NEWSFLASH BOOKLET

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Important

This booklet is simply a collection of Newsflash articles relevant to investors. The articles are transferred from Newsflash into this booklet so it is best read from the back page forwards to ensure you are reading the latest article on the topic first. Note that the information contained in this booklet is not updated regularly so it is important that you seek professional advice before acting on it.

Deductibility of interest

Interest on a loan is tax deductible when the money borrowed is used for income producing purposes. Case J54 (1958) 9 TBRD established the principle that interest is apportioned according to the ownership of the investment purchased. Accordingly, a couple can borrow money jointly for an investment that is held in just one name. The whole amount of the interest attributable to the investment will be deductible to the partner in whose name the investment is held.

Refund of franking credits

On 22nd March, 2001 the Treasurer made a Press Release (No. 016) discussing the deferral of many areas of tax reform. He specifically stated that "refunds of excess imputation credits will be available upon assessment for dividends paid from 1st July 2000". So the refund of franking credits will apply to tax returns for this financial year. This means that it may now be in the interest of many people who, received dividend income, to lodge a tax return even if their total taxable income is under the threshold, because they may get a refund of the imputation credits on the dividends.

How to pay off your home sooner

Make triple the repayments

This may sound a little extreme but it emphasizes very dramatically the power of accelerating your repayments. For example $100,000 paid off over 25 years at 6.5% results in a monthly repayment of $675.24 which is a total amount repaid of $202,572! More than double. If the $100,000 was repaid over 5 years at 6.5% the repayments would be less than 3 times as much, $1,957 per month with the total amount repaid over the 5 years reduced to $117,420. The best part of this strategy is the banks only make $17,420 rather than $102,572, fight back and enjoy your $85,152 saving over the next 20 years.

This strategy may sound extreme but if you are a young couple intending to have children and live on one income for a while, why not start now and use the other income to pay off the house. This will make living a lot easier when you have children. With interest rates and deposits so low you could start early and own your own home completely by the time you are 25. This will give you an excellent start in life to hit the ground running and win.

Dollar cost averaging

On average over a reasonable period of time the value of a diversified portfolio will increase. The trick is not to try and pick the market but just go for the average, not too hard at all. Firstly you need a diversified portfolio. If you are buying direct shares this is very difficult to achieve as the minimum purchase, of any one parcel of shares on the stock market is $500. For a smaller amount you can buy units in a managed fund which will combine all the other unit holders' income and purchase a wide variety of shares. Generally the minimums of these funds are $500 up front and $100 per month but you can stop these monthly payments at any time. The idea of paying monthly is to further the averaging effect. While the share market travels in an upwards direction it has many peaks and troughs. By purchasing shares on a monthly basis you ensure that on average you do not purchase at a peak or trough but on the general upward curve over a larger period of time.

By investing in a master fund you can switch between high and low risk managed funds without entry and exit fees. High risk funds should only be invested in with a long term goal in mind. Again the averaging out of their returns over a long period will usually produce a better result. Averaging is the key, the above strategy averages on time, on a wide variety of shares and on a wide variety of purchase dates.

Let's take as a practical example the couple in "How to Pay Your Home of Sooner" above. They have reached year 5 at 25 years of age and own their own home completely. All their friends are still making repayments of $675.24 per month, they are not. What if they placed this money each month into a managed fund for the next 20 years? The performance would be somewhere between the following, which is based on the performance of these funds over the past 5 years assuming on average it will continue.

Medium Risk Based on BT Wholesale Balance Returns. Average return of 12.14% over the last 5 years. This performance over 20 years would result in $680,717 High Risk Based on Colonial First State Wholesale Imputation. Average return of 26.4% over the last 5 years. This performance over 20 years would result in $5,659,106.

Pretty impressive to have such a large sum invested and no debts by the time you are 45 years of age. The only time in their life that they borrowed money was between 20 and 25. Imagine the impact if they borrowed against their home to invest more. Note, this can be done on just an average income and the only time they live a little tighter than their friends in the same position was from 20 to 25 years of age when they lived off one income and paid off their house with the other. This is what I call hitting the ground running.

Investment loans

Traditionally, interest is claimable only on a loan where the actual money borrowed is used directly to produce income i.e. buy the income producing property.

It is dangerous to use a line of credit facility on a rental property loan when you will be drawing funds back out to pay private expenses. Based on the principle that the interest on a loan is tax deductible if the money was borrowed for income producing purposes, the interest on a line of credit could easily become non-deductible within 5 years. For example: A $100,000 loan used solely to purchase a rental property is financed as a line of credit. To pay the loan off sooner the borrower deposits his or her monthly pay of $2,000 into the loan account and lives off his or her credit card which has up to 55 days interest-free on purchases. The Commissioner now considers there to be $98,000 owing on the rental property. In say 45 days when the borrower withdraws $1,000 to pay off his or her credit card the loan will be for $99,000. However, as the extra $1,000 was borrowed to pay a private expense, viz the credit card, now 1/99 or 1% of the interest is not tax deductible.

The next time the borrower puts his or her $2,000 pay packet into the account the Commissioner deems it to be paying only 1/99 off the non-deductible portion i.e. at this point there is $96,020 owing on the house and $980 owing for non-deductible purposes. When, 45 days later, the borrower takes another $1,000 out to pay the credit card, there will $96,020 owing on the house and $1,980 owing for non-deductible purposes so now only 98% of the loan is deductible, etc, etc.

In addition to the loss of deductibility, the accounting fees for calculating the percentage deductible could be high if there are frequent transactions to the account. The ATO has released TR2000/2 which confirms this and as it is just a confirmation of the law it is retrospective.

To ensure deductibility and maximise the benefits provided by a line of credit you will need an offset account that provides you with $ for $ credit. These are two separate accounts – one a loan and the other a cheque or savings account. Whenever the bank charges you interest on the amount outstanding on your loan they look at the whole amount you owe the bank i.e. your loan less any funds in the savings or cheque account. This type of account is offered by several banks.

A loan setup incorrectly will lose all deductibility within 5 years on average. If your loan is not set up correctly it is important that you act to change it immediately as every day erodes your interest deduction. The man to talk to about this is Don Sutherland as he understands what loans are appropriate, what loans you will qualify for and best of all his services are free. Contact our office or Don direct on his mobile 0414 246 821. Don can see you at our Ningi office or in your own home if you prefer.

Tax deductions for small investors

Contrary to claims made by many Investment Advisers, the fee they charge for the initial drawing up of an investment plan is not tax deductible. Only ongoing fees for monitoring your portfolio are deductible according to TD95/60.

Fees paid to a registered Tax Agent in regard to taxation advice are always deductible under Section 69. But this does not include the preparation of an investment portfolio by a registered tax agent.

Travel expenses incurred in maintaining your portfolio are deductible (IT39) but if there is also a private motive the expense will need to be apportioned. This can include meals when away from home overnight, accommodation and transportation. If claiming less than 5,000km for a motor vehicle, it is most likely that the kilometre method will give you the best deduction. All this requires is a detailed reasonable estimate of the kilometres being claimed. But you must own the car.

Investment magazines and papers such as the Financial Review are deductible providing there is no private use (Case T96). Less specific publications such as the Courier Mail are less likely to be deductible because it is difficult to prove there is no private use.

Interest paid on a loan where the money borrowed was used to buy an income producing investment is deductible. It is a very strict condition that the money borrowed must have been used to purchase an income producing asset. It is not acceptable to use your own funds for the purchase then take out a loan because you want your “own funds” back for a holiday etc. Some banks offer offset accounts to help you overcome this problem. But be careful to check that the offset is dollar for dollar, not 3% interest on your savings offset against 5% interest on your loan. ANZ One is an excellent offset account. Borrowing costs are deductible over the lesser of 5 years or the term of the loan. This includes mortgage insurance when it is a condition of the loan.

Bad habits

Did you know that, if, instead of consuming the following items over a 25 year period you invested the money on a monthly basis in a well diversified growth portfolio you would achieve the following returns plus tax credits depending on the performance of the portfolio:

Bad Habit	Avg 9%	Avg 12%
20 packets of cigarettes per month @ $8	$181,000	$304,000
A monthly subscription to cable TV @ $45	51,000	85,000
Buying your lunch on weekdays say 22 days per month @ an increased cost per day of $4 compared with bringing it from home	99,000	167,000

It is the small but regular expenses that really cost in the long run. Likewise a small but regular investment that compounds will really add up over time. If you expect your working life to be 40 years and you don’t buy your lunch too often and invest the money instead you could have between $417,000 and $1,050,000 at the end of your working life. So by not buying your lunch and investing the money you could have over a million dollars when you retire if your portfolio averages 12%pa.

Tax minimisation schemes alert

The ATO is investigating these schemes. More information is available on its web site:

ATO scheme investigation

The ATO has issued PS2001/15 which outlines the features of a scheme that would cause them to investigate the scheme, these are:

1) Artificial and contrived arrangements with little or no underlying business activity.
2) A significant part of the return on investment in the arrangement stems from tax benefits.
3) Little or no risk.
4) The transfer of a tax benefit in a contrived fashion.
5) Limited or non-recourse financing associated with a round-robin flow of funds.
6) Little cash outlay associated with borrowing of funds under a capitalising debt facility.
7) The investor can exit the arrangement or it is wound up before a profit is generated.
8) Assets over valued resulting in inflated deductions.
9) Use of tax exempt entities such as charities to launder income.
10) Use of tax haven countries.

This is a new segment for the lead up to the 30th June when all the tax minimisation schemes start to come out. Each month we will check the ATO web site for a list of the schemes the ATO is currently investigating and publish them. This month the ATO has listed home loan unit trust arrangements. Typically these would involve the family home being owned by a family trust and rented back to the family. The property would effectively be negatively geared by the family borrowing to invest in the units of the trust. The trust would use the proceeds from the sale of its units to buy the family home. After paying all the expenses associated with the home and claiming a deduction for depreciation the trust would distribute a profit to the unit holders against which they would be able to claim the interest on their loan, which would be more than the income. This loss can then be offset against other income, including wages income, of the family.

Please note, a scheme listed under the alert is only being investigated by the ATO they may still approve of the scheme. On the other hand just because a scheme isn't listed under the alert doesn't mean they have approved it. It is safer not to enter into any scheme unless it has a product ruling from the ATO.

This month the ATO web site has list the following schemes it is currently investigating:

1) Arrangements to access superannuation before 55. For example, you roll your superannuation over into a self-managed fund which invests the money offshore and then lends it back to you. There are considerable fees involved in this arrangement and you still have to pay the interest on the money.
2) The movement of franking credits from one taxpayer to another. There are considerable fees involved and there are provisions in the Tax Act preventing the trading of franking credits which may catch this arrangement.

Please note a scheme listed under the alert is only being investigated by the ATO, they may still approve of the scheme. On the other hand, just because a scheme isn't listed under the alert doesn't mean they have approved it. It is safer not to enter into any scheme unless it has a product ruling from the ATO.

Franking Credit Trading

Taxpayers are offered shares that are cum dividend with an option to sell them straight back to the promoter once the dividend has been paid. Loans are also available to cover the cost of the shares and a transaction fee is charged (claimed to be tax deductible) to cover the cash portion of the dividend. The lender has control of the shares as security for the loan. The taxpayer declares the dividend and the franking credit as income but has a corresponding deduction for the transaction fee to offset the dividend. Therefore the only increase in taxable income is the value of the franking credit and the taxpayer gets the advantage of the full offset of that credit.

Prepaid Service Warrants for Wealth Creation Seminars

More information is available on www.ato.gov.au under Aggressive Tax Plan for investors, entitled: Prepaid Service Warrants for Wealth Creation Seminars

A taxpayer creates a loss for the current year by prepaying for service warrants that are redeemable for the provision of financial and wealth creation seminars or refundable if not used. Further, the prepayment is financed by a loan from the service provider. If the warrants are cashed in for a refund in the next financial year they are assessable income but this is a method of shifting income from one year to the next. To fully utilise this scheme you cannot be in business – refer prepayment rules in Newsflash 37 and the expense must be incurred in respect of investment income otherwise Division 35 could prevent loss from being offset against other income.

If the service warrants are cashed in I feel the ATO would have very little trouble applying Part IVA as it would become nothing but an artificial arrangement.

Investors making PAYG instalments

Many investors who know they will have to pay tax on their investment income that also have wages income have asked their employer to take more tax out of their pay packet to cover themselves against a tax bill at the end of the year. This worked well under provisional tax but will not work at all under the new PAYG regime.

Section 45-340 of the Tax Administration Act requires the ATO, when calculating how much tax you will pay on your wages, to look at the wages you earned in the previous year and work out how much tax would be payable on that figure. There is no provision in the calculation to take into account the fact you are making extra payments in your pay nor is there any way you can have that taken into account.

What is happening this year is that taxpayers have been paying the tax all year in their wages and when they make their annual PAYG installment about this time of year they are paying the tax again. When they do their income tax return they will get the extra payment back as a tax refund but in the meantime things may be tight.

The best remedy is to stop your employer taking the extra tax out and put it aside for next year's annual PAYG installment. If you really can't afford the double tax payment this year you will have to vary your PAYG installment. This can be achieved by ringing the ATO on 132861. But be careful, if you are out by more than 10% you will be fined.

Sold your business or investment but still have a debt?

Two recent cases (Namely Jones 2002 ATC 4135 & Brown 99 ATC 4600) opened the door for interest to be claimed on a loan after the business or investment it related to ceased to be owned by the taxpayer. Providing you use the proceeds of the sale of a business and all its assets or the sale of the investment to pay off a loan in relation to it, any further amounts are outstanding will continue to be tax deductible. The deductibility status will be compromised if the loan is acted upon in anyway that is seen to preserve it beyond reason. But it is ok to refinance the loan into repayments you can afford or in order to secure a lower interest rate.

Now, you may have realised that division 35 (non commercial businesses) may effectively quarantine this deduction anyway but, the ATO web site states that as the business has ceased and Division 35 only applies to businesses, it will not prevent this ongoing deduction. As the business has ceased the interest should be claimed at D13 rather than in a business schedule. Note Division 35 does not apply to loans for rental properties and shares if they are not considered to be a business.

Reader's question – Claiming interest on a loss

A reader has sold an investment property for less than the amount he borrowed. He wants to know if he can still continue to claim the interest on the balance of the loan. The ATO has lost a few cases in this regard lately so there is a good chance that the reader will qualify for a tax deduction. The ATO states the contrary to this in TR 2000/17 but in light of FC of T v Jones, 2002 ATC 4135 and FC of T v Brown, 1999 ATC 4600 this will have to be withdrawn. TD 95/27 has already been amended as the ATO recognizes that an employee using a car for work purposes that sells for less than the outstanding loan can continue to claim the interest.

Everything you can do to bring yourself into line with the positive points of the cases mentioned above should be done. Some of the relevant facts that you may be in a position to do something about are:

All the proceeds of the sale should be used to repay as much of the loan as possible.

Endeavor to appear to be unable to repay the loan from other assets other than the family home. This may mean as a couple if only one member owned the property sold at a loss the other member should hold any further investments.

Don't refinance the loan to extend its term or increase the interest rate. You must appear to be doing all that is possible to eliminate the loan. So refinancing to reduce the interest rate is ok. On the other hand if you have to change the loan from principle and interest to interest only because that is the only way you can afford the repayments you may be able to justify changing the loan.

If the loan is already fixed at the time the investment is sold, then you have an argument that you could not pay it out. This is a factor to consider if you are refinancing before the sale.

The above also applies if the investment was shares or if a business was sold for less than what is owing on it. In the case of a business the ATO has issued a statement that division 35 cannot work to quarantine the interest in these circumstances as the taxpayer is no longer in business. Division 35 is discussed in our Miscellaneous Small Business booklet. But all you really need to know is that Division 35 will not stop you claiming the interest.

Secret plans and clever tricks

The rebate for making super contributions for your spouse is $540 if you contribute $3,000, providing your spouse's assessable (not taxable) income is under $10,000 (shading provisions apply after that). If your spouse is retired from the workforce and over 55 years of age, he or she will be entitled to draw all that money straight back out. Effectively netting you an 18% return on an overnight investment. Note if your spouse has never held paid employment they will have to wait until they are 65 years of age. Spouse super contributions can only be made until the spouse reaches 65 years of age. The rebate is only available to offset tax so if your taxable income is too low to pay tax this will not benefit you.

Non resident with Australian investments

It is a lot easier to become a non resident for taxation purposes than it is for immigration purposes. If a non resident has a rental property in Australia they are still subject to Australian tax at non resident rates on it. If the property makes a loss these losses can be carried forward and offset against future Australian income. In order to carry these losses forward an Australian income tax return must be lodged for each year.

The carried forward losses described above are reduced by any exempt income received (section 36-10) but section 36-20 states that this does not include income made exempt by Section 128B - refer next paragraph.

If a non resident has interest, dividend or royalty income with an Australian source it will only be subject to Australian withholding tax and as a result will be excluded from an Australian income tax return. Note dividend withholding tax rates are 30% for residents of countries with no double tax agreement and 15% for countries with a double tax agreement but if the dividend is franked the withholding tax rate is effectively zero. Section 128B.

Note if you are a non resident there is no point in negatively gearing any interest, dividends or royalties (other than considerations unique to your country of residence) as the withholding tax is calculated on your income before deductions and these deductions would not be claimable in your Australian tax returns as the corresponding income is excluded under 128B so there would be no link of cost of earning income under section 8(1) of the 1997 Act. A non-resident may also be liable for tax on a capital gain arising from a CGT event that occurs in relation to an asset that is "connected with Australia", even if the gain does not have an Australian source. But shares in an Australian public company or units in an Australian public trust where your controlling interest is less than 10% are not subject to CGT in Australia as they are not included in the definition of "connected with Australia".

Becoming a non resident of Australia for tax purposes

IT 2650 examines the relevant factors in depth. Generally if a person leaves Australia for more than two years and sets up a home in another country they will be considered not to be a resident of Australia for tax purposes right from the time they leave Australia. Note it is possible to become a resident of more than one country at the same time.

Upon becoming a non resident of Australia ITAA97 section 104-160 deems a capital gains tax event to have occurred. This is that you are considered to have disposed of all your assets that are not "connected with Australia" and acquired after 19th September, 1985, at their market value. Accordingly, you will be subject to capital gains tax on any increase in value over their cost base. The following is a list of assets "connected with Australia":

1. Land, buildings and structures in Australia
2. An interest or right in land in Australia
3. A strata title flat or home unit
4. A share in a company that owns 1, 2 or 3 above and gives the shareholder the right to occupy.
5. An asset that has been used by its owner at any time to carry on business through a permanent establishment in Australia.
6. A share in a private company that was a resident of Australia when the share was sold.
7. An interest in a trust that was a resident of Australia when the interest was sold.
8. A share in public company that was a resident of Australia when the share was sold and the non resident and associates had control over more than 10% of the shares at any time during the last 5 years.
9. An unit in a unit trust that was a resident of Australia when the unit was sold and the non resident and associates had control over more than 10% of the units at any time during the last 5 years.
10. An option or right to acquire any of the above.
11. Various provisions associated with rollover relief.

But Section 104-165(2) gives you the option of ignoring the capital gain accrued when you leave the country but this will effectively mean you are taxed on any gain while you are a non resident. The options offered by Section 104-165(2) are:

1. Defer the CGT and pay it when the asset is sold but the tax will be on the gain over the whole period up to the sale including when a non resident.

or

2. Defer the CGT on the basis you will be returning to Australian Residency before you sell it but when you do sell there will be no exemption for the gain made while you were a non resident.

So the choice is pay the tax when you leave and be free of Australian tax on any gain you make while a non resident or defer the tax but widen the period of time you are exposed to Australian capital gains tax.

As your home will be an asset "connected with Australia" you will not be deemed to have disposed of your home by 104-160 if you decide to keep a home in Australia to return to and go overseas for longer than 2 years and lose your residency for tax purposes. But note you will have to elect for it to be your main residence otherwise section 118-192 deems there to be a disposal anyway, if it is first rented out after 20th August 1996. If you elect for it to be your main residence but rent it out during you absence the exemption will only last 6 years unless you move back in again. You will qualify for another 6 years each time you move back in. If it is not rented out the exemption from CGT is unlimited. Section 118-145. Note the disposal deemed by section 118-192 does not trigger a capital gain if the house had always been your main resident during the time you owned it but it will start the clock ticking on any gain from that date forward.

You may also have trouble if you are the trustee of your self managed superannuation fund as the trustee needs to be a resident.

Interest, dividends and rent when overseas

This all revolves around whether you are a resident of Australia for tax purposes. Note you can be working overseas and being taxed on the wages you earn in that country by that country. But if you are still a resident of Australia for tax purposes Australia gets to tax your Interest, Royalties, Dividends and Rent from anywhere in the world. It is only your wages earned overseas and that meet the requirements of 23AG i.e. 91 days work, that are exempt in Australia. The interest on the overseas bank account, that your overseas wage is paid into, is taxable in Australia even if the wage isn't. Whether you are a resident of Australia for tax purpose is a question of fact but a big deciding factor is whether you have gone overseas for a period of less than 2 years.

If you are not considered a resident of Australia for tax purposes then you are not taxed by Australia (other than withholding tax) on your interest, royalty or dividend income that has a source in Australia but you are still taxed in Australia on your rental income if the property is in Australia.

Note if you make a capital gain on an asset "connected with Australia" you are subject to tax on that gain in Australia whether you are a resident or not.

Non residents and Capital Gains Tax

Non residents are subject to tax on capital gains made on assets that are "connected" with Australia ITAA97 Section 136-10 if the assets were acquired after 19th September, 1985. But if the Australian assets are actually owned by a non resident company the capital gains tax will not apply. Note the Ralph Review suggested closing this loophole. To be "connected with Australia" (section 136-25) the asset must be:

1) Land, buildings and structures in Australia
2) An interest or right in land in Australia
3) A strata title flat or home unit
4) A share in a company that owns 1, 2 or 3 above and gives the shareholder the right to occupy.
5) An asset that has been used by its owner at any time to carry on business through a permanent establishment in Australia.
6) A share in a private company that was a resident of Australia when the share was sold.
7) An interest in a trust that was a resident of Australia when the interest was sold.
8) A share in public company that was a resident of Australia when the share was sold and the non resident and associates had control over more than 10% of the shares at any time during the last 5 years.
9) An unit in an unit trust that was a resident of Australia when the unit was sold and the non resident and associates had control over more than 10% of the units at any time during the last 5 years.
10) An option or right to acquire any of the above.
11) Various provisions associated with rollover relief.

Accordingly, a non resident will not be subject to capital gains made on shares in Australian public companies or trust if they control less than 10%. But will be subject to CGT on the sale of a house or home unit unless they are utilising the exemption available under section 118- 145 because they have lived in it.

Note some double tax agreements can contradict the above and if so the double tax agreement has authority over Australian tax law.

A non resident is entitled to the 50% capital gains tax discount if they have held the asset for more than 12 months.

Residents of Australia with overseas investments

Note this also covers Australian Residents for tax purposes that are overseas at the time, even if they are working temporarily overseas and even if their wages income is exempt under section 23AG.

Dividend Royalty and Interest Income from Investments Overseas – Under our double tax agreements this should be subject to withholding tax in the country it is earned. Nevertheless, the full amount you have earned before the withholding tax was deducted should be included in your Australian tax return as foreign income with the withholding tax shown as foreign tax credits.

Rental Properties – If your net rent income is taxed in the country the property is located in you are entitled to a foreign tax credit for any tax paid. Your net rent income is determined according to Australian tax law and included as foreign income in your Australian tax return. Section 43 depreciation is available for buildings, alterations etc which began after 21st August, 1990 section 43-20(1) or 26th February, 1992 section 43-20(2).

The foreign tax credit can only be used to offset tax payable in Australia on foreign income of that particular class but unused tax credits can be carried forward and used to cover future foreign income of the same class. Interest income is in a different class to other passive incomes.

. There is no point in negatively gearing any overseas investments (other than considerations unique to the country you have invested in) unless you have other foreign income of the same class to offset the loss against.

Residents of Australia will be subject to capital gains tax on any assets acquired after 19th September, 1985 unless the applicable double tax agreement specifically excludes this. The 50% discount is available if the asset is held for more than 12 months. For the purposes of the tax return this amount is recorded as capital gains not foreign income. A capital loss is not quarantined as foreign income is, a foreign capital loss can only be offset against capital gains but they can be Australian or foreign. Capital losses have special offset rules refer IT2562. In short this allows foreign capital losses to be offset against Australian capital gains first thus maximizing any other foreign capital gain and so maximising the opportunity to utilise the foreign tax credits from the foreign capital gain. If you are entitled to a credit for foreign tax on your capital gain your tax return will need to be lodged manually with a note detailing this as there is no facility within a normal tax return to record the credit.

Australian residents and foreign losses

Foreign losses that cannot be offset against foreign income in the year incurred can be carried forward and deducted against foreign income of the same class in future years. The four classes are interest income, passive income that is not interest, offshore banking income and all other assessable foreign income.

A capital loss is not quarantined as foreign income is, a foreign capital loss can only be offset against capital gains but they can be Australian or foreign. Capital losses have special offset rules refer IT2562. In short this allows foreign capital losses to be offset against Australian capital gains first thus maximizing any other foreign capital gain and so maximising the opportunity to utilise the foreign tax credits from the foreign capital gain.

Unlike other partnership losses that are automatically transferred to the individual partner, foreign losses made by a partnership are quarantined to be offset against only foreign income of the same class only earned by the partnership (TD 92/113).

If you are offsetting a foreign loss against foreign income you are only permitted a tax credit for the amount of foreign tax that would have been payable on the net amount. But this is not the case with Capital losses which have special offset rules refer IT2562.

Overseas summary

Non resident for tax purposes:

1) Subject to normal income tax at non resident rates on wages earned in Australia and investment income earned in Australia that is not subject to withholding tax or imputation credits.
2) Subject to capital gains tax on gains made on assets "connected with Australia"

3) If an Australian resident becomes a non resident they have 3 choices as to how they deal with their assets that are not "connected with Australia" and were acquired after 19th September 1985.
   a) Deemed them to have been disposed of when they leave and pay the CGT. As a result no Australian CGT will be payable on any gains while a non resident
   b) Defer the CGT and pay it when the asset is sold but the tax will be on the gain over the whole period up to the sale including when a non resident.
   c) Defer the CGT on the basis you will be returning to Australian Residency before you sell it but when you do sell there will be no exemption for the gain made while you were a non resident.

Residents for tax purposes that are overseas:

1) Under certain conditions overseas employment income exempt from tax in Australia but taken into account in determining tax bracket.
2) Subject to normal income tax at resident rates on interest, royalties, dividends and rental income no matter where in the world it was earn. But entitled to a credit for any foreign tax paid.
3) Subject to capital gains tax on any gains made on any assets anywhere in the world. But entitled to a credit for any foreign tax paid.

Note: All of the above is written for the small investor not companies or trusts and there are more complex rules if you have a significant investment in a foreign entity.

Warning when settling property on divorce

The following only applies if the assets subject to the settlement belong to a company. It is a horrible combination of Div 7A and the CGT roll over relief provisions. Section 126-5 applies rollover relief if there is a court order or section 87 maintenance agreement under the Family Law Act, corresponding foreign family law or a state or territory or foreign law relating to defacto marriage breakdowns. This is not an option but an unavoidable consequence unless you transfer the property before the court order.

The transfer of the asset out of the company into the hands of the spouse may create a debit loan account and if the transferee spouse is a shareholder, or not yet an ex spouse of a shareholder so considered an associate of a shareholder of the company division 7A would then apply. A dividend would be deemed to have been paid to the extent of the loan or the undistributed profits held by the company (note the legislation specifies undistributed surplus which has a much wider meaning than profits but I am trying to keep this simple).

The gravity of the ramifications varies depending how the company originally got its funds to invest. If the original investment was made by the shareholders loaning the company the money then there may still be a credit loan account to offset at least part of the debit loan account created by the transfer of the asset. How much is offset depends on whether all the assets originally purchased are transferred out. If the original investment was funded by buying a large number of shares in the company there would not be a credit loan account to offset and this is where there is more likely to be a large deemed dividend.

A deemed dividend under Division 7A cannot be franked with imputation credits for the tax the company has already paid on the undistributed profits. So to keep the example simple lets say there was $70 in undistributed profits and the transfer of the property to a spouse who was also a shareholder created a debit loan account of at least that much. Because the undistributed profits are less than the debit loan account the deemed dividend is only the amount of the undistributed profits. To have that $70 in undistributed profits the company must have earned $100 and paid $30 in tax. Then as a deemed dividend to a shareholder in the maximum tax bracket the $70 would attract another $33.95 in tax. So the original $100 would have incurred $63.95 in tax. In reality this means you probably have had to sell the asset to pay your tax bill and only got close to half of the property settlement that the courts credited you with.

Some relief may be gained by declaring a dividend that reduces the undistributed profits to zero. All shareholders of the same class must receive the same dividend.

There is much more than this. Section 126-15 deals with how the cost base of the company shares and any loans to the company are affected. Further there may be FBT concerns if either of the spouses have been employees of the company, for example having to pay interest on the debit loan account created by this nightmare. The legislation leaves more questions than it answers and unfortunately has not yet been tested in the courts.

I apologize that I have not been able to put the above into my usual user friendly form as it is a complex issue with problems specific to the facts of each case. I have printed this article because all too often property settlements do not take the tax ramifications into account and as a result one party can be considerably worse off than they expected. The main message I want to get across, is, that if you are settling property that is held within a company make sure a tax specialist is involved in the decision and refer them to the sections quoted above. Secondly think twice about investing through a company. If you are just doing it for the lower tax bracket a self managed superannuation fund maybe the way to go - though they have their own set of problems which will be addressed in a future edition.

Capital protected loans - ATO Loses - Govt changes law

In Firth v Commissioner of Taxation the court ruled that additional interest charged on a loan because of the loans capital protection features was still deductible as interest. The ATO argued that protecting the underlying investment was a capital cost and only part of the interest was tax deductible. The ATO was refused leave to appeal to the High Court. So now the Government will change the law to ensure that only part of the interest will be deductible. This is not law yet but the Government has announced it will apply retrospectively to loans, that incorporate capital protection, entered into on or after 9.30am 16th April, 2003.

An example of a loan, that the above would apply to, is a limited recourse loan facility used to purchase an investment but the investor would have the choice of giving the investment to the lender in full satisfaction of the outstanding balance of the loan regardless of the current value of the investment.

The ATO in the past has issued product rulings saying that the capital protection portion of the interest is not deductible. It would appear that those rulings may not be binding on arrangements made before 9.30am 16th April, 2003.

The 50% CGT discount

As you are probably aware you need to hold onto a property for over 12 months from the date of signing the agreement to purchase to the date of signing the agreement to sell in order to qualify for the 50% CGT discount. Some clients have been making a very quick gain on properties and are impatient to sell in case prices fall. The choice is sell now and lose a lot of the profit in tax or hold on and take a risk on future prices. From the buyers point of view they are probably more concerned that prices will continue to escalate but are not in a rush to start paying interest on the loan. In fact the chance to fix a contract at today's prices but not have to pay anything for several months could be very attractive to some buyers.

ATO ruling TD 16 states - If an option is granted the date of the acquisition for the buyer and the selling date for the vendor, is the date of the exercise of the option.

Of course an option gives a purchaser the chance of avoiding entering into the contract to buy the property so you must charge a large enough amount for the option to ensure that the purchaser will exercise it after the date you specify.

How franking credits affect investment yield

When you are considering the rate of dividend return you receive on an investment the franking credits should be taken into account. For example assume you purchased shares in A Limited for $100,000 with the expectation that the cash dividend you would receive would be 5.5% and you borrowed the $100,000 at 6.5%. Don’t assume that you would have to top up an interest only loan for the other 1% over and above what you receive in dividends. If the dividends are fully franked the whole arrangement will be cash flow positive after you have completed your tax return. Lets assume you are in the 31.5% tax bracket. The dividend would be $5,500 in cash plus $2,357 in franking credits. Your tax calculation would be as follows:

Assessable Income	$7,857	
Less Interest	6,500	
Taxable Income	$1,357 x 31.5% tax =	$ 427
Less Franking Credits		2,357
Tax Refund		1,930

If you are getting a 5.5% cash dividend return that is also fully franked you are really getting a 7.857% return before tax.

Arranging to make interest payments in advance

Investors who pay the bank next year's interest before 30th June, 2004 can claim the amount as a tax deduction this financial year.

The deductibility of prepaid interest, paid by an individual taxpayer in respect of a rental property for a period not exceeding 12 months is not subject to special timing rules under section 82 KZM of the ITAA 1936 according to ID2002/939.

Taxpayers who have a loan for a rental property or shares can make up to 12 months interest payments in advance and qualify for a tax deduction at the time the repayments are made. Be careful that the ATO cannot argue that it was really a repayment of capital. Make sure the arrangement with the bank is that the payment is interest. Simply putting the money into the loan account will not work as the bank will treat that as a repayment of capital. You must not make an advance payment for a period in excess of 12 months or the whole amount will only be able to be claimed in the period the interest is applicable to not when paid. Businesses do not qualify for this concession unless they elect to enter the simplified tax system. If your business is in the simplified tax system you may want to consider making 12 months lease payments in advance also.

As this arrangement is only moving tax deductions from next year into this year it could work against you if you are in a higher tax bracket next year than this year.

Stop press – Link, split loans case decided

Hart's case, as it is called, was handed down by the High Court on Thursday 27th May. It was decided in favour of the ATO. Interestingly, the Judges would not address the issue of whether capitalised interest was deductible as they decided it was unnecessary to do so as the arrangement was caught by Part IVA, regardless. The basis for the arrangement being caught by Part IVA was that the product put together by the bank had a dominant purpose of a tax benefit. This seems fair enough considering the way these arrangements were marketed back then.

In our Claimable Loans Booklet there is a full discussion of this case and future strategies.

Children's investment income

Last month the ATO released a fact sheet on dealing with Children's investment income. It is very important to know the ATO's policy on this one because the law is such that parents or grandparents are technically liable for the tax on their children's investment income if they are trustee. In most cases they are trustee because the children being under 18 are not allowed to hold shares in their own name. Accordingly, the parents can only rely on the ATO's guidelines as to when they will not exercise their absolute power to tax the parents.

Children are taxed on any passive income over $416 though they do qualify for the $235 low income rebate to offset some of that tax. When their passive income exceeds $416 but is less than $1,446 it is taxed at 66%. Any further income the child has over $1,445 is taxed at 47%.

Note there are concessions for income from the investment of an inheritance, compensation etc.

Considering the hefty tax rate applied to children's passive income it might be more important to find out how to arrange your affairs so that the parent is the one taxed on the children's income anyway.

The fact sheet is in regards to shares and basically states that the person, who controls the shares and proceeds, is the person who should pay tax on them. So if the proceeds of the shares are held for the child then the child pays the tax and must lodge a tax return if their passive income exceeds $772 if there are no franking credits or $416 if there are franking credits. A tax return will also need to be lodged if TFN tax has been withheld. If there are franking credits on the shares and the child's income is under $416 they can complete an application for a refund of franking credit form rather than lodge a tax return.

The ATO's opinion as to who is taxed on bank account interest can be found in IT2486. Which examines where the money in the account came from and whether the parent uses the money. This is basically the same as the fact sheet on shares. Children with only interest income need to lodge a tax return if their income exceeds $772 or they have had TFN tax withheld.

Note both the fact sheet and the ruling make it clear that the more money in the account the more likely they are to consider it the property of the parent.

Gearing – don't forget the franking credit

The objective of negative gearing is to run an investment at a loss by the expenses associated with it such as interest exceeding the income, while you are in a high tax bracket. During this time the investment should be increasing in value but you do not sell until you are in a lower tax bracket. The 50% CGT discount also makes capital growth more attractive than income.

The trouble is some people investing in shares and managed funds are not doing their sums right because they forget that the franking credit is taxable. Generally if the investment is negatively geared it should be held in the name of the high income earner but if it is positively geared it should be held in the name of the low income earner. Another factor to consider is that if the negatively gearing is not that great, inflation may soon see it become positively geared, if all goes well. On the other hand there is the possibility of interest rates increasing but you would not expect this to be as great as inflation. If the investment becomes positively geared you are going to wish you purchased the investment in the low income earner's name but cannot transfer it across without incurring a capital gains tax bill. This scenario is not just a possible outcome but the outcome you are investing with the intention of achieving, so do not be short sighted when deciding whose name the investment should be in. You can't blame the average shareholder for misunderstanding as the rate of dividend return quoted always ignores the franking credit; at best you hear plus tax credits.

Crunching the numbers for $1,000 worth of positively geared shares that pay a fully franked dividend borrowing 100% of the purchase price:

Dividend @ 5% $50.00 Plus Franking Credit (Dividend/70x30) $21.40 Equals $71.40 Assessable Income Less Deduction for Interest of $1,000 x 7% 70.00

Taxable Income $ 1.40

Owner Taxed at 48.5%		Owner Taxed at 31.5%	
Tax Calculation 1.40 x 48.5%	.68	Tax Calculation 1.40 x 31.5%	.44
Less Franking Credit	21.40	Less Franking Credit	21.40
Tax Refund	20.72	Tax Refund	20.96

On the other hand if the shares are negatively geared because they are only producing a 4% return:

Dividend @ 4% $40.00 Plus Franking Credit (Dividend/70x30) $17.14 Equals $57.14 Assessable Income

Less Deduction for Interest of $1,000 x 7% 70.00

Tax Loss to Offset against other income 12.86

Owner Taxed at 48.5%		Owner Taxed at 31.5%	
Tax Calculation 12.86 x 48.5%	6.24	Tax Calculation 12.86 x 31.5%	4.05
Plus Franking Credit	17.14	Plus Franking Credit	17.14
Tax Refund	23.38	Tax Refund	21.19

While the rate of return on the share price at the time might not change, inflation should increase the return in relation to the original amount borrowed. So if the investment is positively or slightly negatively geared but the dividends are expected to increase and the shares will be held for a long time it is better to hold the shares in the name of the low income earner. This will also be helpful when realising a capital gain.

Reader's question – Travel to AGM

An investor can claim the costs associated with travel to an AGM. Including meals, accommodation, air fares, and motor vehicle expenses. This is verified by the ATO in ID 2002/948 but with the condition that if the costs exceeded the dividend income the motive would be questioned and apportionment of the expenses maybe necessary unless it is clear that the sole purpose of the travel is in regard to the AGM.

Capital Gains Tax and shares or managed funds

While capital gains tax (CGT) is not a death tax, it does impose a huge headache on the beneficiaries of your estate to find necessary information when you are not around to help them. The transfer of your assets to your heirs will not trigger CGT but when your heirs eventually sell the assets they need a cost base in order to calculate any CGT payable. The ATO can fine them if they do not have the appropriate records and they could end up paying a lot more tax than necessary.

To keep it simple!! I will just consider the costs base for shares and units in managed funds. The cost base is the original purchase price plus any reinvestments of dividends or distributions, brokerage fees and initial financial advice costs less tax deferred distributions or returns of capital. The capital gain or loss is the difference between the cost base and the selling price. It is helpful if you record the number of units or shares as any discrepancy between this total and the quantity sold will detect an error in the records. Documentation explaining any tax free distributions should be kept safe as they may also effect the cost base. If you have sold some of the parcel, your records should show how the cost base was calculated as this is relevant to determining the cost base of the remaining shares or units. In my experience you cannot always rely on your fund manager to keep for you the information you need to calculate your cost base. If the fund has been taken over the relevant records may no longer be available. The funds are under no obligation to provide this information. It is the owner of the asset, namely you or your heirs, that is required to keep the records necessary to calculate the cost base and liable for a fine from the ATO.

If the thought of having to dig up this information gives you the horrors imagine how difficult it will be for your heirs. So what can you do to leave your estate in good order? Firstly acquire a big box and then start to do what I have been planning to do over the last 10 years. Include in this box a folder for each investment containing all correspondence. Just because some of the information provided on the taxation statement each year has been included in that year's tax return does not mean that is the end of it. Keep all statements and explanatory information, even if the fund claims the distribution is tax free.

Tax Minimisation Between Spouses

Before entering into an arrangement that effectively shifts income from one partner to the other or deciding whose name in which to buy an income producing asset, check the need for this considering the new tax brackets. This includes arrangements like the kit discussed above.

The way for a couple to minimise their overall tax is to arrange their affairs so that they are both in the same tax bracket. They do not need to have the same taxable income. Their combined tax bill will not benefit from any income shifting arrangement if they are already in the same tax bracket. Even if one is at the higher end and the other the lower end.

By the 2007 financial year the government expects that only 2% of the population will be in the maximum tax bracket due to the new tax rates. The 31.5% bracket is so wide that a taxpayer only working part time may well be in the same bracket as his or her spouse who is working full time.

For example, 2007:

Between $25,001 and $75,000 in taxable income you will pay a marginal rate of 31.5%
Between $75,001 and $150,000 in taxable income you will pay a marginal rate of 41.5%

Note the above does not take into account the low income rebate of $600 which starts to shade out after $25,000 in taxable income. You need to have gone well into the next bracket above your low income spouse before any tax arrangement that shifts income to them is worth your while.

Superannuation Co Contribution

Assessable income not taxable income determines whether you are entitled to the co contribution. Assessable income generally means your income before tax deductions. In the case of a sole trader this means the turnover of the business or for a sole rental property owner gross rent is included in assessable income without tax deductions. On the other hand if the business is a partnership or the rental property is owned by more than 1 person then it is only your share of the net profit that is included in your assessable income. Though a loss cannot reduce assessable income it just has zero effect. Note even though a jointly owned rental property does not require a partnership return to be lodged we recommend that you do this so that the ATO computer will automatically treat your data correctly. Any person jointly in receipt of income is entitled to lodge a partnership tax return. This does not just apply to rental properties, jointly owned shares and units in a unit trust also qualify.

Examples of Co Contribution entitlements if you contribute $1,000 from after tax dollars:

Assessable income of:	**receive from the Government:**
$28,000 or less	$1,500
$30,000	$1,400
$40,000	$ 900
$50,000	$ 400
$58,000	$ 0

Losing Interest Deductibility

Imagine how you would feel if you borrowed $100,000 to invest in shares. Then when it came time to do your tax return your Accountant told you the interest is not tax deductible because the money went from your loan to your cheque account in order to write a cheque to your broker. A recent AAT case decided that if loan funds are intermingled with other funds before being used for income producing purposes they are no longer considered to have their source in the loan.

Interest is not deductible on a loan unless the proceeds of the loan have been used to purchase or relate to an income producing investment. The link can be simply lost by paying some spare cash off the loan and drawing it back later, or not being able to trace the flow of the funds to the investment. The ATO's own ruling states "a rigid tracing of funds will not always be necessary as appropriate." Yet in Domjan and Commissioner of Taxation [2004] AATA 815 the ATO successfully argued that the placing of borrowed money into a savings/cheque account with other personal funds broke the link necessary to prove the funds were borrowed for tax deductible purposes.

The AAT is not the highest court in the land but relevant nevertheless. The sitting AAT member stated: "I accept the Commissioner's submissions. Where the funds have been intermingled it is impossible to determine the use to which they have been put. In other words the purpose of the borrowing cannot be ascertained. It cannot be said that the expenditure – that is the payment of interest – has been incurred in the course of gaining or producing assessable income"

Mrs Domjan also tried to argue that when she deposited private funds into her loan account they were quarantined from the loan so when she drew money from the loan for private purposes it was simply a redraw of those funds, not a separate loan for private purposes. She also contended that any private funds put back into the loan after the redraw should go only towards reducing the loan for private redraws. Further she should not be penalised for using her private funds to temporarily reduce the interest on the loan and as a result reduce her tax deduction. The AAT found that the funds could not be divided so all repayments were to be spread equally over the loan and she could not choose the character of the funds she was redrawing from.

Mrs Domjan was in for a penny in for a pound. She even claimed that as the bank required her to insure her home because it was security on the loan, the insurance should be tax deductible. No luck here either.

The AAT also found that when Mr Domjan used a lump sum he personally received to pay off his half of the loan, the amount had to still be split equally between them as they were co debtors on the loan. Therefore even though he had paid his share back he was still entitled to claim half the interest that related to Mrs Domjan's share. As a result of this it would now be prudent, when only one member of a couple is borrowing to buy their share of an income producing jointly owned investment, the loan should only be in his or her name, not both. Trying to get a bank to agree to this may be a problem. If the bank will accept the non borrowing partner only giving a guarantee and his or her name does not actually appear on the loan, the problem may be avoided.

What was alarming was the fact that Mrs Domjan, who prepared her own tax return received, a 25% penalty on the basis she had been careless in claiming the interest in relation to the redraws. The ATO's argument being she had been careless in relying on a draft ruling after the final ruling had been issued. In the ATO's world taxpayers preparing their own tax returns should have a knowledge of the thousands of ATO rulings available and check regularly for updates. The AAT agreed with the ATO. I have quite a problem with this conclusion because unlike the draft ruling the final ruling did not cover redraws. So the ATO's argument is really that Mrs Domjan should have followed up the daft to read the final ruling and then realise that by ommitting parts of the draft but not issuing a counter view the ATO was really saying they no longer held the view expressed in the draft. The issue of redraws was eventually addressed in another ruling 2 years after Mrs Domjan had lodged the returns in questions.

Probably Mrs Domjan greatest mistake was representing herself before the AAT. Though I have no answer as to how the average taxpayer can afford to be equally represented against the ATO and its unlimited, taxpayer funded, resources.

Readers should seek professional advice before taking any action on specific issue in relation to any matter or information contained in this publication

Centrelink family payment threshold changes for 2004/2005

Even if one parent is earning hundreds of thousands of dollars a year Centrelink's Family Tax Benefit Part B is still payable if the lower income parent earns less than $18,947 per year and they have a child under 5. If the youngest child is over 5 the low income parent can earn up to $14,421 per year and still receive some Part B. Neither the high income earner's income or the family's assets are taken into account. To qualify for full Part B the low income parent must have an income below $4,000. The payment reduces by 20 cents for every dollar of income the low income parent receives, above the $4,000. Previously the threshold was $1,825 and the payment was reduced by 30 cents for every dollar above the $1,825. These changes, only introduced this financial year, certainly allow a lot more room for the low income parent to hold profitable investments in their name.

Following from our discussion on how negative gearing is less attractive now that the maximum tax bracket threshold has increased. Consider just how attractive a profitable investment is when no tax is payable on the income because the owner is earning below the taxable amount. Further any franking credits will be refunded by the ATO.

The only catch is finding the profitable investment. The idea is simple enough make sure the income exceeds the expenses associated with earning it. Usually the most significant expense is interest. If you have a decent deposit the investment may be profitable for tax purposes. Or you could consider a monthly investment into a managed fund with spare cash. If you owe money on non tax deductible debt it may be better to borrow for the investment and use your spare funds to reduce the non deductible debt. Don't limit your thoughts to houses and please remember return is normally a reflection of the risk. To get the optimum strategy see a financial planner.

Invest In Trees vs Paying The Tax

Taxpayers with large capital gains may consider investing in tree plantations to qualify for an immediate tax deduction to offset the gain. Trouble is the return on the trees is generally lower than other investments of similar risk and the proceeds from the sale of the trees at the end of the 10 year term are subject to normal income tax with no 50% CGT discount. The eventual sale of the trees all in the one financial year will probably push the taxpayer into the 48.5% tax bracket when they may only in the 31.5% the rest of the time. For the 2006 financial year the 31.5% tax bracket stops for every dollar over $63,000 then each dollar is taxed at 43.5% until they go over $95,000 where they will pay 48.5% on each dollar over that amount. In the 2007 financial year taxpayers can earn $70,000 before they start into the 43.5% tax bracket and have to earn over $125,000 before 48.5% applies to each extra dollar earned. The government predicts that by the year 2007 only 10% of the population will be in the 48.5% tax bracket.

Before you go investing in trees or similar tax motivated investments crunch the numbers for your particular circumstances. Below I have crunched the numbers for a person who would have been taxed on all their capital gain at 48.5% and had such a high income over the next 10 years that all their investment income was taxed at 48.5% then when the trees paid up this whole amount was taxed at 48.5%. I have also crunched the numbers for a person who was in the 48.5% for all of the gain and 48.5% for all of the proceeds from the sale of the tress but during the middle years was only taxed at 31.5%.

There are many possible variables you need to re work my calculations putting in the returns and tax brackets you think are most likely to apply to you. For example it would be very unusual for all of the gain and sale proceeds from the trees to be subject to the 48.5% tax bracket. Another consideration is the taxpayer may have a low income spouse so choose to invest the shares in his or her name. Note the trees will have to be in the name of the person who made the capital gain. The numbers are time consuming but not hard. Do not invest in these sorts of investments unless you do the numbers as I believe due to the new tax breaks these investments are not worth it, when you look over the whole 10 years, for the majority of taxpayers.

Let's just see how the numbers stack up. Assuming a gain of $100,000 but after applying the 50% CGT discount only $50,000 is taxable A 50% capital gain can span more than one tax bracket. I have just assumed all of it is taxed at 48.5% this will weigh the calculation in favor of the trees as most taxpayers will have space in their 31.5% bracket for some of the gain.

The following will compare paying the tax and therefore only having $75,750 to invest against not having to pay the tax. Therefore being able to invest the full $100,000, but $50,000 of it must be in trees. The annexure shows how the return on the $75,750 investment is calculated. Please take a close look as even if you do not have a CGT problem working through them will give you an appreciation of the miracle of compounding interest.

No Trees and 48.5% for all 10 years:

According to the calculations in the Annexure at the end of 10 years they have between $131,668.11 and $166,697.29 after tax depending on how good the growth was.

With Trees and 48.5% tax rate for all 10 years:

Instead of paying the tax they could have put half the proceeds ($50,000) into trees and invested the other half as above. The trees are predicted to provide a return of 7% compounded. But in the past they have only returned 5%. Note the return on the trees is income not capital growth so there is no 50% discount.

Return of 5% as per history	$82,350.47	Return of 7% as predicted	$100,483.07
Less Tax 48.5%	39,939.98	Less Tax 48.5%	48,734.29
	42,410.49		51,748.78
Plus $50,000 4% div. & 3% growth	86,909.64	Plus $50,000 4% div. & 6% growth	110,031.21
	129,320.13		161,779.99

The return on the $50,000 was based on the figures in the shares calculation above. To calculate the result if $50,000 was invested instead of $75,750 to net return after tax was divided by 75,750 and multiplied them by 50,000.

So at the end of 10 years they have between $129,320.13 and $161,779.99 after tax depending on how good the growth was.

I think I have already given the trees enough of a head start by picking only moderate returns on the shares. But to be sure let's look at the absolute best case scenario for the trees ie they return 7% and shares only grow by 3%. That's $86,909.64 plus $51,748.78 = $138,658.42 return on the trees as opposed to $131,668.11 on paying the tax and investing all of the net gain into shares.

Conclusion When 48.5% all the time:

Much of a muchness after 10 years but that is only if you are in the maximum tax bracket for 10 years. This will apply to less than 10% of the population. You also need to ask yourself are the trees riskier than the shares you would purchase?

A more likely out come would be 48.5% tax bracket when sold but only 31.5% for next 9 years then pushed into 48.5% bracket in final year.

No Trees 48.5% only when realizing the gains rest of the time 31.5%:

According to the calculations in the Annexure at the end of 10 years they have between $140,585.81 and $177,891.76 after tax depending on how good the growth was.

With Trees and 48.5% tax rate for the first and last year otherwise 31.5%:

Instead of paying the tax they could have put half the proceeds ($50,000) into trees and invested the other half as above. The trees are predicted to provide a return of 7% compounded. But in the past they have only returned 5%. Note the return on the trees is income not capital growth so there is no 50% discount.

Return of 5% as per history	$82,350.47	Return of 7% as predicted	$100,483.07
Less Tax 48.5%	39,939.98	Less Tax 48.5%	48,734.29
	42,410.49		51,748.78
Plus $50,000 4% div. & 3% growth	92,795.91	Plus $50,000 4% div. & 6% growth	117,420.30
	135,206.40		169,169.08

The return on the $50,000 was based on the figures in the shares calculation above. To calculate the result if $50,000 was invested instead of $75,750 to net return after tax was divided by 75,750 and multiplied them by 50,000.

So at the end of 10 years they have between $135,206.40 and $169,169.08 after tax depending on how good the growth was.

Looking at the absolute best case scenario for the trees ie they return 7% and shares only grow by 3%. That's $92,795.91 plus $51,748.78 = $144,544.69 return on the trees as opposed to $140,585.81 on paying the tax and investing all of the net gain into shares.

Conclusion When Only in 48.5% Bracket First and Last Year:
This is about Mr or Ms average to high income earner who is not always going to be in the maximum tax bracket. There is very little chance the trees will give them the better outcome especially if only some of the gain is taxed at 48.5%.
Note:
1) The highest possible returns considered in the calculations were 10%. The higher the return on shares the less the argument for trees.
2) If you need funds quickly you can always sell some of your share portfolio but if you need enough that you need to sell some trees you will be hard pressed to find a buyer as the secondary market is very limited.

Noel's Rules of Thumb

Rule of 72 – the number of times the return on your investment goes into 72 determines how long it will take for your investment to double in value. For example a 9% return compounded will double every 8 years, so $100,000 becomes $200,000 in the first 8 years then $400,000 in the next 8 years.

$12 for every $1,000 – If your monthly home loan repayment is $12 for every $1,000 you owe you will pay off the home loan within 10 years. On a $100,000 loan the monthly repayments should be $1,200.

AMP Return of Capital

In June 2006 AMP made a payment to shareholders that was a return of capital. This is treated differently from the normal dividend income. It will reduce the cost base of your shares. If the cost base is reduced to below zero you must declare a capital gain in the 2006 financial year though it is highly unlikely that a return of capital of 40 cents per share will have this effect. But if you received the return of capital after you had sold your AMP shares then you will have to include a capital gain of 40 cents per share in your 2006 tax return.

Death Bed Superannuation Withdrawals

From the 1st July 2007 people over 60 and retired will not pay tax on withdrawals from their superannuation fund. If you die and your superannuation is paid to your spouse or dependants they will not be taxed on it either. There is a trap here, if you are over 60 without a spouse or dependants (children under 18yrs). If you die your beneficiaries will have to pay tax of 16.5% on some, even all of the money they receive from your superannuation fund. Whereas, if you had taken it out during your lifetime you would have received it tax free and have been able to pass it onto them through your will tax free. There is all sorts of talk at the moment about leaving a signed withdrawal form for your beneficiaries to lodge before informing the authorities of your death. Hopefully, the government will make this situation a bit more reasonable before 1st July, 2007. This should concern you even if you have a spouse as you may be both killed in the one accident.

Bequeathing Your Shares through a Life Tenancy or Trust

We call it the 45 day rule. In order to be able to claim the franking credit that comes with most dividends you must have held the shares for at least 45 days. This can be a problem if you received the franking credit through a trust i.e. you don't hold the shares or a fixed interest in the trust. Small investors need not worry because they can claim up to $5,000 in franking credits before being caught by this rule.

Creating a Life Interest (Life Tenancy) in shares you own means that you leave the income stream from the shares to a beneficiary for the rest of their life (the Life Tenant). When the Life Tenant dies the shares are given to another beneficiary (the Remainderman). A will that leaves a life tenancy interest in shares would normally set up a testamentary trust to hold these shares. A deceased estate holding a life tenancy will pass the 45 day rule but if the estate is wound up and a testamentary trust set up to hold the shares the rule is not passed by the life tenant as they do not have an interest in the assets of the trust only the income.

On 20th March, 2006 the government announced they were going to change the law to fix this problem and it would apply retrospectively back to 1st July, 2002. As at 16th October, 2006 a bill covering this problem had not even been submitted to Parliament. In the meantime we recommend that you do not leave a large amount of shares in this way. If you are executing an estate at the moment it may be worth delaying finalising it if there is a life tenancy on a large amount of shares that are likely to generate more than $5,000 in franking credits per beneficiary. Another option, if the beneficiaries are related, is to make a family trust election so that the franking credits can be claimed. The media release did say that testamentary trusts that make a family trust election to overcome this problem will be entitled to revoke it once the changes to the law go through. Remember this is all based on a media release so there are no guarantees. Beneficiaries of a testamentary trust that is discretionary (ie each year the trustee can decide who gets what) are also caught by the 45 day rule if a beneficiary receives more than $5,000 in franking credits. The media release did not state any intention to fix this. Accordingly, large portfolios of shares should not be held in a testamentary trust unless it can make a family trust election.

Changes to Superannuation for Non Employees

If you do not have employer support you can make a tax deductible superannuation contribution for yourself. Examples of this would be the Self Employed or people under 65 but not working. From 1st July, 2007 you will be entitled to a 100% deduction for your contributions so up to your age base limit of $50,000 if you are under 50 and $100,000 if you are over 50 but under 75.

If your income for 2008 will be under $58,000 you should also consider making an undeducted contribution of $1,000 to qualify for the government co contribution of up to $1,500.

From 1st July, 2007 you are entitled to claim a tax deduction for superannuation contributions up until you reach 75 years of age, subject to other conditions. You have up to 28 days after your birthday to make the contribution.

Warning on Claiming Financial Planning Fees

TD 96/50 states that fees paid to a financial planner to prepare a plan for your investments is not tax deductible because it is incurred at a point too soon before the earning of investment income. The ruling goes onto state this is the case even if the new plan contains some old investments. Fees paid to a financial planner for the ongoing review of your investments is tax deductible.

Some financial planners have a ruling stating that their fees are tax deductible. This ruling is only applicable to fees they personally claim as a tax deduction. You must have a ruling in your own name to be able to claim the fees you have paid. So ask them for a copy of their ruling and quote it in your application. Make sure their ruling correctly describes your circumstances.

It is not unusual for financial planners and managed funds to charge an up front entry fee of 4% of the value of the amount you invested, plus ongoing fees. Before you go shopping around for a financial planner that will charge less, consider how this fee is spent. If the firm is repretable they will spend a good portion of this money on research to monitor your investments so it is important that they have the funds to properly look after your investment. On the other hand if the fund or financial planner wants a fee higher than 4% you should ask why.

New SMSF Trustees Must Sign a Declaration

From 1st July, 2007 all new trustees of Self Managed Superannuation Funds (SMSF) must sign a declaration which lists their responsibilities as trustee. This is an attempt by the ATO to try and improve compliance within SMSFs by making trustees aware of want they can and can't do. The declaration is well worth a read for all trustees of SMSFs and is available from the ATO. The reference number is NAT 71089-06-2007.

Cancellation of Henderson Shares

If you have ever owned AMP shares this may apply to you. On the 13th October 2006 22% of Henderson Group plc shares were cancelled. This triggered a CGT event that will apply to your 2007 income tax return. The ATO deems you to have received $2.38 per share because this was their market value at the time of cancellation. The ATO does not consider the $1.93 per cancelled share paid by Henderson the market value of each cancelled share. So the market value is substituted.

This may at first seem that you are paying tax on income you didn't receive but the truth is you still own just as much of Henderson Group plc as you always did. Let's assume Henderson Group's assets are worth $1million after the return of capital and there were 1milllion issued shares in the company. If you owned 100,000 share then you owned 10% of the company. Assume the $1.93 per share paid by Henderson's to shareholders upon cancellation of the shares totalled $100,000 so now the assets of the company are $900,000. Because 22% of shares were cancelled you only own 78,000 shares and there are now only 780,000 issued shares so you still own 10% of the company which in a perfect market is 10% of $900,000 worth of assets so your 78,000 shares should now be worth $90,000 on the share market anyway and you would have received $10,000 cash for the shares that were cancelled.

So what are you up for in CGT? Well that depends on your cost base of the Henderson Group plc shares. First reduce your cost base by the return of capital you received in 2006 and make sure you have already reduced that cost base by the return of capital you received in 2005. Multiply this new amount by 22% to get the cost base of the shares that were cancelled. If this is less than $2.38 multiplied by the number of shares that were cancelled you have made a capital gain which you will either have to offset against other capital losses or pay tax on. If 22% of your cost base is more than $2.38 multiplied by the number of shares that were cancelled you have made a capital loss which can be offset against any capital gains you made in 2006/07 or carried forward to be offset against future capital gains. Note if your cost base before the return of capital is less than the return of capital, your capital gain will be greater than the $2.38 per share market value set by the ATO. Don't worry about the $1.93 per cancelled share that you received, it is part of the $2.38 so is not needed to be taken into account in the calculation. It was probably paid to make sure you had more than enough cash to pay any CGT and as explained above you still own the same percentage of the company's assets. Reference CR 2006/123.

Holding an Investment in Trust for a Minor

Children under 18 cannot hold property or a share portfolio in their own name. Accordingly, parents or grandparents wanting to set up a nest egg for a child have to put the investment in their own name rather than the child's. The ATO accepts that providing the investment is always treated as the child's and never "borrowed" from by the parent, that the child can be taxed on the investment's earnings. This is not always a good thing as children with taxable income greater than $1,667 will pay 66% tax on their passive income.

Recently a Grandparent advised a fund manager than his grandchild had now turned 18 so the investment could now be held in the child's name. The fund manager was quite adamant that this triggered a capital gains tax event and the Grandfather would have to pay CGT on the change of ownership. This is not correct because the ownership has not changed at all. The Grandfather merely held the investment as trustee for his Grandson because his Grandson was under a legal disability. The investment always belonged to the Grandson, it was a bare trust, his Grandson was absolutely entitled to the investment at any time. So no CGT event happens when the name on the investment changes because there is no change of ownership.

The relevant section number is 106-50 of the 1997 ITAA. Unfortunately this section is not very clear but if you look at the way it is interpreted in ID 2003/804 it becomes clear that when an asset is held solely for the benefit of another and later the name is change to that other's name no CGT event takes place.

Super Funds Allowed to "Borrow" to Buy Property

That is the wording being used and some talk suggests super funds can borrow in the same fashion as other entities. This is not correct, there are many restrictions on the circumstances under which a super fund can "borrow". The two most important being that the loan must be have limited recourse and that assets of the super fund cannot be used as security.

By the way the borrowing does not have to be for property it can be any other assets that a super fund is permitted to purchase.

The way the approved loans work, the super fund borrows money from the " lender", the lender's only security is an asset held in trust for the benefit of the super fund. This is where the limited recourse comes in. The Lender can only recover this property if the super fund defaults. The Lender has no further right of action against the super fund's assets. So the Lender is going to want the super fund to come up with quite a large deposit for the asset held in the trust and probably charge a higher than normal interest rate. The super fund invests this "deposit" in the trust; once the final installment has been made the asset is transferred to the super fund.

To date it does not seem that any lenders are offering this facility and it is expected that if they did, in order to compensate for the limited recourse, the interest rate would be higher and probably only a 50% lend. A way around this problem maybe to borrow from the bank under normal conditions and then provide the appropriate loan to your super fund yourself. The asset held in the trust could be used as security plus cash from the super fund for the first installment being the deposit the banks require on a normal loan or you could use other assets held outside the super fund but you cannot use super fund assets. The ATO has not yet commented on whether it would be acceptable for a member of a super fund to provide the borrowings and it certainly seems that of section 66 of SISA could prevent a member or his or her associate from being the lender or the trustee for the asset subject to the loan. Another option may be to persuade the bank to offer the limited recourse loan but reduce the premium by offering your personal guarantee. Again this maybe caught by section 66.

The changes to section 67(4A) that opened up this possibility, only became law at the end of September, 2007 so there are no cases or ATO rulings to use as a guideline yet. I have read commentary on both sides of the fence regarding section 66 so I would prefer to wait and see at this stage.

Current costs for setting up such an arrangement range from $5,000 to $23,000 so it is not worth it for the average investor. If the cost doesn't put you off and you are not prepared to wait and see, make sure you have a ruling from the ATO that you are permitted to act as a go between on the loan.

Salary Sacrificing Tricks for Share Investors

The ATO has just issued a private ruling agreeing that the high income earner in a family can salary sacrifice all of the interest payments on a share portfolio they own jointly with their low income spouse and their employer does not have to pay FBT because of the otherwise deductible rule. This effectively means that the high income earner gets to deduct all of the interest expenses but gets to split the income with his or her spouse. The private ruling number is PBR 79617. PBRs are only copies of private rulings, not binding on the ATO. To be absolutely sure that your employer is protected it should get its own private ruling from the ATO.

SMSF Borrowing – ATO Concerned

In the December 2007 minutes of the Superannuation Consultative Committee concerns were raised about the installment warrant products being marketed to SMSFs with a resolution to provide the public with better information on these products and watch for any associated risks. Unfortunately full details of the discussion were not available so we do not know what area of the use of installment warrants the ATO is concerned about.

ATO Finally Speaks Up About Super Fund Borrowings

On Friday 4th April released a Tax Payers Alert and a Fact Sheet on the issue of Superannuation Fund borrowings (Installment Warrants). We have covered this issue in as much detail as possible as it has become available. The law only changed in September 2007 so there has been a great variety of opinion as to how the new laws will be interpreted by the ATO. Professional opinions varied and until now the ATO had remained silent. The following is a summary of the issues covered by the ATO that are relevant to our discussions. The full transcript can be obtained using the ATO web site's search engine. Search the Aggressive Tax Planning section for TA 2008/5 and the All ATO (except legal data base) section for Installment warrants and super funds - questions and answers . With the main stream lenders only just starting to come into the non-recourse loan market place, interest rates and charges should become more competitive in the future so it would seem certainty and savings can be gained by waiting a while before entering into these arrangements anyway.

The ATO clearly states that the new law does not prohibit the lender being a related party to the superannuation fund. But it warns in doing so, the superannuation fund must not breach the sole purpose test. The ATO feels this would be breached if the interest charged on the loan was higher than market rates and if it was lower than market rates the interest saving to the superannuation fund could be considered a superannuation contribution by the member which may breach the superannuation contributions cap and lead to excess non-concessional contributions tax being payable.

If a party related to the superannuation fund, provides a personal guarantee to a lending institution in order to secure a "limited recourse loan" for the superannuation fund, the loan may not be considered limited recourse.

If the interest on the loan is capitalised that new borrowing would not be considered to be for the acquisition of the asset so would not be permitted.

Wash Sales

It's that time of year again when the tax office starts warning about year end tax strategies. They have just released TA 2008/7 warning taxpayers not to try and sell off shares where they have made a capital loss so they can offset it against a capital gain. It is ok to do this if you just want to offload the shares but they brand it as a scheme with the dominant purpose of a tax benefit (Part IVA) if you continue to effectively hold the shares. For example buy them straight back again or sell them to a trust you control.

I have particular trouble with this attitude because the taxpayer is making a simple choice and Part IVA is not supposed to interfere with taxpayers simply choosing a course of action that is readily open to them. The ATO uses its usually elusive naughty thoughts argument. The scheme is supposed to be, thinking about, maybe even discussing future purchase prices with a broker, selling the shares to trigger the capital loss, with thoughts of buying them back. This sounds like, to borrow a concept from Hart's case, how can any rational person not consider this benefit?

Anyway just to make sure no one triggers these naughty thoughts they rant and rave about what they will do to "promoters" that dare suggest such naughty thoughts to their clients. So I won't say much more other than such bullying tactics seem to appear in rulings they don't want to have to prove in the courts. There has been a case the ATO won where the shares were transferred to a trust in a very dodgy fashion.

The example they use in the Alert is selling your shares after checking with your adviser that the price is unlikely to go up overnight and buying them back the next day.

Do you pay your PAYG Instalment Annually?

If you pay your PAYG instalment annually (the old provisional tax) then you will be due to make your annual payment for the financial year ending 30th June, 2008 on 21st October, 2008. If, by then, you have already lodged your 2008 income tax return there is no need to worry about paying this.

When You Have a Carried Forward Loss

I am not talking about a capital loss. Just a normal revenue loss. This can happen if you have a negative rental property and take some time off work to travel or look after children. It is also applicable to non residents of Australia for tax purposes that own a negative geared rental property here, they save these losses for when the property becomes positively geared or they move to Australia.

Carried forward losses are reduced each year by exempt income. Basically exempt income is income that you do not have to include in your tax return. But this is more complicated than you would expect because income is a wide term. For example it can include Family Tax Benefits Part A payments received for your children. Here is a list of some typical payments that you may be concerned about:

Does Reduce Your Carried Forward Losses	**Does Not Reduce Your Carried Forward Losses**
Family Tax Benefit	Government's Co Contribution to your Super - because it is income to the super fund not you
Child Care Benefit	Any capital gain not taxed due to CGT concessions - because this is not exempt income it is income but not actually taxed due to the concessions Reference ID 2004/120.
Child Care Tax Rebate	Non resident income of a non resident of Australia - specifically excluded from the offset rules by section 36-20
Maternity Allowance	
Maternity Payment	
Baby Bonus	
Maternity Immunisation Allowance	
One-off Family Payments	
Defence Force Reserve Payments	
Educational Scholarship, Bursaries, Assistance etc	
Apprenticeship Wage Top-Up	
Exempt Payments to Overseas Defence Force Members	
Foreign Diplomats wages earned in Australia	
The Overseas Earning of Foreign Diplomats in Australia	
Australian Residents for tax purposes exempt overseas	
Overseas wages exempt in Australia because you worked 91 days or more	

The same conditions apply if you have a loss from a business.

Low Income Tax Offset Now Very Important For Retirees

With the low income tax offset increasing over the next five years, accurate income splitting is more important than ever for retirees with an income source outside of superannuation. If retirees are over 60 and receive their income from a pension or superannuation fund it is tax free in their hands. If the fund is a superannuation fund the earnings are taxed at 15% in its hands but if it changes to a pension fund then even the earnings within the fund are not taxed. This makes it very attractive to receive your retirement income from a superannuation fund rather than investments you directly own.

Some retirees maybe too old to be allowed to contribute to superannuation or not want to sell up their assets outside of superannuation in order to transfer the proceeds into a superannuation fund. If you have a large capital gain on a rental property transferring it into a superannuation fund may not give the best result after tax. While the capital gains tax can be offset in your personal tax return by contributing it to a superannuation fund the fund will pay 15% tax on the portion of the contribution you claim as a tax deduction. If the property was not sold in the first place no tax would be payable.

If for one reason or another you are caught with your retirement income outside of superannuation all is not lost as there is the Senior Australian's Tax Offset which combined with the Low Income Tax Offset allows a single person to earn $25,867 without paying any tax. The combined tax free amount for a couple is currently $43,360 and any Senior Australian Tax Offset not used by one member of a couple can be used by the other. But the Low Income Tax Offset cannot be shared in the same way. Back when the Low Income Tax Offset was only $150 this was no big deal but over the next five years this is set to increase as follows:

2007/2008	2008/2009	2009/2010	2010/2011	2012/2013
$750	$1,200	$1,350	$1,500	$2,100

As a result it is now more important than ever to make sure your retirement income, that is outside of superannuation is split as equally as possible between husband and wife. This should be a consideration (among many other issues) when deciding which name to purchase a rental property in if you intend keeping it after you retire.

Henderson Group Share Cancellation - ATO Backflip

The law regarding how the market value substitution rule applies to cancelled shares has recently been changed but it is back dated to apply from 1st July, 2006. This means that taxpayers who prepared their tax returns regarding the cancellation of shares in the Henderson Group, in accordance with ATO advice have actually prepared their tax returns incorrectly.

The ATO advice was to calculate the market value of the shares at $2.38 even though they only received $1.93 per share. In accordance with the new law the market value only has to be $1.93 so anyone owning these shares can go back and amend their 2006/07 tax return to reduce the capital gain.

Exceptions to the Market Value Rule

Last Newsflash we pointed out that the ATO had changed how the cancellation of Henderson shares are to be treated. If applicable you can amend your 2007 tax return to reduce the gain previously recorded on ATO advice. These changes are retrospective dated back to 1st July, 2006.

The intention of the new law is to make it fairer when taxpayers have no control over the company and are paid less than the shares are worth. The test for companies will be that they have at least 300 shareholders or unit holders. In these circumstances the ATO will accept that the price paid on cancellation of the shares is the proceeds received for CGT purposes and the market value substitution rule does not apply.

Demutualisation of MBF

Most members of the health insurance fund MBF have received a cash payment when it demutualised. There was some concern that this cash payment would be taxable. The government has passed retrospective laws to ensure that it will not be taxable. In short if you received a payment from MBF after 1st July, 2007 due to its demutualisation you do not have to worry about including it in your tax return.

PAYG Variation – Interest drop

Just a warning to clients with variable loans that have lodged a PAYG variation for the 2009 financial year. We would have estimated your interest expense on a much higher rate of interest so you may end up with a small tax bill rather than break even as planned.

If your estimate is out by more than 10% you could be fined but if the circumstances were unforeseen this is unlikely. The current low interest rates were certainly unforeseen.

If you are concerned you can lodge another PAYG variation.

Pension Minimum Draw Down Suspended

Once your superannuation enters the pension stage you are required to draw down a minimum percentage each year. Due to the economic crisis the government has announced that for the period 1st January 2009 to 30th June 2009 retirees will not be forced to drawn down from their superannuation savings. To make this work on an annual basis they are simply halving the minimum percentage for the 2009 financial. The percentage varies according to your life expectancy.

Wash Sales

TR 2008/1 is the relevant ruling on when the ATO will apply Part IVA (scheme with the dominant purpose of a tax benefit) to a share transaction that creates a capital loss in a year where that loss would be very handy in offsetting a capital gain. Not a problem unless you still effectively benefit from holding the shares. So all you have really done is triggered a capital loss but still indirectly hold the shares in the hope of making a future capital gain. Quite a topic for this financial year considering the drop in share prices.

A key quote from the ruling:

"The term wash sale does not have any precise meaning. In commerce the term wash sale is used to describe the sale and purchase of the same, or substantially the same, asset within a short period of time of each other. The sale and purchase cancel each other out with the result that there is effectively no change in the economic exposure of the owner to the asset. More generally, the expression wash sale is used to describe arrangements where a disposition of an asset occurs without an intention of ceasing to hold an economic exposure to the asset."

Examples of the sort of transactions the ruling would apply to include the following but only when the ATO considers that the dominant reason for the transaction is a tax benefit.

Buying and selling the substantially the same asset in a very short period of time including the use of options or derivatives to extend the time.

Arrangements where title might pass but the benefits of ownership are retained under an agreement with the purchaser.

Transferring the asset to a trust or company that the tax payer controls or transferring to a family member.

A full list of the transactions listed in the ruling is available in our Year End Tax Strategies Booklet.

In paragraph 6 it states "Where a taxpayer disposes of shares in one company, and purchases shares in a competitor company that carries on a similar business, the shares in the two companies do not constitute substantially the same assets". So at least you can still stay in the same industry and recognise a capital loss. The ruling also targets sales to associates, so selling the shares to your spouse or selling your shares and your spouse buying the same may be caught

Of course you do not have to worry if the sale does not result in a loss.

I have particular trouble with this attitude because the taxpayer is making a simple choice and Part IVA is not supposed to interfere with taxpayers simply choosing a course of action that is readily open to them. The ATO uses its usually elusive naughty thoughts argument. The scheme is supposed to be, thinking about, maybe even discussing future purchase prices with a broker, selling the shares to trigger the capital loss, with thoughts of buying them back. This sounds like, to borrow a concept from Hart's case, how can any rational person not consider this benefit?

Marina Berths as an Investment

Marina berths are generally a long term lease (without an option to renew) not actually direct ownership. So you may pay a couple of hundred thousand dollars but you don't own the site, the money you pay is simply rent in advance. All you are looking to profit from is by renting it out short term at higher than the rent you have paid, plus, of course the interest, you have to pay on your borrowings to pay 25 years rent up front. And don't forget you are also liable for maintenance, body corporate fees and probably management agent fees.

The marina berth is quiet often rented back to the marina that sold it to you in the first place. Sometimes this is a condition of the contract. Let's assume for the first 3 years you are required to rent the berth back to the people who sold it to you. From the information I have gathered the following figures apply but it is best that you substitute these for the particular berth you are considering.

In my case the berth costs $190,000 but there are various fees associated with the purchase so you would need to borrow $200,000

They will pay you rent of	$15,200 pa
You will get a tax deduction for	
Interest $200,000 x 6.5%	$13,000
Body Corp Fees	2,100
Management fees	1,520 (maybe waived for first the three years)

Negative cash flow	$1,420

Note to keep this simple this does not take into account GST considerations

At this stage you are out of pocket at least (doesn't include maintenance or insurance) $1,420 on the arrangement and now have a lease for only 24 years. The cash flow saviour is that you get to right off 10% of the amount you invested ie $19,000 so for tax purposes your loss is $20,420 and if you are in the 31.5% tax bracket (between $35,000 and $80,000) then your tax refund will be $6,432. Giving you a spare $5,012 each year but you have not paid anything off the principle portion of the loan yet you have claimed a deduction for $19,000 based on the purchase price you paid. This will catch up with you when you sell. Let's assume at the end of those three years you decide to sell. Now there are only 22 years left to run on the lease so, even considering inflation, it may be worth less than you paid for it. Even if we assume it is worth the same amount as you paid for it. Have a look at these numbers:

Sell for	$190,000
Less the balance of what you paid for it including Fees after deducting the 3 x $19,000 you have Claimed $200,000 - 57,000	$143,000

Capital gain	$47,000
Less 50% CGT discount	$23,500

Taxable Amount	$23,500

Now for all of this amount to only be taxed at 31.5% your other taxable income would have to be under $56,500. But again let's give it the benefit of the doubt and assume this. So the tax will be $7,403. And of course there is still the original $200,000 to repay.

In the best case scenario you would have paid the $5,012, in spare cash the arrangement generated, off the loan so now only owe $184,964 add your capital gains tax to this amount and you need $192,007 from the sale just to pay the tax and the loan off. This means you need to sell a 22 year lease for more than you paid for a 25 year lease just to get out of it with no real profit! And that is not even taking into account maintenance costs, insurance, extra tax return and possibly BAS preparation costs and the costs to sell? What if interest rates increase above 6.5%? If interest rates were to go up 3% to 9.5 your tax refund would barely cover you net cash outflows so you would have nothing over to pay down your loan and your capital gains tax bill is still increasing with each year of ownership.

You really would have to be betting on the berth increasing a huge amount in value (despite the decreasing lease) for this to be a profitable investment, even after the tax benefits are taken into account. The odds are already stacked against an ever decreasing right of ownership increasing in value. And if you don't believe me ask yourself why the marina doesn't just hold onto the berth itself rather than sell the right to it to you for 25 years. Note the marina automatically gets the berth back at the end of 25 years at no cost. There is no option to extend the lease.

The real danger here is that you keep the berth for more than 10 years so you have nothing to reduce the sale proceeds by because you have fully written off your purchase price and you have not paid anything off your loan. It is quite possible that, with less than 15 years left on the lease, the berth will not be worth enough to clear you debt of $200,000, after you pay tax on 50% of the all of the sale proceeds because you have fully written off your cost base.

Warning, if after crunching the numbers on the above, you still go ahead, make sure you initial each page of the lease that you sign or the wording of the lease boils down to nothing more than their word against yours and you might find you yourself on Noah's ark rather than a marina berth.

You should also check out other practical considerations such as the possibility that the marina maybe selling off the berths to finance further developments that could affect access to your berth during the construction period and when completed lead to an oversupply of marina berths in the area. Further, leases normally allow for the lease to sell their right under the lease, only with the landlords approval and generally this approval is not given unless you agree to cover any non payments by the person who purchased off you.

Fees Paid for Financial Advice or Courses

TD 95/60 is an ATO determination on when fees paid to a financial adviser are tax deductible. It differentiates between an upfront fee and an ongoing management or annual fee.

The initial or up front fee to draw up a financial plan is considered to be capital in nature rather than relating to the ongoing management of the portfolio. This is considered to be the case even if the investor already has some investments but enters into a new financial plan. To quote the ruling:

> *"We do not think that the fee for drawing up the plan is deductible ......It is too early in time to be an expense that is part of the income producing process. It is an expense that is associated with putting the income earning investment in place".*
> *"Expenditure on drawing up the plan is incidental and relevant to outlaying the price of acquiring the investment, and is so associated with the making of the investment as to warrant the conclusion that it is capital or capital in nature"*
> *"The character of the outgoing is not altered because the existing investments fit in with the plan. It is still an outgoing of capital"*
> *"However, to be wholly deductible, all of a management fee must relate to gaining or producing assessable income. If the advice covers other matters or relates in part to investments that do not produce assessable income, only a portion of the fee is deductible"*
> *"Advice may be received suggesting changes be made to the mix of investments held. This would normally be part and parcel of managing the investments in accordance with the plan.... Provided the advice is not in relation to drawing up an investment plan it will be an allowable deduction."*

Possibly if the initial financial plan takes into account buying several properties each house acquisition may not be considered a new plan. If you are paying for training on how to find the right property it will probably be considered incurred at a point too soon to be deductible. In considering the deductibility of training, meetings and courses the best example of this is Petrovic's case which examines payments made to Henry Kaye. These payments were not considered deductible because they did not have a sufficient connection with assessable income and was an investment of capital made to prepare Petrovic for future property investments. This is despite the fact he already owned property before attending the courses. Of particular interest is the end of paragraph 14 which states:

> "At best, the incurring of that expenditure was itself an investment of capital to prepare him for the future commencement of a business property investment should he choose to do so and had the financial ability."

Careful, if you try to argue that learning how to buy and sell properties is a business expenses ie you are buying the properties to sell for a profit, then the properties would be trading stock, not a passive investment and so the 50% CGT discount would not be available. Training in how to buy and improve properties would be capital in nature and unlikely to even qualify for inclusion in the properties cost base. Trying to align the purchase of your next property to being just like buying another share in you share portfolio, may work to argue that the advice you received regarding the property was part of the management of the original plan but certainly not if you don't already have one property. In Petrovic's case even having a couple of properties made no difference. The trouble with apply rulings like TD95/60 which is directed at share investing, to property

investing is that the ATO will probably try to look at each property in isolation, something they would have no chance of with a share portfolio. The only saving grace appears to be this paragraph from TD95/60
"Advice may be received suggesting changes be made to the mix of investments held. This would normally be part and parcel of managing the investments in accordance with the plan.... Provided the advice is not in relation to drawing up an investment plan it will be an allowable deduction."

SMSF Anti Detriment Rules

In short an anti detriment payment is a tax credit your superannuation fund receives if you die and a lump sum is paid from your superannuation fund to your spouse or children of any age. The ATO does not pay it in cash only as a tax credit and before your fund can apply for the tax credit they must have paid the beneficiary in cash.

The catch for SMSF's is whether they can ever utilise the tax credit. They will need to have an upcoming generation of members to take full advantage and as SMSF can only have 4 members, it may be difficult to utilise the tax credit. If you can't utilise the tax credit then in effect you didn't really get that money back from the ATO. Of course in a public fund there is no doubt that the tax benefit would be utilised. Not that it matters because the public fund would be required to pay the anti detriment amount to your beneficiaries anyway, it does not matter to you how they utilise the tax credit.

The anti detriment rules are a major disincentive to form your own SMSF, that is not often considered.

Taking the anti detriment rules one step further. Bear with me here this is getting a bit deep. It is about a re-contribution strategy. The idea is that once you have passed 60 years of age you are entitled to take all your money out of superannuation tax free. The catch is if you die with some funds still left in super then unless your heirs are children under 18 or your spouse, some of the amount they receive as a death benefit from your super fund maybe taxable. This means that you would have been better off to take the money out as a tax free lump sum then reinvest it (within the caps) as an undeducted contribution. Undeducted contributions later paid as a death benefit are not taxable to your heirs no matter who they are. The catch is the recontribution strategy also requires you to draw out the funds on which tax has been paid because they are also the funds on which your children over 18 will have to pay tax. The anti detriment rules only refund tax on these very same funds. So here is the catch 22. If you use a re investment strategy ie draw the funds out tax free then re invest in super. You want to go back into super so that the income they earn will be tax free. At the point of originally drawing them out you given up your rights, upon your death, because you are not yet dead but you have drawn them out, to your family getting any tax back that the super fund paid on your behalf when you or your employer were making the contributions.

Now get your crystal ball out. If your superannuation death benefits are going to be paid to your spouse or children under 18 (students under 25) then they will not pay tax on the benefit anyway and their payout will be increased by the anti detriment amount so don't bother with a re investment strategy. On the other hand if your beneficiaries are not as above a redistribution strategy has potential to give you the best outcome. Ultimately, it depends on the mix of your beneficiaries and you need a financial planner (with a good crystal ball) to make sure you maximise your anti detriment payment.

In short do not participate in a re investment scheme if your beneficiaries are going to be dependant children or your spouse and do not set up your own SMSF unless someone can benefit from the tax credits received from the anti detriment payment.

Property Versus Shares

The following is an interview with Julia Hartman.

Personally I have made more money out of property than shares but as I have got older and lazier I have concentrated on shares. Property provides a much better opportunity to make money out of your own initiative, whether it be research, renovation or management. Shares really only provide you with the opportunity to research and even then you are competing with people that have more inside knowledge.

I have heard that shares out perform property and this doesn't surprise me because all share purchases are based on a profit making motive whereas most house purchases do not have profit on resale as a priority so it is not correct to compare these two options simply on statistical data.

The main differences I see between these two markets are:

Liquidity - you can't just sell off the bathroom of a house because you need $10,000 quickly, shares can be sold in $500 lots. Also with shares you can have your money within 24 hours, you would wait months for the funds if you needed to rely on the sale of a house. You might say that is ok I have a LOC that I can draw on in an emergency but this means you do not have money working for you so it is still a drain on liquidity. **Effort** - It appears to me that if you have the energy and time to be a pro active property investor then you even as Ms or Mr Average have a better chance of profiting from your efforts than through the share market. This is also a personal consideration about what you like doing.

Leverage - Using real estate as collateral for a loan means you can borrow more and at a lower interest rate and one of the important rules of growing wealth is to have as much money working for you as possible. I wonder, if borrowing costs were factored into the performance comparisons whether shares would still come up as a better return on investment?

Diversity - Is a key risk reducing strategy in building wealth so you should have both but unfortunately with real estate this still means having a lot of your eggs in the one basket. Say you have $600,000 to invest. You could diversify by putting $300,000 into shares and $300,000 into property but this would mean just one type property in one particular area whereas the shares could be diversified across a large variety of industries. A share portfolio can even have exposure to the property market by investing in property trusts but unfortunately property trust, while giving you access to the highs and lows of the property market cannot deliver one of the main advantages of property investment, namely the opportunity to profit from your own effort.

I try to avoid directing clients specifically to shares or property but concentrate on the numbers for each particular investment decision. Though when a client is keen to have as much money working for them as possible in the property market I do recommend at least a small share portfolio as a must have for instant liquidity.

From the tax point of view it depends totally on your profile, investments available and your time frame. I am sure most readers are aware of how a tax refund generated by claiming depreciation can help a property's affordability but many don't factor in franking credits when comparing property to shares. For example let's say you borrow $100,000 at 7% to buy Commonwealth bank shares which you expect to pay a 5% cash dividend that is fully franked. If held in a low income earners name:

Tax Calculation		**Cash Flow Calculation**	
Dividend Income	$5,000	Cash Dividend	$5,000
Franking Credit	2,143	Tax Refund $2,143-$21	2,122
	7,143		7,122
Interest Expense	7,000	Less Interest	7,000
Taxable Income	143	Cash inflow on bank's Money	$122
Tax Payable $143 x 15% = $21.45		plus capital growth	

In the same situation for a high income earner the only difference would be the size of the tax bill $143 x 38.5% (assuming between $80,000 and $180,000) = $55 so the cash flow calculation would be:

Cash Dividend		$5,000
Tax Refund $2,143-55	2,088	
	7,088	
Less Interest	7,000	
Cash inflow on bank's Money	$88	plus capital growth

Aiming For The Same Tax Rate Each Year

The tax bracket (excluding Medicare) upper thresholds are expected to be as follows:

	2010/11	2011/2012	2012/13	2013/14
Zero tax	$ 16,000	$ 16,000	$ 20,000	$ 20,000
15% tax	$ 30,000	$ 30,000	$ 30,000	$ 30,000
19% effective tax	$ 37,000	$ 37,000	$ 37,000	$ 37,000
34% effective tax	$ 67,500	$ 67,500	$ 82,500	$ 82,500
30% tax	$ 80,000	$ 80,000	$ 80,000	$180,000
35% to 37% tax	$180,000	$180,000	$180,000	

Claiming Deductions Against Trust Income

The ATO is clamping down on beneficiaries of discretionary trust claiming a tax deduction in their own tax return for expenses that relate to the trust's income.

Certainly you cannot claim, against trust distributions, interest on money you have borrowed in your own name and put into the discretionary trust, because you do not have a fixed entitlement to a distribution in a discretionary trust. You need to charge the trust interest at the same rate or more than what you are paying and then claim the interest you are paying the bank as a deduction against the interest income you receive from the trust.

Other expenses a beneficiary may incur such as paying some of the trusts bills can only be deductible to the trust so you need to have the trust reimburse you rather than claim the expense against your distribution. The bottom line is the same affect because the trust then has less profit to distribute to you. It is also probably a better result overall because the trust will be able to claim the GST back.

There is an exception when it comes to typical work related expenses but it is best that you also receive a wage from the trust. Then of course these expenses are deductible just as they would be for other employees. Nevertheless, it is still better to have the trust reimburse you so that the GST input credits can be claimed, if it is registered.

If you use your own car to produce income for the trust and you are paid a wage by the trust there are no problems to claim the car as would any employee. There is also a nice little double dip that may interest you. Keep a log book on the vehicle and work out the trust's share of your actual expenses then ask the trust to reimburse you for these expenses so that the GST can be claimed. This will not stop you being able to still use the kilometre method to claim your motor vehicle expenses in your own tax return. You cannot claim a deduction in your tax return for expenses that the trust has reimbursed you for, but that does not stop you claiming the rate set by the ATO per kilometre for business use up to 5,000 kilometres per car.

In short it is important that your trust pays you a wage to keep your options open but it is always better to get the trust to reimburse you for the expense (assuming profitable) rather than you claim it in your own tax return even if you do qualify.

Did You Claim a Deduction For Superannuation Last Year?

Section 290-170(1)(b) ITAA has, since 2007, set the end of the following financial as the deadline to notify your superannuation fund that you are claiming your superannuation contribution as a tax deduction. Further you must have advised the fund before you lodge your tax return so it really should be notified well before the end of the next financial year anyway.

The trap here is even if you don't lodge your 2010 tax return on time you must advise the superannuation fund, before 30th June 2011 that you intend to claim the contribution as a deduction, or you will simply not be entitled to that tax deduction.

The ATO has no discretion to extend this time. No matter how good your excuse you simply cannot go beyond the end of the next financial year. If you miss the deadline the contribution will be treated as an undeducted contribution so at least it won't be taxed in the hands of the superannuation fund but it is locked away until you retire.

Capital Protected Borrowings

After the Global Financial Crisis capital protected borrowings may look pretty attractive to you. This is where you borrow to invest in shares but the bank guarantees that if at the end of the term the shares are worth less than the amount you borrowed then you don't have to make up the difference you can walk away from the investment at the end of the term with no shares and nothing more to pay. On the other hand if the investment grows then you can sell the shares, pay off the loan and walk away with your profit. Naturally enough the banks will charge you a much higher interest rate on the loan because they consider themselves to be assuming a much higher risk or for the skeptics, because they think they can get away with it.

The ATO deems a portion of the interest not to be tax deductible because it is really not interest but a payment for protecting the capital portion of your investment. The undeductible portion of the interest will be included in your cost base when you calculate the CGT on the sale of the shares. If you choose to take advantage of the capital protection and not take the shares at the end of the loan term then the portion of the interest that applies to the capital protection creates a capital loss you offset against a current capital gain or carry forward.

The area of contention is what portion of the "interest" is deductible. Initially it was the amount above the RBA's rate for personal unsecured loans. There is currently a bill before Parliament to change this to 1 percent above the housing loan interest rate and it will be backdated to cover any of these types of borrowings that were entered into after 13th May, 2008. So if you have a post 13th May, 2008 capital protected loan you may need to amend your previous tax returns unless you took the proposed legislation into account when originally lodging them. The ATO has undertaken that penalties will not apply or interest charged when these amendment result it a tax bill. It is not unusual for the personal loan rate to be twice the housing loan rate or more so it could now halve taxpayers' deductions. The proposed legislation will only require taxpayers to amend back 2 years from the date the bill receives Royal Assent.

Note the limited recourse loans required for a superannuation fund to be able to borrow to invest, are effectively capital protected borrowings. Fortunately, capital protected borrowings for real estate are not caught under these provisions so the amount of deductible interest on limited recourse loans in superannuation funds is not restricted when the borrowings are for property but the above would apply to restrict the deduction to the superannuation fund for the interest limited recourse borrowings for shares.

Now if that isn't enough to put you off capital protected borrowings consider how they work. Generally the term of the borrowing would be for 5 years. Regardless of which way the shares go you have to pay interest for that whole 5 years. As you can imagine the chances of the shares being worth less in 5 years time is very slim, in fact I challenge you to find a point in history when that was the case.

Margin loan interest is fully deductible and is usually a lower rate than capital protected loans. With the added advantage that if at any time during the 5 years you find you can no longer afford the investment at least you can sell up and pay down the loan, leaving you at worst a much smaller loan repayment. Further, capital protected loans are a more suitable investment for when the market is high and you are worried it might not go any higher. Capital growth within 5 years of a low market is virtually unavoidable.

Reverse Mortgages

These can be a great retirement tool if you live too long. The idea is that the bank lends you money secured by your home. You do not have to make any repayments on the loan and the bank cannot take your house until you die. Of course the power of compounding interest is working in reverse getting you more rapidly in debt each year. But if the banks can't sell the house out from under you, what does it matter. For reason that I can't quite comprehend people seem to worry about leaving something to their children. If you use this strategy as a backup, in case you live longer than you anticipated, then your children will already have retired and have accumulated enough assets in their working life. If they haven't by then, they are probably only going to waste yours.

. Terms vary from bank to bank but you are unlikely to ever be able to borrow more than 45% of the valuation and then probably not until you are 85 years old. At 65 years of age you are only likely to be able to borrow 20% to 25% of the valuation depending on your lender.

NIB Return of Capital

On the 21st July 2011, NIB returned capital to their shareholders at the rate of 16.07 cents for every share owned. As this amount is probably less than the cost base of the shares, it simply reduces the cost base rather than create a capital gain. It is important that you keep the information on this return of capital until you finally sell your NIB shares as it is relevant to the final CGT calculation.

If you acquired your NIB shares under the demutualisation of NIB on 1 October 2007, the cost base of each of your NIB shares is $0.85, so the return of capital has reduce their cost base to 68.93 cents a share.

The ATO has issued a product ruling CR 2011/56 if you need more detail.

Check Interest Earned By Children

This is the first financial year that children under 18 years of age will not be able to use the low income tax offset to reduce the tax on their passive income. There are exceptions for married children, those working full time, orphans, disabled etc but generally, if a child has interest income exceeding $416 it will be taxed at 66% on the amount between $417 and $1,307 then 45% the maximum tax rate. Time to check your children's bank balance. It may be more tax effective to hold the money in your name.

Tax Rates - Time for Tax Planning

Over the next 4 editions of Newsflash we will be bringing you lots of articles on year end tax strategies. It is important to consider whether your tax situation this year really warrants planning. There is little benefit in drawing deductions into this year if you are going to be in a higher tax bracket next year. The higher the tax bracket the more that the ATO will contribute towards the expense. So here are the tax rates for this year and next year.

2011/2012

Tax Free Threshold $6,000
Due to the Low Income Tax offset (LITO) no tax if your total taxable income is Under $16,000
Taxpayers are entitled to LITO when their income is under $67,500 but it starts to shade out at 4 cents for every dollar after $30,000. Accordingly, if your total taxable income is under $67,500 the marginal rate of tax you will pay on each extra dollar, will be:
15% tax rate between $16,001 and $30,000
19% tax rate between $30,001 and $37,000
34% tax rate between $37,001 and $67,500

If your total taxable income is above $67,500 then LITO does not affect you at all. Your tax brackets are:

Between $67,500 and $80,000	30%
Between $80,001 and $180,000	37%
Over $180,000	45%

2012/2013

Tax Free Threshold $18,200
Due to LITO no tax if your total taxable income is Under $20,542
Taxpayers are entitled to LITO when their income is under $66,660 but it starts to shade out after $37,000 at the rate of 1 and a half cents per dollar. Accordingly, if your total taxable income is Under $66,660
19% tax rate between $20,543 and $37,000
34% tax rate between $37,001 and $66,660

If your total taxable income is above $66,660 then LITO does not affect you at all. Your tax brackets are:

Between $66,661 and $80,000	32.5%
Between $80,001 and $180,000	37%
Over $180,000	45%

Note all the above excludes the Medicare levy, which is 1.5% in most cases.
The flood levy only applies to the 2012 year if your income is over $50,000 you pay half a percent on each dollar above that up to $100,000 then 1% above that. So for example in 2012/2013 if you earn $37,000 then the last $16,458 you earn will be taxed at 19% plus Medicare but if you earn another dollar that dollar will be taxed at 34% plus Medicare.

Get Those Superannuation Contributions in on Time

Employers have until the 28th July to make the superannuation contributions they are obligated to pay for the June period, under the superannuation guarantee. But if the contribution is made after the 30th June, 2012 the employer will not be entitled to a tax deduction for it until the 2012/2013 financial year even though the liability fell in the 2011/2012 financial year.

If you are contributing salary sacrificed contributions or have employees who are close to the $25,000 or $50,000 cap you should also take a careful look at their particular circumstances. The amount contributed for the purposes of the cap is also based on the date it is received by the fund. Delaying these contributions until after 30th June could result in your employees missing out on maximising their cap this year and possibly exceeding their cap next year.

On the other hand if last year you made the June contribution in July but this year you are making it in June your employees will have 5 quarters' worth of contributions in the 2011/2012 financial year. Before you do this make sure you will not be pushing anyone over their cap.

In Peaker 2012 AATA 140, the employer posted the contribution on 28th June but it was not recorded as income of the fund until 5th July. This meant that the employee exceeded his cap for the following year. The AAT upheld the ATO's assessment of excess contributions tax as there were no special circumstances which would allow the amount to be allocated to another year.

Due to data matching the ATO will always be informed should your cap be exceeded.

Employees when negotiating their salary package should consider including a clause requiring their employer to physically make the superannuation contribution in the month that it is sacrificed.

Saving Tax on Your Investment Property – The Book

"Every investment property tax-related question you've ever wondered about is answered here and – perhaps more importantly – the ones you didn't think to ask but should have! For property investors who want to refine their strategy for maximum gain, this resourceful handbook will make a great constant companion." Eynas Brodie, Editor, Australian Property Investor magazine.

Combining Noel Whittaker's easy reading style with Julia Hartman's mind numbing attention to detail was a major challenge but made it to the book stores. You can also purchase it online by going to: bantacs.com.au/book_savingTax.php. The cost is $29.95 plus $5.95 postage – tax deductible of course!

New Reporting Obligation for the Construction Industry

From the 1st July, 2012 businesses in the building and construction industry will be required to provide the ATO with a report on all the payments they make to contractors. So make sure you get your record keeping in place straight away.

You will need a separate report for each entity or person you pay, it needs to record their ABN, name; address, gross amount (including GST) you paid them for the financial year, and the GST portion. Note even if the amount includes materials it must still be included in the report but invoices that are solely for materials do not need to be included. The report must be submitted to the ATO by the 21st July of the following year.

A standard accounting system will probably not be able to produce this report because it requires the amount to include GST and to only list payments made in that period. While your accounting system may be able to give you a report of the payments you have made to individual contracts it will probably be net of GST and on an incurred not paid basis so you may need to start a separate system to meet this requirement.

Anyone whose business is primarily in the building and construction industry and makes payments to contractors who are also in that industry is required to report. The obvious examples come to mind but it also includes payments for designs such as architects, decorating, earth moving, project management, installations, repairs and maintenance.

A business is considered to be primarily in the building and construction industry, if in the current financial year or previous financial year 50% or more of its income or activity is from the building and construction industry. So there is a carve out for businesses that may sell materials but also provide an installation service as a minor part of their business. The catch is many businesses are not going to know whether they cross the 50% threshold until the end of the financial year so you will need to keep the appropriate records if you are anywhere near the 50%.

Please note this obligation affects even the smallest contractors who may just pay someone to help them.

Discretionary Trust Distribution Minutes

Bamford's case resolved that the income of a trust is to be determined according to the wording of the trust deed and not in accordance with ordinary accounting concepts. This means that as a minimum the income clauses in your trust deed will need to be reviewed and possibly amended. In the following, a reference to a trust is a discretionary trust.

This article is based on a draft ATO ruling, changes to legislation that are less than a year old so untested and test cases that barely scratch the surface of the issue. In its draft ruling TR 2012/D1 the ATO creates some very bizarre circumstances where it claims that while some items are included as income for tax purposes they can't be included in trust income Accordingly, there are no guarantees with the following. It is compiled from a variety of material on the topic, looking for consistencies in opinions but also pointing out some possible traps. To truly cover yourself you should discuss this with a specialist lawyer in regard to your particular circumstances and the wording of your trust deed. The catch is the ATO hasn't finished with the changes yet! So of course if your trust is not in the danger zone below it would be great if you could delay a review of your deed until there is more certainty. To help in this regard we have listed the situations that may put you in the danger zone. If none of these apply to you then you may want to take the calculated risk of waiting for your review. For example previously it was thought that an income equalization (stating that trust income equals taxable income) clause was the solution but now in some cases this could work against you.

The Danger Zones - If any of the following apply to you, you need advice on the wording of your distribution minutes and may need to have your deed amended before 30th June, 2012.

1) There will be a small business capital gain made by the trust within the next 15 years. You will need to make sure there is continuity of ownership.
2) You will make a small business capital gain this year.
3) You want to stream (identify the beneficiary that is to get that particular stream of income) capital gains or franking credits.
4) You will make a capital loss this year. It will need to be recorded in the balance sheet to be carried forward.
5) Your deed states that trust income equals taxable income.

Our Ideal Income Distribution Statement In The Trust Deed – Would give the trustee the discretion to decide what is the income of the trust and the power to stream capital gains and franked dividends. This flexibility should be backed by a default definition of income, if the trustee chooses not to exercise its discretion, this clause should state that the trust income is to be determined in accordance with tax law.

Further, the trustee should be entitled to distribute gross income if it desires. This may be necessary to avoid the loss of franking credits as they are not entitled to be passed onto beneficiaries unless they follow at least some income. The Trustee should also have the power to make interim distributions.

The catch in all this is that you may trigger resettlement by making these changes. A resettlement will cause a CGT event.

Important Points For The Distribution Minutes - Do not delay organising your distribution minutes for the 2012 financial year. It must be done before 30th June, 2012.

The big concern when sorting out the wording of your distribution minutes is if the ATO later audit the trust tax return and decide that its taxable income is higher. Bamford's case determined that the taxable income is to be apportioned on a pro rata basis with the trust income. For example if the trust income was $1,248 and the distribution minutes gave $416 to a child and the rest of the income namely $832 to the parent then if the ATO later audited the trust and determined that the trust income was $1,500 then the child would have to include $500 in his or her tax return. The trap with this is children receiving passive income over $416 are subject to penalty tax rates.

It appears there is no way of wording the distribution minutes to avoid this problem so it is probably not worth the risk of distributing any trust income to children considering the little tax benefit gained compared with the risk.

As you are making the distribution minutes before the income of the trust is known it is important that the distribution minutes does not just list all dollar amounts. There needs to be a beneficiary that receives the balance, a mop up, as at this stage you only have a vague idea of the trust income.

Guidelines For Minutes In Simple Circumstances – First review the deed to check that the trustee has the discretion to determine income. Start with an explanation of how the trust deed defines income. If the trustee has discretion then make sure the minutes thoroughly covers how the trustee is exercising that discretion.

Franked dividends, capital gains and other income should be individually addressed. Distribute at least $1 of gross income as it may help you distribute franking credits.

If your circumstances are very basic, with no expected capital gain or franking credits and the trustee has the right to determine income, here is an example of minutes of a distribution meeting. No guarantees, but it does have a few extra points that may help cover the unforeseen.

Minutes of the Meeting of –
Location –
Date –
Present –

In accordance with the powers granted to the trustee in the trust deed the trustee determines income to include all sources of income including if applicable gross capital gains and franking credits. From this gross income all beneficiaries listed below are to receive a distribution of $1. All expenses and outgoings from the trust are then to be deducted from the gross income to determine the net income of the trust which is to be distributed as follows:

A $ or %
B $ or %
C receives any balance of net income remaining

For the avoidance of doubt should any adjustment be made to the net income of the trust the dollar amounts stated above are not to change.

For the avoidance of doubt payments made by the trustee during the year do not necessarily constitute distributions unless expressly recorded by a resolution of the trustee. Further any interim distributions so recorded count towards the amounts shown above.

There being no further business the meeting was closed.

Signed as a true and correct record Dated

Traps - If the trust deed says income in ordinary concepts then only the net capital gain can be streamed. This could result in other beneficiaries paying CGT on a distribution they did not receive. To avoid this, an interim distribution of the whole capital gain will need to be made to the beneficiary who receives the capital gain.

A nasty shock in TR 2012/D1 was the ATO's opinion that franking credits, while taxable, cannot be considered trust income. If a trust does not have net income (ie does not make a profit) it cannot distribute its franking credits and they are wasted. A possible but not proven method of avoiding this problem is to distribute a small amount of gross income. If this could apply to you no harm in including it in your minutes just in case, as shown above.

Tip For Small Business Capital Gains - The small business concessions can reduce a capital gain to zero. On a $100,000 capital gain this could work as follows:

Capital Gain	$100,000
Less 50% CGT Discount	50,000
Less 50% Active Asset Discount	25,000
Less Retirement Exemption (Max $500,000)	25,000

When a beneficiary receives this amount it must be grossed back up again in their tax return but all the above discounts still apply. The trap is if that beneficiary had capital losses they would be wasted. If the beneficiary had capital losses of $20,000 the entry in their tax return would be:

Capital Gain	$100,000
Less Capital losses	20,000
	$80,000
Less 50% CGT Discount	40,000
Less 50% Active Asset Discount	20,000
Less Retirement Exemption (Max $500,000)	20,000

Still no capital gain but only 25% of the losses were effectively used. If instead of the retirement exemption the small business rollover was used by the trust then nothing would be distributed to the beneficiary in the current year. The trust has two years to buy a replacement asset. If it does not buy one then in two year's time the beneficiary will simply receive a capital gain of $25,000 (no grossing back up) this can be offset by the $20,000 capital loss and the balance of $5,000 applied to the retirement exemption leaving more of the $500,000 limit available in the future and requiring less of the funds to be locked away in superannuation if the beneficiary is under 55 years of age.

Transferring Shares to the Beneficiaries of a Deceased Estate

The executor of a deceased estate can make a huge difference to the value of the estate by simply considering the beneficiaries' individual circumstances. For example before an executor distributes shares owned by a deceased to the beneficiaries the CGT consequences need to be considered. The first step would be to calculate the capital gain associated with each parcel of shares. Even if the shares are not going to be sold this is very important as the beneficiaries still need to know their cost base.

If the shares were purchased by the deceased before 20th September, 1985 they are inherited with a cost base of the market value at the date of the deceased's death. This means that they can be sold now for with minimal capital gains tax. Or they can be passed to a beneficiary in specie and that beneficiary will only ever be liable for CGT on the gain from the date of death, the beneficiary does not inherit any ongoing tax bill. Obviously the beneficiary that gets these shares is truly getting a legacy of the face value of the shares.

On the other hand a beneficiary who inherits shares acquired by the deceased after 19th September, 1985 will inherit the deceased tax bill as well so their true legacy is less than the face value. To fairly divide the estate it may be necessary to take this into account.

With some careful planning the executor can maximize the benefit received by each individual by considering their tax bracket and asking them whether they intend to sell the shares or not.

If a beneficiary intends cashing in the shares then consider selling them within the estate and distributing the cash instead. For the first three financial years after the deceased's death the estate is treated like an adult for tax purposes so it will get approximately $18,500 tax free and then be taxed at 19% up to $37,000 etc but with no Medicare levy payable. So it is quite likely that the estate will pay less capital gains tax than the beneficiary. If the beneficiary intends to keep the shares then think about the tax bracket they are likely to be in when they sell the shares. If it is high then they will get the most benefit from inheriting the pre 1985 shares or shares that were purchased post 1985 but are now worth less than the price the deceased paid for them. Beneficiaries in a lower tax bracket are going to be less affected by inheriting the deceased's unrealized capital gain.

When planning your estate it is important to give your executor the flexibility to sell or distribute in species and to decide which actual shares go to which beneficiary even if the overall value they receive is defined by the will. It is also important that your executor knows where to access information about the cost base of your shares including any dividend re investment programs you have participated in.

PAYG Instalments – Not So Simple

The ATO have recently begun calling small businesses to discuss PAYG instalments reported on quarterly activity statements. This unusually proactive approach from the ATO indicates that there are still a lot of errors being made in the arena of Pay As You Go (PAYG) tax.

PAYG is a system for paying instalments towards your expected tax liability. When you lodge your tax return for the year your actual liability is assessed and instalment amounts that you have paid are credited against your assessment to determine your final refund or tax bill.

As a general rule the ATO will place you in the PAYG system if you have reported $2k or more of gross business and/or investment income (excluding net capital gains) in your last tax return; your last assessment notice included tax payable of more than $500; your notional tax is more than $250; you are not entitled to the Senior Australian or Pensioner Tax Offset.

Most people are required to pay instalments on a quarterly basis and will receive an Instalment Activity Statement (IAS). On this statement you will have the option to pay either an instalment amount calculated by the ATO or your own instalment calculated by multiplying your instalment income by a rate provided by the ATO.

The calculation of instalment income is the area in which the majority of mistakes are made. Instalment income is generally your gross business and/or investment income, excluding GST. It includes gross sales and fees received for services, gross interest, gross rent received, unfranked and franked dividend amounts, foreign pensions and other foreign income, royalties and income from trusts and partnerships. It does not include wages, imputation credits or income that is not assessable. Nor does it include Capital Gains.

You are able to vary the instalment amount or rate but there are heavy penalties for getting it wrong so it is a good idea to seek professional advice before making any variation to your PAYG instalments and before making a decision as to which instalment option you will select.

Contributed by Lyn Gower, owner of our Tenterfield, Stanthorpe and Gold Coast offices.

Converted House Residential or Commercial For GST?

When is a house commercial premises? This is a very important question because if a house has been changed enough it will no longer qualify for the GST exemption that residential premises receive. If the property is considered to be commercial then the rent will be a supply that is subject to GST and the sales of the property will be subject to GST for up to 1/11th of the sale proceeds even when sold at market value.

This of course only applies if you are registered for GST. You must register for GST if your turnover exceeds $75,000 (exclusive of GST). Turnover does not include supplies that are input taxed such as residential rents and sales of capital assets. So converting one of your rental properties to offices is not going to force you into the GST arena if your only other income is wages and rent on residential properties.

Nevertheless, for owners of converted homes who are registered for GST (for example they may operate their own business from the premises through the same entity as the owner of the premises) it is extremely important to know whether GST applies when you sell. You will probably get the same price for the property, market value, but whether GST applies or not will determine whether you are required to send the ATO 1/11th of the amount you receive, so there are tens of thousands of dollars at stake.

Until the end of last year houses converted to commercial use would have been caught under paragraph 31 of GSTR 2000/20 which stated:

> *the purpose for which the premises are to be used will be evident from their form or fit-out. This is most clearly the case where premises have been fabricated, or altered, to accommodate commercial or professional activities.*

GSTR 20002/20 has been withdrawn and replaced by GSTR 2012/5 which elaborates on when a house would be considered residential premises. Paragraph 10 states:

> *Premises that display physical characteristics evidencing their suitability and capability to provide residential accommodation are residential premises even if they are used for a purpose other than to provide residential accommodation (for example, where the premises are used as a business office).*

Despite the differences between these paragraphs apparently the ATO has not changed their view only elaborated. Both rulings say it is all about the physical characteristics rather than the use to which the premises are put. GSTR 2012/5 points out at paragraph 36 that a shop that is used as a home is still commercial premises for GST purposes.

GSTR 2012/5 looks at the original intention of the design of the property and asks does it provide shelter and basic living facilities. Now you could say this was the case in many office blocks but the ruling differentiates by stating that they were not designed for that purpose. The next step is to consider whether the house has been modified to the extent that it is no longer residential premises. A significant physical modification that the ruling considers to have changed residential premises to commercial are a doctor's surgery where sealed car parking area, an operating theatre, hygiene facilities, industrial security, altering walls and additional lighting pushed it over the line.

Simply putting a sign out the front, fitting out an office and connecting the appropriate power and phone lines will not change a residence to commercial because it can still be used as a home without modification. On the other hand if you want to be sure the premises are considered commercial, remove the shower and bath. Anything in between get a ruling from the ATO because there is too much at stake.

GSTR 2012/5 has introduced a third scenario to the mix. You can be considered to have changed only part of the property to commercial so its sale or lease would be a mixed supply for GST purposes. In the doctors example GSTR 2012/5 found that the waiting room and store room were still considered residential premises because they had not changed in appearance (other than furniture) from the lounge and bedroom that they were in the original home. This means that on sale only part of the proceeds would be subject to GST. This is despite the GST Act at section 40-65 (1) on the sale of residential premises stating:

A sale of real property is input taxed (not subject to GST) *but only to the extent that the property is residential premises to be used predominantly for residential accommodation.*

If a property such as this, where some of the rooms still resemble residential property, is rented out then the rent also has to be apportioned, some of it subject to GST and some not. The same apportionment would apply to claiming GST input credits on expenses.

The worst consequence is that when you purchased it pre GSTR 2012/5 the sale may have been considered to be fully subject to GST because it had been "predominantly" modified to commercial purposes. Well now it seems that apportionment is necessary, you will have to pay some of that GST input credit back (even if you bought under a going concern clause).

Don't be upset about the advice you got at the time here is some extracts from the GST Act:

Section 195-1 – The term 'residential premises' means land or a building that:

(a) is occupied as a residence or for residential accommodation or

(b) Is intended to be occupied and is capable of being occupied as a residence or for residential accommodation

Yet the ATO make it clear in GSTR 2012/5 that whether the property is being used as a residence or not has nothing to do with the GST outcome ie a shop being used as a home is not residential premises. It is all about the design. That is what the word intended means, not the intended use by the buyer but what the designers intended it to be used for. This is how they can dissect up a house catching some rooms for GST and not others. They can look at the lounge room and say no real change since it was a house even though it is now being used as a waiting room but then look at one of the bedrooms and say it has now been changed, the last person who was involved in the design of that part of the property (ie modifying it) changed the intended use to a commercial purpose because a wall was removed, extra lighting, hygiene facilities and industrial security have been added.

Our advice is that if you are buying, selling or leasing a property that was originally a house that has undergone some modifications to make it suitable for commercial use but still has a shower or bath tub, apply to the ATO for a ruling on how much of it is subject to GST and let the ATO sort out its own mess. Unfortunately, you will need to do this before signing a contract and you will have to wait at least 28 days before receiving a reply. If you are the seller it would be sensible to apply for the ruling before you even have a buyer.

Note, in Newsflash 261 there was a story about a reader who purchased a house converted to a medical practice but intended to use it as her home. Under this new ruling GSTR 2012/5 the property may well have been considered residential premises rather than commercial or a mixed supply. Where taxpayers have relied on the wording of GSTR 2000/20 for any sale contracts they entered into before 19th December, 2012 they are protected from the findings in GSTR 2012/5 but that is not going to help you when you sell and if you are charging rent you need to get it right from 19th December, 2012 going forward.

2013 Budget Update

Data Matching – Funds in the budget have been allocated to increasing the data matching that the ATO collects, to include, government grants, sales of property, shares and units in managed funds. They will also have access to data on sales through merchant services i.e. Managed investment fund distributions, partnership distributions, company dividends and interest payments.

Ask BAN TACS

For $79.95 at Ask BAN TACS, www.bantacs.com.au/ask-bantacs.php, you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion. There is also a notice board where some askbantac users have generously allowed their question and answer to be published. Lots of good real life information.

More Information

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How to Make Sure Your Next Property Is a Good Investment

- Do you really know how much the property is going to cost you to hold?
- What name should the property be purchased in?
- Will this property fit your investment strategy and goals?
- What does the contract say about GST?
- How does the price compare with similar sales in the area?
- If it is negatively geared, how much capital growth is required before you breakeven?
- Do you know what records you need to keep and how?
- Are your financing arrangements maximising your tax deductions?
- What happens if interest rates rise?

......and the list goes on!
To ensure you don't make a costly mistake with your next purchase make sure you see a BAN TACS Accountant before you sign

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