2015 the A.T.O. boosted its data matching program by requesting 32 years' worth of state property records in a bid to catch tax cheats and crack down on foreign buyers.

In its new role watchdog for foreign investment, the A.T.O. demanded data relating to property sales, sub-divisions, land transfers and valuation details, dating as far back as September 1985, until June 2017.

Previously the A.T.O. received access to applications made by foreign investors to the Foreign Investment Review Board (FIRB) between 1.07.2010 and 30.06.2016.

The records of 11.3 million people will be cross-checked in a bid to hunt down illegal owners of Australian real estate and ensure foreign buyers are complying with local laws. This includes around 1 million rental bond and 30 million land title office records each year.

All relevant records held by the Residential Tenancies Board, State Revenue Office and land Titles Office in each state and territory in Australia will be reviewed, giving the A.T.O. access to personal details about rental property landlords, and anyone who has bought or sold a property since September 1985.

This means the A.T.O. also has access to information about every property sold since 1985, including the address, land area, total transfer price, valuation, sale contract date and settlement date.

THE PPSA AND INTEREST IN LAND

Landlords and tenants would be forgiven for thinking they need not worry about the new Personal Property Securities Act 2009 (PPSA), which took effect from 31st January, 2012.

Although these laws refer to personal property, not land, the PPSA has implications for real estate as well.

The PPSA effectively created a national registration system for security interest in tangible (and some intangible) items of personal property, which essentially means property other than land. Someone with an interest in tangible property like goods or equipment ("chattels") can register that interest on the PPS Register. The PPSA is specifically prevented from applying to an interest in a tangible item of property when that item is sufficiently annexed to land such as to be deemed a fixture.

However, there is a difference between how a fixture is defined under the general law and the definition of a fixture in the PPSA, specifically with the degree of "annexation". In the past the courts have been somewhat variable in applying tests of annexation has created uncertainty and led to disputes between landlords and tenants.

Disputes may arise when fixtures and loose chattels are to be removed from the premises at the end of a tenancy. If they are not removed the lease usually provides that they then belong to the landlord. A landlord is helpful in this regard by the fact that where some chattels are so annexed to the premises as to become fixtures they are put beyond the reach of the PPSA. Here the terms of the real property lease take priority over the financier's PPSA security interest registered against the tenant.

Real property lease documents should make clear how a landlord can deal with items of personal property left behind when the lease is terminated or if the tenant vacates the tenancy. The landlord would be well advised to search the PPSA register in order to determine whether any other party should be consulted prior to dealing with the items. On the other hand if a claim is made asserting a PPSA interest, a landlord should not be bluffed into accepting the secured party's position without first making investigations and considering the legal definition of fixtures as applied under the PPSA.

THE FOUR YEAR CONSTRUCTION RULE

Extending the Main Residence Exemption

When a taxpayer builds a new home on land, or repairs or renovates and 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 – refer to ATO ID 2003/810.

Where an existing house is demolished to build a new home there are a number of scenarios and valuable guidance is contained in A.T.O. ID's 2003/322, 2003/466 and 2006/185.

ENCROACHING SUBURBIA AND FARMLAND

A.T.O. finds sale of farm land a 'mere realisation' ID 2002/700

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

Here the A.T.O. considered whether the sale of farm land 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 A.T.O. 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.

A.T.O. ID's 2001/55 and 2002/483 contain valuable guidance.

TRUSTS MISCHARATERISING 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 A.T.O. 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 A.T.O. 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 our 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 C.G.T. 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 A.T.O. 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 C.G.T. 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 A.T.O. 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 A.T.O.'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 C.G.T. 50% individual discount if they have held at asset for more than 12 months.

In our Capital Gains Tax bonus edition #86, 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 C.G.T. discount is that the trust is an investor with their adviser's confining their analysis to the C.G.T. 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 A.T.O. 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 a booming property market there is plenty of this going in for both residential and commercial. The A.T.O. 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 C.G.T. 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.

CAN RENTAL PROPERTIES BE 'BUSINESS REAL PROPERTY'?

YPFD and Commissioner of Taxation (2014) AATA 9

This case provides self-managed superannuation fund (SMSF) trustees on the circumstances where residential properties owned by the SMSF may be considered 'business real property'.

Note, that real estate owned personally by trustees or by a related party generally cannot be transferred to their SMSF unless the property is 'business real property' (real estate used wholly and exclusively in a business). In this case the A.A.T. considered whether the applicant taxpayer was in the business of letting residential rental properties.

In this case, the taxpayer:

- was employed full time as an industrial chemist;
- owned nine rental properties with her husband;
- spent a lot of time in connection with the properties, including quarterly inspections;
- was involved in advertising for tenants; and
- was actively involved in managing the properties including advertising for and sorting arrangements with new tenants, arranging repairs etc. notwithstanding that they had appointed real estate agents to manage the properties.

The A.A.T. concluded there was a business, giving particular weight to the fact that the taxpayer intended to make a profit, the extent of the taxpayer's active involvement, her oversight and part management of the rental properties and her intention to engage in the business of renting properties regularly and routinely. The A.A.T. formed this view even though the taxpayer:

- had never made a profit from the rental business:
- was not necessarily operating in a business-like manner; and
- had no written business plans.

The A.A.T. also noted that some reliance on estate agents to manage the properties did not necessarily mean the taxpayer was not carrying on the business of letting rental properties.

This case doesn't give the green light to trustees regarding acquiring rental properties from fund members or their associates. The facts in this case are unusual and you should seek professional advice before going down this path.

G.S.T. AND RESIDENTIAL PREMISES

In 2012 the A.T.O. issued three G.S.T. Rulings. These relate to G.S.T. and residential premises (GSTR 2012/5), G.S.T. and commercial residential premises (GSTR 2012/6), and long-term accommodation in commercial residential premises (GSTR 2012/7). The Rulings were previously released as Draft G.S.T. Ruling GSTR 2012/D1 and replace GSTR 2000/20.

GSTR 2012/5 sets out the Commissioner's views on how G.S.T. applies to supplies of residential premises.

A supply of residential premises may be:

- An input taxed supply by way of lease, hire or licence of residential premises to the extent that the premises are to be used predominantly for residential accommodation (regardless of the term of occupation) s40-35(1)(a) of the G.S.T. Act;
- A taxable supply by way of sale, or long-term lease, of new residential premises (other than those used for residential accommodation before 2 December 1998) s40-65; or
- An input taxed supply by way of sale, or long-term lease, of residential premises (other than new residential premises) to the extent that the premises are to be used predominantly for residential accommodation (regardless of the term of occupation) s40-70

Premises, comprising land or a building, are residential premises under paragraph (a) of the definition of "residential premises" in s195-1 where the premises are occupied as a residence or for residential accommodation, regardless of the term of occupation. The A.T.O. considers that the actual use of the premises as a residence or for residential accommodation is relevant to satisfying this limb of the definition.

As an alternative, paragraph (b) of the s195-1 definition extends to premises that are intended to be occupied, and are capable of being occupied, as a residence or for residential accommodation, regardless of the term of the intended occupation. This limb of the definition refers to premises that are designed, built or modified so as to be suitable to be occupied, and capable of being occupied, as a residence or for residential accommodation. In the A.T.O.'s view, this is demonstrated through the physical characteristics of the premises.

Residential premises used predominantly for residential accommodation

The Ruling states that the requirement is ss40-35, 40-65 and 40-70 that premises be "residential premises to be used predominantly for residential accommodation (regardless of the term of occupation)" is to be interpreted as a single test that looks to the physical characteristics of the property in order to determine the premises' suitability and capability for residential accommodation.

GSTR 2012/5 - This ruling deals with the application of Subdivisions 40-B and 40-C of the G.S.T. Act apply to supplies of residential premises. It does not deal with the following issues:

- When a sale is of "new residential premises" – that is dealt with in GSTR 2003/3
- When premises are "commercial residential premises" – that is dealt with in GSTR 2006/6

The Ruling states that the requirement in section 40-35, 40-65 and 4070 that premises "be premises to be used predominantly for residential accommodation" is to be interpreted as a single test that looks to the physical characteristics of the property – there is no requirement to examine the subjective intention of, or use by any particular purpose. The Commissioner relies on the decision of the Full Federal Court in Suncheon Pty Ltd v Federal Commissioner of Taxation (2010) FCAFC 138 where the Court looked at the physical characteristics of the property rather than the intended use of any person.

Where premises include basic living facilities for residential accommodation, but those facilities are incidental or ancillary to the premise's primary function which is not to provide residential accommodation (e.g. office buildings and hospitals), those premises are not residential premises to be used predominantly of residential accommodation.

Where a residential apartment includes a garage, car-parking space or storage area within the complex, the ruling considers that these supplies are ancillary or incidental to the dominant supply of the residential apartment – therefore there is a composite supply of residential premises. This is the same even if these other items are separately titled, but located within the same complex. These matters may not be ancillary or incidental where they are supplied after the original supply of the residential unit, or they are located in a separate building.

The ruling takes the view that the supply of premises needs to be apportioned to the extent that part of the premises is not residential premises to be used predominantly for residential accommodation. For example, if a house is modified so that part of it is used as a doctor's surgery. Looking at the ruling, whether apportionment is required will be a matter of degree in each case, and a question will also be whether the non-residential use is ancillary or incidental to the residential use (and also whether the residential use is ancillary or incidental to the non-residential use).

The ruling considers that vacant land cannot be residential premises. The Commissioner relies on the decision of the Full Federal Court in Vidler v Federal Commissioner of Taxation (2010) FCAFC 59.

This deals with the application of Subdivisions 40-B and 40-C of the G.S.T. Act apply to supplies of commercial residential premises and supplies of accommodation in commercial residential premises.

The ruling provides a detailed analysis of the definition of "commercial residential premises" in s195-1 of the G.S.T. Act.

The ruling accepts that premises may still fall within the definition if they are not operating at the time of the supply – this is because such premises may be classified by their overall physical character, considered with other objective characteristics. For example, a newly constructed hotel (although vacant) would still be commercial residential premises).

The ruling accepts that separately titled rooms, apartments or adjacent cottages or villas on adjoining or abutting land can be combined with sufficient commercial infrastructure so that, as a whole, it can be operated similarly to a hotel, motel, inn or hostel. Further, a single supply by sale or lease of premises consisting of rooms, apartments, cottages or villas as well as commercial infrastructure, regardless of whether they are separately titled, is a supply of commercial residential premises under paragraph (a) or (f) of the definition.

However, the supply by sale or lease of part of building cannot be characterised by reference to another supply. For example, a supply by sale of residential apartments without sufficient commercial infrastructure will not be the supply of commercial residential premises. The ruling adopts the analysis of the Full Federal Court in South Steyne Hotel Pty Ltd v Commissioner of Taxation (2009) FCAFC 155.

The ruling departs from GSTR 2000/20 on the treatment of accommodation provided by employers. In GSTR 2000/20 (which is now withdrawn) the Commissioner's view (at (39)) was that as a general proposition accommodation provided by an employer in premises controlled by them or their associates is usually residential premises. At (39), this general proposition was modified providing that short-term accommodation provided in specific circumstances was not a supply of residential premises, or of commercial residential premises, and the supply was subject to the basic rules.

In the current ruling, the Commissioner considers that the supply will be either an input taxed supply of residential premises or a taxable supply of commercial residential premises, depending on the circumstances.

Given this change in view, the Ruling contains transitional provisions to address those circumstances where taxpayers may be financially disadvantaged.

The Commissioner has adopted a position consistent with the decision of the Federal Court in ECC Southbank Pty Ltd and trustee for the Nest Southbank Unit Trust v Commissioner of Taxation (2012) FCA 795 and notes that he previously issued advice to some members of the boarding house and rooming house industry that supplies of accommodation to residents that do not have the status of guests are input taxed supplies of residential premise. Further, the Commissioner accepts that this previous advice created a general administrative practice for the purposes of PSLA 2011/27.

To address this change of position, the ruling provides for transitional rules to allow operators to change their systems to correctly account for G.S.T.

GSTR 2012/7 - This ruling deals with the application of Division 87 and s40-35 of the G.S.T. Act to supplies of long-term accommodation in commercial residential premises.

The ruling considers that the supply of commercial accommodation does not need to be provided to an individual, allowing corporate entities to acquire long-term accommodation for their employees to benefit from the concessionary treatment. In such cases, the employee is being provided with the accommodation, but the corporate entity is the recipient of the supply.

The Commissioner accepts that it is only necessary to establish that the supply of commercial accommodation is being made to an entity and is for 28 days or more and the accommodation, under the terms of the agreement, is able to be taken up by an individual. It is not necessary that the commercial activity is actually taken up by the individual.

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 jointly 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 below).

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 A.T.O., 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.

A.T.O. Crackdown on Rental Property Tax Claims

Early in 2016 the A.T.O. 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 A.T.O. 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.

In 2015 the A.T.O. sent property investors letters reminding them to only claim eligible deductions for the periods that the rental property rented out or genuinely available for rent.

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

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 point names.

DEVELOPERS CLAIMING G.S.T. CREDITS ON CONSTRUCTION COSTS

The A.T.O. has released GSTR 2009/4: New residential premises and adjustments for change in creditable purpose.

The ruling provided relief for property developers providing them with the opportunity to claim a portion of input tax credits on construction costs while renting out new residential premises so long as the properties were being held for sale. However, the recent A.A.T. Case, GXCX and Commissioner of Taxation ("GXCX"), highlights that developers need to be very careful when applying this approach.

In GXCX, the taxpayer developed approximately 91 apartments in 2000 and 2001. The apartments were marketed for sale before and during construction. In December 2001, when the development was completed, 22 apartments remained unsold and were rented. A further 10 apartments were then sold in 2008 and 2009. The taxpayer claimed input tax credits on the full construction costs. The issue which was the subject of the Tribunal decision was whether they were required to make an adjustment under Division 129 of the G.S.T. Act when they made the decision to rent out the 22 unsold apartments.

The A.A.T. took the view the 22 unsold apartments were not available for sale and that "there were no overt acts demonstrating the fact that the apartments were available for sale and the evidence of the directors, demonstrates that the intention was not to sell in the short term. The intention to sell was predicated upon the market reaching a level where the capital growth could be realised." The A.A.T. held that the construction of section 12-55 of the G.S.T. Act requires an analysis of the present application of the premises.

They concluded the application of the premises during the period in question was entirely for the non-creditable purpose of leasing, and that the mere intention to sell the properties at some time in the future, without more, did not amount to an application of the premises for a creditable purpose. An increasing adjustment therefore was required.

Developers intending to claim input tax credits should be mindful of the following:

- The residential premises are "held for sale" as described in GSTR 2009/4. Factors that will assist in demonstrating that the premises are held for sale include business plans, finance documents supporting the planned sale, past activities of the entity that demonstrate they carry on an enterprise of selling residential premises and marketing of the property for sale; and
- The calculation of the amount of input tax credits that can be claimed should be performed in accordance with the reasonable methodologies set out in GSTR 2009/4.

Investment in Residential Property – saving on G.S.T.

The leasing of residential premises is input taxed under the G.S.T. 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 C.G.T. 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 C.G.T. 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 C.G.T. 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 A.T.O. 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.

Interpretative Decision A.T.O. ID 2004/950 specifies 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 C.G.T. 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:

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

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

= $100,000

Susan can then apply the 50% C.G.T. 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 $24,500 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 2018

If you prepay a rental property expense, such as insurance or interest on money borrowed, that covers a period of 12 months or less AND the period ends on or before 30 June 2019, 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.
- Incorrectly claiming the full cost of an inspection visit when it is combined with another private purpose, such as a holiday. In such cases, you can only claim that portion of the travel costs that relate directly to the property inspection.
- 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
- Travel and car expenses (prior to 30.6.2017)
  - Rent collection
  - Inspection of property
  - Maintenance of property
- Water charges

A.T.O. INCREASES FOCUS ON RENTAL PROPERTY DEDUCTIONS

Throughout 2017 the A.T.O. will have 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 A.T.O. 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 A.T.O. will be paying close attention to these issues in 2017, it will also be actively educating rental property owners about what they can and cannot claim.

For example, the A.T.O. 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 A.T.O. 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 A.T.O. 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 A.T.O. 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 we believe they have been done deliberately.

Refinancing

The A.T.O. 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 recognised 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% C.G.T. 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.

NEGATIVE GEARING – THE FUTURE

This was a topic of considerable discussion and debate in the recent federal election. To recap.... the policy of the Labor Party was to restrict negative gearing to new housing from 1.7.2017.

Their considered view was that negative gearing and the C.G.T. discount gave property investors an unfair advantage over first home buyers.

With the return of the Turnbull government, it would appear these proposed changes are very unlikely to occur in the next three years. With their house majority being wafer thin, it is also unlikely that the Coalition's policy is likely to change as there are significant numbers of property investors in marginal seats.

It is also possible that the ALP may revise their policy – they certainly did this 1987 while in Government. Having quarantined losses in the former sections 82KZC to 82 KZJ of the ITAA 1936, they abolished these changes with a Federal Election looming.

Here the Labor Party was in danger of losing an election due to changes which had affected people who had entered negative gearing arrangements on the basis the tax concessions would remain.

It was no surprise therefore when 30 years later, in announcing their 2016 policy, the Labor Party then insisted the proposed changes would be prospective in nature meaning existing arrangements would not be impacted.

It is also significant that when the Government (in the 2016-17 Federal Budget) made retrospective changes to non-concessional superannuation contributions, they were widely condemned.

For this reason, it is considered any future changes to negative gearing are highly unlikely to be retrospective in nature, meaning existing arrangements will not be affected.

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 A.T.O. 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 A.T.O.'s website www.ato.gov.au.

We would point out the A.T.O. appears to be increasing its focus in this area.

A.T.O. CRACKS DOWN ON SPLIT LOAN ARRANGEMENTS

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

The Determination contains the A.T.O.'s view regarding the potential application of Part IVA of the ITAA 1936 to 'investment loan interest payment' arrangements.

Part IVA contains the general anti-avoidance rules designed to prevent taxpayers obtaining tax benefits from blatant, artificial or contrived tax avoidance schemes.

The arrangement described in the Determination comprises:

- A home loan

- An investment loan; and
- A line of credit loan that funds interest on the investment loan.

No cash is required from the borrower to pay interest on the investment loan because the interest is paid from the line of credit. The line of credit has no monthly repayment obligation.

The result of the arrangement is that interest is capitalised on the line of credit and the borrower applies the cash saved to reduce the home loan faster.

The A.T.O. rejects claim by borrowers that these arrangements are entered into for the purpose of paying their home loan of sooner.

According to the A.T.O., borrowers would otherwise pay interest on the investment loan out of their cash flow rather than using the line of credit and that means they would have fewer deductions if it were not for the arrangement.

On that basis the A.T.O. considers that the tax benefit may be either:

- The whole amount of the allowable deduction for interest incurred on the line of credit; or
- The difference between the otherwise allowable deduction for interest on the line of credit and the amount of interest on the line of credit that would have been an allowable deduction if the arrangement had not been carried out.

FURTHER COMMENTARY

In this discussion it is stressed that compound or capitalised interest, if it meets the normal tests in section 8(1), the interest is deductible.

The question becomes does Part IVA of the Tax Act apply? Part IVA is the anti-avoidance provision.

The Commissioner may make a determination that Part IVA applies to cancel a tax benefit obtained by a taxpayer where all three elements are present:

1. There is a scheme;
2. A taxpayer obtains a tax benefit; and
3. Having regard to several objective criteria in the legislation, the sole or dominant purpose of a person who entered into or carried out the scheme was to enable the taxpayer to obtain the tax benefit.

This is our considered view:

- 19 years ago the A.T.O. outlined its position in Taxation Ruling TR98/22;
- At this time the A.T.O. sought a “test case”;
- That test case was Hart which we suggest was carefully chosen;
- Significantly the marketing of the split loans by the Business concerned had as its focus the tax benefits;
- We have sighted opinions from second tier firms that capitalised interest is deductible and Part IVA does not apply in some cases where taxpayer restructure their loans when they purchase investment property;
- TD 2012/1 is carefully worded and only says Part IVA may apply in some situations. If its purpose was to intimidate, it appears to have succeeded;
- However, as mentioned above the A.T.O.’s register of private ruling contains a number of rulings that have gone in favour of the taxpayer;
- If you as an investor want to claim compound interest, we would suggest you seek a private ruling.

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 G.S.T. 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).

C.G.T. - 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?

G.S.T. - Per MT 2006/1, the A.T.O. is likely to take the position that Tony and Alison are carrying on an enterprise, and therefore required to register for G.S.T.

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 A.T.O. 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.

C.G.T. - 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?").*

G.S.T. - 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 A.T.O.

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).

C.G.T. - 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.

2. Avoid a facility offered by a bank or other financial institution which promotes the “tax savings” in its marketing materials.

3. Avoid a split loan borrowing facility (i.e. one loan with two notional sub-accounts for separate borrowing purposes). This is unacceptable to the A.T.O.

4. 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;

5. 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.

6. 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.

PROPERTY DEVELOPMENT

6 (A) Are sale proceeds Capital or Income?

There can be significant benefits in a profit or gain being taxed as capital, rather than income. If property has been acquired prior to 20 September 1985, a capital gain will not be assessable. For property acquired after 19 September 1985, the availability of the C.G.T. discount and in some cases the C.G.T. small business concessions can result in significantly less tax being payable than if the gain is taxed as ordinary income.

The distinction between a property developer and an investor in the property market is crucial but often is a difficult one to make. The taxation consequences can be significant. It a taxpayer is a property developer, the land is generally held as trading stock and the costs incurred in developing the property are deductible to the taxpayer when the property is sold. Proceeds of any sale are treated as ordinary income generated from the business of property development. As discussed, where a person merely holds property for rental and/or investment purposes, the development costs are capital in nature and, when the property is ultimately sold, the gain or loss is also capital in nature. This means that the capital gains tax (C.G.T.) discount and/or the small business C.G.T. concessions may be available to the taxpayer, resulting in a very different tax outcome.

In a recent case the Administrative Appeals Tribunal considered whether the taxpayer was a property developer or investor, in order to determine the assessability of a partnership distribution.

In this case, the taxpayer (a company) went into partnership with another company and purchased two properties in NSW for the purpose of developing and building units. The cost of the land and of the development was financed by way of short-term debt and, on the admission of the taxpayer, it was established that any rental income received on the units (once built) would not have been enough to cover the interest repayments on the debt.

The partnership sold the units and returned an amount of income to each of the partners. In the taxpayer’s 2003 income tax return, the gross distribution from the partnership was disclosed as ordinary income. The taxpayer then objected to the assessment on the basis that the income was not ordinary income, but a capital gain to which the small businesses C.G.T. 50% discount should be applied. Clearly as an afterthought the taxpayer was seeking access to the C.G.T. concessions. The Commissioner disallowed the objection, claiming that the taxpayer was a property developer and, therefore, the amount represented ordinary income.

The Tribunal upheld the Commissioner's decision, holding that the taxpayer was in fact carrying on a business in relation to the purchase, development and sale of the property. The taxpayer was unable to discharge the onus of proving that the property was purchased for the purposes of developing the units for rental purposes.

The Tribunal looked to the accounts of the partnership, which showed that the land was held as trading stock. It also considered the financing of the developments and the fact that the interest payments could not be met with rental income alone. The Tribunal agreed that the statements made by the taxpayer that it intended to hold the land for investment following the development, was "completely inconsistent with the way the project was initiated, the way in which the project preceded and the way in which the units were sold".

When making that crucial determination whether a taxpayer is a property developer or an investor, the Commissioner and the courts have consistently looked to the intention of the taxpayer from the beginning of the venture. In this case, even though the taxpayer was a property investor in relation to other projects, the partnership venture was judged entirely on its own merits. The treatment of the assets in the partnership and the method of project finance are factors that the Tribunal relied on and, therefore, readers involved in such ventures should carefully weigh up these factors when determining how to treat their investments.

Mere Realisation of Asset Not Income

Note under the Australian tax system it has long been accepted that proceeds from the mere realisation of a capital asset do not give rise to income according to ordinary concepts.

It has also been held by the courts that there is a mere realisation even if the activity is carried out in an advantageous manner and in an enterprising way so as to secure the best price. This may even involve the taxpayer seeking out and acting on the advice of an expert or undertaking certain work to enable the land to be sold to its best advantage.

If this sounds too rosy, it probably is, given a number of cases have fallen either side of the line.

In *Antlers Pty Ltd v FCT (1997)*, the Federal Court held that the relevant lot had been acquired by the taxpayer for the purpose of profit-making by sale since, from the outset, the lot had enormous subdivision potential. The profit was thus assessable as income, rather than as capital gain.

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 A.T.O. 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 G.S.T. PURPOSES?

G.S.T. 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 G.S.T. Registration is not necessary due to realisation of a capital asset, the position is far from clear. The A.T.O. 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 A.T.O. can come in with the benefit of hindsight and form the view that an entity was carrying on a business for G.S.T. purposes. This can result in unsuspecting taxpayers suddenly having a large G.S.T. liability to deal with.

Under the G.S.T. 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 G.S.T. 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' below.

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 below.

Case Study: Carrying on Business or Mere Realisation of an Asset

In 1983 Lloyd and Poppy purchased "Aminya", a 90 hectare beef cattle farm near Tweed Heads.

In 2017, after farming for 34 years, Lloyd and Poppy decide to wind back their farming activities and provide for their retirement by subdividing a portion of Aminya into a number of blocks intending to sell them to "weekend farmers." Aminya has made losses for several years and Lloyd and Poppy's superannuation is inadequate.

(a) Lloyd and Poppy subdivide 2-hectares into 10 half-acre blocks. Seeking local council approval, they engage a contractor to construct a road, build storm water works, and connect water, sewerage and electricity. They sell the blocks for $120,000 each through a real estate agent.

Let's consider the income tax and G.S.T. implications.

Income Tax - Are Lloyd and Poppy merely realising a capital asset in the most advantageous manner or do their activities amount to them carrying on a business or business venture?

When one considers their commercial activities, Lloyd and Poppy don't appear to have done much more than obtain Council approval, storm water, road, water and power.

At first sight, activities amount to no more than mere realisation of capital asset:

- Scottish Australian Mining (1950) – after coal seams exhausted, the taxpayer subdivided land, constructed roads and a railway station. It was held, the taxpayer had only sold capital asset in advantageous way.
- Statham (1989) – the taxpayer sold land originally acquired for cattle farming. Held, mere realisation, by most advantageous means, of asset the taxpayer had on hand when abandoned intention of farming.
- Casimaty (1997) – the taxpayer sold land due to increasing debt and deteriorating health. 8 subdivisions amounting to almost 2/3rds of property over 18 years. Held, activities amounted to no more than mere realisation.
- McCorkell (1998) - the taxpayer discounted fruit growing business after land rezoned and sold off 37 lots through 2 stages of subdivision. Held, facts similar to Statham; proceeds therefore of capital nature.

It would not appear that Lloyd and Poppy are engaged in the business of development or an isolated business venture.

Furthermore the profit doesn't appear to arise from carrying on or out of profit-making undertaking or plan: ITAA 1997, sec 15-15.

C.G.T.- Since Aminya was acquired before 20/09/1985 there is no C.G.T. event.

It should be noted from Casimaty and McCorkell (above) that even relatively large subdivisions can be on capital account.

G.S.T. THE MARGIN SCHEME

When a taxable supply is made by a registered entity, it is liable for G.S.T. on the supply. The amount of G.S.T. is usually 1/11th of the sale price.

However, when such an entity sells real property and is liable for G.S.T. on the sale of the property, it may elect to use the margin scheme to calculate its G.S.T. 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 G.S.T. was worked out without using the margin scheme.

Under the margin scheme the amount of the G.S.T. 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 G.S.T. and both entities are registered for G.S.T.

Builder now sells the land to Smithers for $1.32 million. Builder is eligible to use the margin scheme to calculate its G.S.T. liability on the transaction. This is because the original purchase of the land from Wealthland constituted a taxable supply to Builder and the G.S.T. 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 G.S.T. 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 G.S.T. 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 G.S.T. 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 G.S.T. registered entity at the time it sold to Builder and not required to be registered, it would not be liable to pay any G.S.T. 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 G.S.T. 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 A.T.O. 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 G.S.T.-free; no deduction for trading stock

The A.A.T. has confirmed that the sale of a property by a property developer was not a G.S.T.-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 A.A.T. considered whether an amount of $220,000 was considered legitimate trading stock and as such tax deductible. However, the A.A.T. 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 A.A.T. 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.

Margin Scheme and G.S.T. Anti-avoidance – The Taxpayer and Commissioner of Taxation (2010) AATA 497

This case dealt with "Developco", an ASX listed company which was part of a G.S.T. group and all other companies involved in the case were members of this group.

Developco was involved in property development and like most developers had a pattern of using a separate company to undertake the development and sale of each of its developments.

However in 2003 and 2004, Developco changed the manner in which it undertook developments and transferred some partly completed developments to separate special purpose development companies in the same G.S.T. group. These transfers were on a G.S.T.-free basis by applying the going concern exemption.

Subsequently the member companies sold the completed apartments applying the margin scheme. When applying the margin scheme, these member companies used the purchase price of the going concern paid to Developco as the consideration for the acquisition of their respective interests in the units sold.

Essentially this case decided whether the G.S.T. anti-avoidance rules applied to this arrangement.

The A.A.T. held that the G.S.T. anti-avoidance provisions did apply to certain parts of the scheme that the parties entered into. This centred on the use of the going concern exemption to impact on the amount of G.S.T. subsequently payable under the margin scheme. However, in relation to other transactions, the A.A.T. was satisfied that the dominant purpose was asset protection and on that basis the taxpayer's appeal was allowed.

Most of us are familiar with Part IVA – the anti-avoidance provision of the Tax Act which pertains to income tax. This case is noteworthy in that it provides a comprehensive analysis of the G.S.T. anti-avoidance provisions.

The A.A.T.'s analysis on the application of the margin scheme will impact on the Commissioner's position in relation to other related schemes particularly where the Commissioner relies on the single entity concept that was rejected by the A.A.T..

As mentioned in previous issues, the margin scheme rules have been updated to apply a look-through approach but these changes only apply to sales made after 16 March, 2005.

MARGIN SCHEME RELATED ISSUES

We draw your attention to the Tax Laws Amendment (2008 Measures No 5) Act 2008 which defined when a supply would be 'ineligible' for margin scheme application.

These key legislative matters ensure that the margin scheme cannot be 'refreshed' by selling land via G.S.T.-free 'going concern', or via an 'intra G.S.T. group' transaction.

Taxpayers and their advisors continue to make simple errors regarding the incorrect application of the Margin Scheme. Those more cavalier sometimes get their desired outcome by either misconstruing or ignoring events as they transpired.

If there is the slightest doubt, get a property lawyer to review the original contract and also consider section 75-11(5) to ensure the correct valuation method is used. At the very least go through your files to establish exactly what has occurred? We have seen taxpayers choose the Margin Scheme because it was the best outcome, only for them to suffer amended assessments with severe penalties after an audit.

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 A.T.O. 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 any 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?

Unit 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.

Share holder

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	OWING	SELLING
Did you know?	**Did you know?**	**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 A.T.O. 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.

WONG AND COMMISSIONER OF TAXATION (2012) AATA 254

In this case the A.A.T. held that the taxpayer was carrying on a business of share trading in relation to the listed shares and units in an aged care and retirement property trust (the units).

The units were purchased by the taxpayer from her family trust, which gave rise to a significant unrealised tax loss of over $1 million by virtue of the taxpayer treating these units as trading stock of that business and having a closing value of nil. This led to the taxpayer reducing her taxable income for the year ended 30 June 2009 from over $300,000 to nil.

In considering whether the taxpayer was carrying on a business, the A.A.T. looked at the following factors, taking the view that given the extent and volume of the trading, the taxpayer was carrying on a business of share trading and accepted that the units were trading stock of that business, having been acquired for profit-making purposes:

- The nature of the activities and whether they have the purpose of profit-making
- The complexity and magnitude of the undertaking
- An intention to engage in trade regularly, routinely or systematically
- Operating in a business-like manner and the degree of sophistication involved

- Whether any profit /loss is regarded as arising from a discernible pattern of trading
- The volume of the taxpayer's operations and the amount of capital employed.

The matter was remitted to the Commissioner for re-consideration and the issue of an amended assessment in accordance with the A.A.T.'s finding that (a) the taxpayer was carrying on a business of share trading, (b) that the units were trading stock of that business and (c) the taxpayer's taxable income for the 2009 income year was nil. Finally, the A.A.T. also noted that the exact quantification of the taxpayer's consequent carry forward loss can be left for determination by the Commissioner at a later date.

TAXPAYER WAS NOT IN THE "BUSINESS" OF SHARE TRADING

Hartley and Commissioner of Taxation (2013) AATA 601 ('Hartley')

The A.A.T. accepted Commissioners contention that the taxpayer was an "investor". This meant the taxpayer was denied revenue deductions for the losses incurred.

We wonder if the case was properly argued.

We have already discussed August v Commissioner of Taxation (2013) FCAFC 85 ('August') where it was confirmed that assets considered to be investments could derive some income, not be trading stock, yet still be on "revenue" account. There would need to be requisite intention to sell for a gain – however this is conceded as being present in Hartley.

Deputy President Deutsch considered the matters to be finely balanced – may be accepted as correct on the facts and arguments presented. There is little doubt the question of whether the taxpayer was in the "business" of being a "share holder" – then able to treat the shares as trading stock was correctly addressed by Section 70-10(1) of the Income Tax Assessment Act 1997 ('ITAA97') makes it clear that trading stock provisions only apply if relevant items be held "...for sale or exchange in the ordinary course of business".

The key question is whether your actions places you within the ambit of Section 6-5 of ITAA as ordinary income as the case in August. If so, then it follows that the receipts on sale are ordinary income and the outgoings deductible against that income. This means the purchase of shares with any costs are deductible and the receipts from sale assessable. This leaves only the issue of the non-commercial loss provisions to affect an offset to other assessable income.

Naturally, in this situation you are unable to access the trading stock provisions.

A number of commentators have contended that if the Hartley case was argued under the principals expressed in August, a different decision may have been reached.

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 A.T.O. 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 A.A.T. 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 follows:

- 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 sharetrader.

In giving her evidence, it was clear the Taxpayer lacked detailed knowledge of the ASX and the shares she had invested in.

Also, expect A.T.O. scrutiny, where "sharetrading" losses cause losses resulting in large refunds on PAYG employment income.

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 C.G.T. purposes. The length of time shares are held for will determine the C.G.T. 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 (C.G.T.). The length of time shares are held for will affect the C.G.T. 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 C.G.T., but is assessable for income tax. However, there are C.G.T. considerations following disposal of shares that are received form 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 (C.G.T. event). When a C.G.T. 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 C.G.T. 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 accountant's 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 C.G.T. 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 amount 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 C.G.T. 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 (C.G.T.) 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 A.T.O. 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.

Although this is only a draft ruling, we do not expect substantial revisions in the final ruling.

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 2011/21

TD 2011/21 released on 18 August, 2011 flags the intention of the A.T.O. to target trusts and capital gains.

It is vital that you keep proper documentation to support a particular investment plan in respect of the various share portfolios.

Paragraph 56 outlines:

- the absence of an investment style which envisages an exit point – for example the trustee adopts a 'buy and hold' style of investment;
- A low average annual turnover
- A lack of regularity in the particular sale activity – AGC (Investments) Limited v FC of T (1992) 23 ATR 287; 92 ATC 4239 (AGC Investments); Trent Investments Pty Ltd V FC of T 76 ATC 4105; (1976) 6 ATR 201;
- A high proportion of those stocks that are sold have been held for a significant number of years (see AGC Investments where 75% of stocks sold was held more than 5 years). However, if a high proportion of the remainder is then also turned over, this tends to support the opposite conclusion;
- A low level of sales transactions compared with the number of stocks in the portfolio – see Milton Corporation Pty Ltd V FC of T 85 ATC 4243; (1985) 16 ATR 43
- Profits on sale normally only constitute a small percentage of total income;
- Significant percentage of 'aged' stocks remain in the portfolio (see AGC Investments where nearly 60% of remaining stocks had been held more than 10 years); and
- The existence of a family as distinct from a commercial explanation for the dealing.

If you are unsure of your position you should seek specialist advice.

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.

A.T.O. TARGETS DIVIDEND WASHING

In mid-August 2014, the A.T.O. commenced the next phase of their dividend washing compliance program by issuing letters to 500 taxpayers who did not respond to initial letters, and up to 1,500 other taxpayers who updated data analysis suggests may have entered into a dividend washing transaction.

The letters will ask those taxpayers to self-amend their tax returns in order to reverse franking benefits they may have obtained from dividend washing transactions.

The A.T.O.'s position is that obtaining two sets of franking credits from one dividend event is not allowed, and in April 2014 issued a Tax Determination (TD 2014/10) which provided the technical reasons outlining their view. In addition, in May 2013 the government announced an integrity measure that reinforces our position on these types of arrangements. The changes to the law apply from 1 July 2013.

The A.T.O. will not impose any penalty on taxpayers who have entered into dividend washing transactions and who come forward to self-amend their tax returns before the date specified in the letter they receive from the A.T.O.

Taxpayers who have entered into dividend washing transactions, but do not receive a letter from the A.T.O., will not be subject to penalties provided they amend their tax returns by 22 September 2014.

Taxpayers who are unsure about their own circumstances should seek independent advice or apply for a private ruling from the A.T.O. Taxpayers can call the A.T.O. on 1800 177 006 if they require further assistance.

In March 2014, the A.T.O. issued letters to taxpayers who may have been involved in dividend washing transactions. As at 30 June 2014, approximately 1,300 of the taxpayers contacted in March have responded by coming forward to make voluntary amendments under which the franking benefits obtained from dividend washing transactions have been removed from their tax returns.

A dividend washing arrangement occurs where a taxpayer sells shares in an ASX listed company after the company's shares trade 'ex-dividend'. As a result of having sold the shares ex-dividend, the taxpayer retains the entitlement to the franked dividend payable on the share. Then, within days of the sale, the taxpayer buys back shares in the same company on the ASX special market, and the taxpayer also becomes entitled to a second franked dividend payable on the newly acquired shares. The end result is that the taxpayer receives two sets of franked dividends on effectively one parcel of shares in relation to the same dividend event.

EMPLOYEE SHARE SCHEME

The Tax and Superannuation Laws Amendment (Employee Share Schemes) Bill 2015, allows employees, including those at start-up, to defer tax until they exercise their options.

From 1 July 2015, employees issued with share options will be able to defer paying tax until they are exercised and converted into shares, rather than paying tax upfront.

Eligible start-up companies will also being offered a tax discount on employee options and share schemes.

The Government is also extending the maximum time for tax deferral from seven to 15 years.

To summarise:

- The acquisition time for Capital Gains Tax (C.G.T.) discount purposes of shares obtained on the exercise of ESS rights that are subject to the start-up concessions will be pushed back to when the rights were acquired, rather than when they are exercised, which increases the likelihood of a C.G.T. discount being available on the ultimate disposal of the shares.
- Investments by tax exempt entities that are deductible gift recipients and eligible venture capital investments are ignored in determining whether ESS interests qualify for the start-up concessions.
- The Bill extends the unlisted eligibility condition for the start-up concessions beyond the provider company to encompass all subsidiaries in a corporate group, modifying the time at which satisfaction of the 'unlisted' and the 'less than 10 year incorporation' conditions are tested.
- To be entitled to access the start-up concessions for ESS rights, it will not be necessary for the (75%) 'Broad Availability' test (contained in the existing ESS laws) to be satisfied.
- The Commissioner of Taxation will have a discretion to relax the (three year) minimum holding requirement (for accessing the new start-up and existing 'upfront' reduction ESS concessions) in situations where an earlier disposal of ESS interests is effectively outside of an employee's control (for instance, where there is an initial public offering or sale of a company requiring employees to dispose of their ESS interests).

NOTICE OF DATA MATCHING PROGRAM – SHARE TRANSACTIONS

This was published in the Government Gazette on 18 November 2014.

The Australian Taxation Office (A.T.O.) will acquire details on entities share registries for the period 20 September 1985 to 30 June 2016 from the following source:

- Link Market Services Limited
- Computershare Limited
- Australian Securities Exchange Limited
- Boardroom Pty Ltd
- Advanced Share Registry Services Pty Ltd
- Security Transfers Registrars Pty Ltd

It is estimated that more than 95 million records will be obtained, including the records of approximately 1.2 million individuals.

These records will be electronically matched with certain A.T.O. data holdings to identify non-compliance with registration, reporting and payment.

This program is called the share transactions data matching program and its purpose is to ensure that taxpayers are correctly meeting their taxation obligations including registration, lodgments, reporting and payment responsibilities.

While on this subject we should consider other A.T.O. Data Matching initiatives.

Real Property Transactions

Real Estate Agents or conveyancing solicitors may be required to report additional details of vendors and purchasers of real property transactions. The additional details could include addresses, date of births, tax file numbers, ABN's and ACN's for entity transactions along with property details such as ID and property address, type of property, contract dates, settlement dates and consideration.

It is unlikely to be as simple as having additional information provided on a contract or settlement statement as there would be privacy issues in having a purchaser's and vendor's personal details available to each other. The privacy of personal data would be important in implementing this policy and it would be interesting to see how the A.T.O. addresses this.

Transactions of shares and units in unit trusts

The A.T.O. already has information provided on the date and number of shares sold in relation to shares listed on the ASX where a shareholder has provided their tax file number. The additional reporting requirements could mean the reporting of acquisition dates and number of shares, purchase and sale prices, broker's fees and capital returns and their payment dates.

Private companies and unit trusts may also be required to report these details of any transfer of share or units in the near future.

Merchant debit and credit transactions

In 2013 the A.T.O. requested that all the major financial institutions provide credit card and debit card data from 1 July 2012 to 30 June 2014.

This data was used to verify sales data of businesses by matching this with information contained in BAS' and income tax returns.

Due to the growth of e-commerce sites and overseas website operators selling into Australia, the A.T.O. is proposing that any businesses with merchant facilities are now required to report these transactions to the A.T.O. Given that credit and debit card transactions are now an everyday part of life and the majority of businesses have these facilities in place, the burden of this reporting will shift to businesses from the large financial institutions.

This regime may also impact on overseas e-commerce sites that are operating in Australia as the A.T.O. may look at attributing tax on sales made in Australia. Previously, the A.T.O. did not have this data available to them to enforce payments of tax or G.S.T.

Your Notes

Your Notes

DISCLAIMER

This information, statements 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 preperation of the 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 information set out in this publication and its accuracy in relation to their own particular circumstances.

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