Chartered Accountants

Client Newsletter - Tax, Super & Business Ideas

February 2015

When you have to deal with a natural disaster

The recent bushfires across much of the country are a reminder that as well as the more obvious immediate devastation inflicted on people's property, these destructive events can also mean loss of income for many affected people — not only directly, but also in terms of damage done to workplaces, income-earning tools of trade, vehicles and essentials such as computers and other equipment.

The Tax Office says that if you are affected by natural disaster, such as bushfires, floods or storms, you need not worry about your tax affairs right away. It says it will give you time to deal with your more immediate problems first, and later can help you to sort out your tax affairs.

More time to lodge, pay and respond

The Tax Office says that your tax obligations can generally be put to one side until you have dealt with the immediate effects of the disaster – whether you are affected yourself or are helping those affected. It can allow more time to settle tax debts, or if you are unable to lodge your return or activity statement, or cannot immediately deal with any other correspondence that may be in train.

The Tax Office also says that if a business owner is unable to lodge a superannuation guarantee charge (SGC) statement, it can give you more time to lodge, although you will still be liable for the SGC and the nominal interest component (NIC) will continue to accrue. You may be able to vary the amount of your next instalment if you are liable to pay your tax by instalments under the PAYG Instalments system.

Early access to your money

If you are expecting a refund from an income tax return or activity statement, the Tax Office may be able to arrange for your refund to be issued as a priority. In limited circumstances, you may be able to access your superannuation to assist you and your dependants, but special consideration will need to be sought.

Assistance payments

After a natural disaster, it may be the case that you receive assistance from government authorities, charitable institutions, employers, your family, a trade union or other sources. Most one-off assistance payments are tax free, but regular Centrelink payments remain taxable.

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About this newsletter

Welcome to our monthly SRF newsletter, where we bring to your attention recent changes in the areas of Business, Taxation and Superannuation.

If you would like to discuss further any of the issues raised in the newsletter, please call your SRF advisor.

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Also in this issue:

When you have to deal with a natural disaster (cont)

Damaged or destroyed property

If your property is damaged or destroyed in a disaster, you may receive an insurance payment. How this is treated for tax purposes depends on the type of property and whether or not the property is income-producing. Repairs to income-producing properties are generally tax deductible in the year you incur them. However, this depends on whether the work you do restores the original condition or goes beyond remedying the damage to the point where it is an improvement or a complete replacement. Talk to this office for guidance.

Reconstructing your tax records

If your records have been lost or destroyed — whether you are an individual, in business, or responsible for a self-managed superannuation fund — talk to this office about how we can help. The Tax Office can also provide assistance to help reconstruct your tax records and make reasonable estimates where necessary.

Fast help

See the government's website www.disasterassist.gov.au for current disaster assistance and other valuable information. Also ask this office should you require help with lost records, lodging forms, payments, getting a faster tax return and more.

Fuel tax credits

Following a disaster, you may need to use taxable fuel (such as diesel or petrol) for generating electricity for domestic purposes; you may then be eligible to claim fuel tax credits. Businesses that are registered for goods and services tax (GST) can claim credits for the fuel tax included in the price of fuel used in eligible business activities to run machinery, plant, equipment and heavy vehicles. Non-profit organisations that are not registered for GST can claim credits for fuel used in operating emergency vehicles or vessels. ■

Tips and traps for SMSFs investing in property

Many SMSF trustees contemplate investing in real property as part of the fund's investment strategy. However a recent Tax Office notification raised its concerns that some trustees may not fully consider the risks and issues associated with holding a real property investment and how this can affect other aspects of the fund, such as benefit payments.

The Tax Office's notification alerted trustees to consider the following issues.

Investment strategy

Trustees are required to invest in accordance with the investment strategy of the fund, including giving regard to liquidity. When deciding whether to invest in property, trustees should consider if this meets the diversification and liquidity requirements of their fund. For example, when members retire and start receiving pensions, there needs to be sufficient money in the fund to meet minimum pension payment requirements.

Borrowing

Superannuation law allows a fund to borrow only in limited circumstances. When an SMSF borrows money to invest in property, it needs to do so via a limited recourse borrowing arrangement (LRBA). These borrowings need to be made on commercial terms to avoid adverse income tax consequences, such as income being deemed non-arm's length income that would attract non-concessional tax rates.

Related party transactions

In the case of the property being leased to a related party, trustees need to ensure compliance with the super laws, such as:

- in-house asset rules
- sole purpose test
- arm's length requirements.

Use of property in retirement

When an SMSF starts to pay a pension, all property investments must continue to be maintained in accordance with super laws, in particular the sole purpose test and in-house asset rules. For example, members are not able to occupy or lease residential property on retirement without the asset first being sold or transferred to the member(s) as a benefit payment. Trustees need to keep in mind that the transfer of any asset from an SMSF to a member must also be permitted under the governing rules of the fund and that a capital gains tax (CGT) event may occur, with possible taxation implications for the fund.

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Tips and traps for SMSFs investing in property (cont)

Offshore investments

The Tax Office warns that the risks and issues that are associated with property investments may be heightened when these investments are located in an offshore jurisdiction.

The Tax Office notification says that there is no specific guidance other than the rules of the superannuation laws as to what trustees can invest in regarding to real property, and also emphasised that it is not its role to provide investment advice.

It is important to be mindful that the trustees of any SMSF are ultimately responsible for managing the super fund, so appropriate research and scrutiny should be applied when making investment decisions. The Tax Office encourages trustees to seek professional advice.

Insurance

SMSF trustees also need to seriously consider insurance for their fund to cover unforseen events. This cover can include:

- general insurance – trustees should ensure they have adequate insurance to cover property repair or replacement costs in the event that the property is damaged.
- third-party liability insurance – trustees should be aware that as a property owner, the fund can be sued. This may put the fund's assets at risk.
- death or total and permanent disability insurance – trustees should consider the benefit of policy proceeds to assist in meeting ongoing obligations, including where the property is business real property used in a family business. ■

The taxation implications of 'debt forgiveness'

"Pardon" is a word that can sound somewhat archaic — which could be why the term "debt forgiveness" is barely mentioned in discussions on "bankruptcy", even though the two concepts are related. Bankruptcy is dramatic, Hollywood; debt forgiveness seems dated, even mildly medieval.

In reality debt forgiveness, on the face of it, is a means by which commercial debts are wiped away, at least in part. In Australia debt forgiveness protocols are designed to help entities that cannot pay all of their loans restructure so they can repay as much as possible. Often, but not always, debt forgiveness is a precursor to or a result of bankruptcy.

Tax considerations go along with any forgiven debt. They don't disappear. Tax law has mechanisms to make sure people who have bad debts forgiven still honour their tax obligations to the revenue and can't manipulate the system to get an unfair advantage. So an important take away point is that entities that have debts pardoned will generally see a commensurate decrease in their future tax breaks.

Debt forgiveness provisions exist to help curb hairy bookkeeping and arbitrage opportunities as a result of bad debts. Debt forgiveness would typically provide the creditor with a revenue loss (or in some cases, a capital loss). Meanwhile in the absence of debt forgiveness rules, the debtor may not have been assessed on any gain, and could continue to claim deductions for revenue and capital losses, as well as other deductible costs.

This kind of situation could constitute a doubling-up of tax breaks between the two taxpayers. So the commercial debt forgiveness provisions take aim at duplications by applying the forgiven amount with a view to reducing certain future deductions.

The nitty-gritty

The legislation lists a few "circumstances" under which debts may be forgiven:

- The creditor's obligation to pay the debt (or part of it) is released, waived, or otherwise extinguished other than by repayment in full
- the debtor loses its right to sue for recovery of the debt because of the operation of a statute of limitations

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An overview of debt forgiveness (cont)

Division 7A

Division 7A is one of many sizeable banners that come within the ambit of the debt forgiveness rules. This is because a forgiven debt could be deemed to be a dividend paid to a shareholder (and therefore taxable), unless certain conditions are met. It applies to debts forgiven on or after 4 December 1997, being the date Division 7A took effect.

- the creditor enters into an arrangement with the debtor, where the obligation to pay the debt ends at a mutually agreed time and the creditor pays only a token amount, if anything
- "debt parking" occurs (certain assignments to third parties), and
- a subscription for shares occurs to enable the debtor to discharge some or all of the debt with the subscription monies.

How do the commercial debt forgiveness rules work?

A commercial debt is defined as a debt in respect of which interest, (or amounts akin to interest), if it was paid or payable in respect of the debt, would be deductible.

The debtor's "net forgiven amount" can be calculated using a simple equation. Gross forgiven amount of the debt, less:

- amounts included in assessable income as a result of the forgiveness,
- reductions in allowable deductions as a result of the forgiveness,
- reductions in cost bases of CGT assets as a result of the forgiveness,

= net forgiven amount of the debt.

Where the debtor and creditor are companies under common ownership, the debtor's net forgiven amount can be reduced to the extent that the creditor agrees to forego their revenue deduction or capital loss arising from the debt forgiveness.

The total net forgiven amount is then applied successively to:

- carry forward tax losses and capital losses
- tax written down values of depreciating assets, and balances of the amounts deductible over time
- reduce cost bases of CGT assets.

Once all of these amounts are reduced to nil, any remaining net forgiven amount simply disappears forever.

As with CGT, market value rules may apply to determine consideration in respect of the forgiveness of a "non-money" debt. Specific rules also apply to determine consideration for the purposes of the debt forgiveness provisions where debt parking applies or where there is a debt for equity swap.

Exclusions to debt forgiveness provisions

Debt forgiveness provisions do not apply to debts forgiven:

- if the debt waiver constitutes a fringe benefit
- if the amount of the debt has been, or will be, included in the assessable income of the debtor
- under an act relating to bankruptcy
- where forgiveness is affected by will
- for reasons of natural love and affection.

There are other exclusions to be mindful of as well, such as where the forgiven debt can be seen to be in respect of employment. In these cases, the benefit of being forgiven a debt will typically constitute a fringe benefit, and be taxed as such. Exclusions may also apply if the forgiven amount sees it included in the assessable income of the debtor. This can happen (as detailed above) where a private company is deemed to have paid a dividend (under Division 7A) where a debt owed to the company is forgiven.

There are even situations where the forgiven debt gives rise to ordinary income. For example this can occur when a taxpayer's resulting gain from a released debt deemed to have arisen from the ordinary activities of the taxpayer, or it otherwise displays generally accepted characteristics of ordinary income (such as if such gains are periodic, recurrent and/or expected).

A few years ago taxpayers saw an unprecedented result out of the global financial crisis — a huge increase in the number of loans written off or compromised. Forgiveness in those circumstances may not be so prevalent now, but it's important taxpayers remain conscious of the broad definitions of "forgiveness" listed in tax law. Making sure the consequences of a forgiveness is understood before it takes place — in no small part by consulting the myriad of laws on the subject — is vital, and don't forget that the creditor will also have vested interests in the details of the arrangement as they will bear tax consequences too. ■

Income averaging: Who is eligible, how it works

Australian tax legislation recognises that certain taxpayers, due to the nature of their work, can make inconsistent levels of income from year to year. In light of this, there is a concessionary tax treatment available that allows for a reduction of the otherwise unreasonable tax rates that would apply in higher income years, in effect smoothing out these income spikes to come to a fair level of tax overall.

The concession comes in the form of special tax rates applied, broadly, to a four year rolling average taxable income. It is available only to certain specified categories of income earners, known as "special professionals". These are:

- sportspeople
- authors (literary, dramatic, musical, but also other artistic works and in some cases computer programmers)
- inventors
- performing artists, and
- production associates (those who provide artistic support to performing artists).

The principle behind the income averaging provisions is that those working in these fields may spend a number of years working on a project that will only realise income at a future point in time. For example, a film-maker can spend years developing and producing a work that will only make any income once it is released, or a sportsperson may be limited to compete in their field on an occasional basis (for example, some major sporting events only happen once every four years). In each case, the income earned is characterised by peaks and troughs.

For the purposes of income averaging for special professionals however, what the legislation refers to as "special professional income" is that which is derived from the specific category of professional activity. For an artist for example, income from the sale of paintings counts, but income from running painting workshops does not.

The benefits to an eligible individual's tax outcome by using such income averaging provisions will typically be mostly felt in the first few years of application, and can result in significant tax savings for those years. The benefit tends to reduce once income flattens out, which is of course the intent of the legislation. Note that all other income is taxed in the usual way and at normal rates.

The eligibility criteria for special professional income averaging includes that an individual:

- earns income from one of the "special professional" categories
- is an Australian resident at any time during the income year, and
- satisfies the first year requirements (see below) in either the current income year or an earlier income year.

Note that assessable professional income includes:

- rewards and prizes
- income from endorsements, promotional activities, advertisements, interviews, commentating and any similar service
- income from assigning copyright or granting a licence of a literary, dramatic, musical or artistic work
- income from assigning a patent, or the right to apply for a patent, or granting a licence for an invention
- income from providing professional services, and
- other assessable income from a literary, dramatic, musical or artistic work, from copyright in such a work or for an invention.

To then calculate the "taxable professional income", apply the formula given by the law:

Apportionable deductions x (assessable professional income ÷ {taxable income + apportionable deductions})

Broadly, to reduce the assessable professional income by deductions relating to it, and the relevant part of any apportionable deductions (for example, donations).

The first year a taxpayer becomes eligible for income averaging is the year in which they have more than

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Income averaging (cont)

$2,500 taxable professional income. This then becomes year one of a four-year period over which taxable professional income is averaged.

Over the ensuing years of the four-year phrase-in period, the Tax Office deems the average taxable professional income (TPI) to be:

- year 2: one-third of the TPI in year 1
- year 3: one-quarter of the sum of TPI of years 1 and 2, and
- year 4: one-quarter of the sum of TPI of years 1, 2 and 3.

From the fifth year onwards, the average taxable professional income for each ensuing year is simply based on the rolling four-year averages — that is, the total of the past four year period is divided by four.

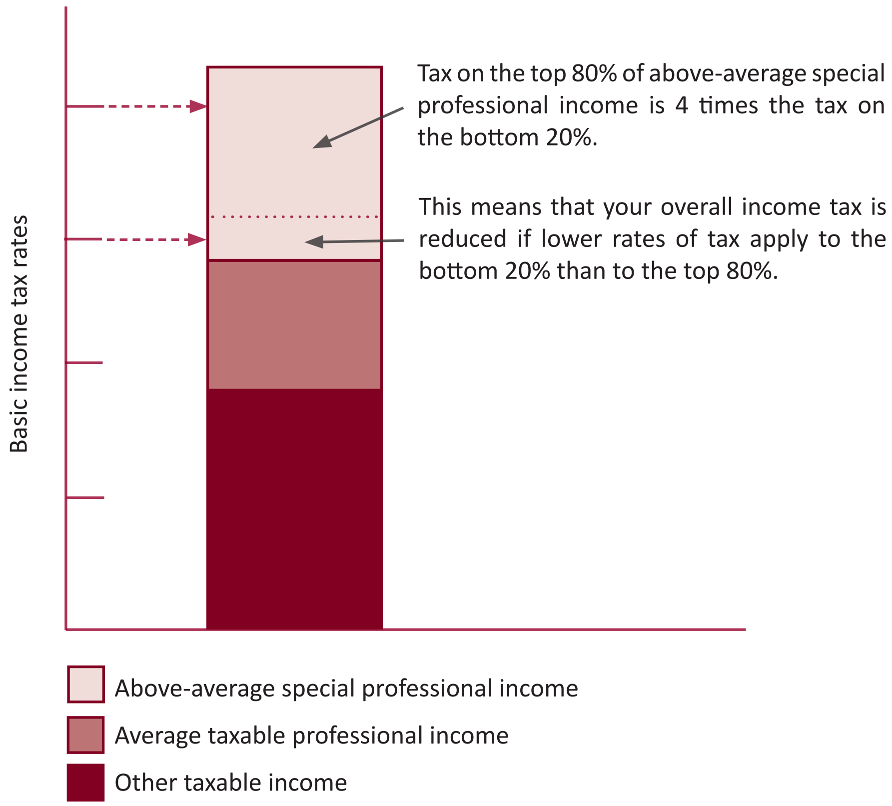
Note that the following are specifically excluded from assessable professional income:

- a superannuation lump sum or an employment termination payment
- payments for unused annual or long service leave on retirement or termination, and
- a net capital gain.

To deal with the peaks of higher income that such special professionals encounter (or perhaps hope to) over their working lives, the law provides that the tax payable on "above average" income — that is, the amount that exceeds the average taxable professional income — is calculated by applying a unique formula. This is set by applying, to 80% of the above average amount, four times the basic rate of tax that 20% of the above average amount would have borne had it been the top slice of the taxpayer's taxable income in the relevant income year (the illustration below will hopefully make this more clear).

As you can see, the income averaging regime for special professionals is a complicated area, and can easily be misunderstood. Not only that, but the Tax Office tends to put applications to apply these income averaging provisions under the microscope — to ensure a taxpayer is legitimately eligible, but also to check that all the correct income is included and the correct tax rates are applied. It is essential that you seek clarification from this office should you believe you can make use of the special professional income averaging provisions. ■

Income tax treatment of above-average special professional income



Changing the makeup of a partnership through 'reconstitution'

Over time, or due to circumstances, the composition of a partnership can change – for example, a partner may retire or die, or a new partner is admitted. In many such situations, the existing partnership may need to be dissolved and a new partnership formed at general law.

The new partnership will need a new tax file number (TFN), Australian business number (ABN), and goods and services tax (GST) registration. Both partnerships will generally need to lodge a separate partnership tax return – one return for the old partnership from the beginning of the income year to the date of its dissolution, and another for the new partnership from the date of its formation to the end of the income year.

At general law, dissolution leading to the winding up of a partnership is called a "general dissolution". But a Tax Office ruling recognises that there can alternatively be what is known as a "technical" dissolution.

A technical dissolution does not result in the winding up of the existing partnership, and occurs where the assets and liabilities of the partnership are taken over by the continuing partners (and any new partners) and the partnership business is continued without any apparent break. The Tax Office refers to this as a "reconstituted partnership".

What reconstitution entails

As a reconstituted partnership, the business does not need a new TFN and ABN, and only one partnership tax return is required covering the full income year. For the purposes of the GST, the partnership does not need new GST registration (where the partnership was already required to register).

Generally, the Tax Office will treat a changed partnership as a reconstituted partnership, and the following factors apply:

- the partnership is a general law partnership (as opposed to a tax law partnership; contact us if you are unsure of the difference)
- at least one of the partners is common to the partnership before and after reconstitution
- the partnership agreement includes an express or implied continuity clause
- there is no break in the continuity of the enterprise or firm (the partnership's assets remain with the continuing partnership and there are no changes to the nature of the business, the customer or customer base, the business name or name of the firm)
- there is no period where there is only one partner (in a two-person partnership, there is a direct transfer of interest from the outgoing partner to a new partner).

Note that a two-person partnership can be reconstituted. This may occur where a partner dies, and the partnership agreement allows for continuity of the partnership with either the executor, trustee or beneficiary of the deceased partner's estate. The continuity clause may be express, or implied by way of conduct. Where this happens, and the firm continues without any break in the continuity of the enterprise, the Tax Office generally considers there is a change in members and that the entity is a continuing reconstituted partnership.

Continued use of the partnership's TFN

To apply for continued use of the partnership's TFN, the partners or a partner, or an authorised contact, must inform the Tax Office within 28 days of the change of registration.

The following information will be required:

- a clear statement by an authorised continuing partner that all new, continuing and retiring partners agree to the continuity and reconstitution of the partnership

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Partnership 'reconstitution' (cont)

- the date of the reconstitution
- the names of the new, continuing and retiring partners
- the TFN or address and date of birth of all new partners
- any changes to persons authorised to act on behalf of the partnership
- a statement that
  - the partnership is a general law partnership
  - at least one of the partners is common to the partnership before and after reconstitution
  - there is no period where there is only one "partner" (that is, in a two-person partnership, there is a direct transfer of interest)
  - the partnership agreement contains a continuity clause, or in absence of written partnership agreement, the conduct of partners is consistent with continuity
  - there is no break in the continuance of the enterprise.

Lodging the tax return

At the end of the financial year, a reconstituted continuing partnership needs to lodge only one partnership tax return covering the full financial year. The tax return must include the distributions made to every person who was a partner at any time during the financial year, including those who left the partnership during the year.

When lodging the partnership tax return, the following details will need to be supplied via a schedule of additional information:

- the date of dissolution
- the date of the reconstitution
- the names of the new, continuing and retiring partners
- the TFN or address and date of birth of all new partners, and
- details of the changes, if the persons authorised to act on behalf of the partnership have changed.

See this office for more guidance should the makeup of your partnership change, or if you know such changes are imminent. ■

Employee or contractor? 12 common myths

The Tax Office says that it has encountered several myths and assumptions adopted by both workers and employers when it comes to trying to decide the tax status of a job appointment. It found that employers continually rely upon some inaccurate factors when making distinctions about what makes a worker an employee or contractor — and therefore the tax treatment that applies in these cases.

Here are 12 common myths the Tax Office says can often get both businesses and workers into hot water.

1. Having an Australian business number (ABN)

Myth: If a worker has an ABN they are a contractor.

Fact: Just because a worker has an ABN does not mean they will be a contractor for every job. Whether the worker has or quotes an ABN makes no difference and will not change the worker into a contractor. To determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed.

2. Common industry practice

Myth: "Everyone in my industry takes on workers as contractors, so my business should too."

Fact: Just because "everyone" in an industry uses contractors does not mean they're correct. Don't use "common industry practice" to make determinations.

3. Short-term work

Myth: Employees cannot be used for short jobs or to get extra work done during busy periods.

Fact: The length of a job (short or long duration) or regularity of work makes no difference to whether a worker is an employee or contractor. Both employees and contractors can be used for:

- casual, temporary, on call and infrequent work
- busy periods

Continued ➔

Employee or contractor? 12 common myths (cont)

- short jobs, specific tasks and projects.

To determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed.

4. The 80% rule

Myth: A worker cannot work more than 80% of their time for one business if they want to be considered a contractor.

Fact: The 80% rule, or 80/20 rule as it is sometimes called, relates to personal services income (PSI) and how a contractor:

- reports their income in their own tax return
- determines if they can claim some business-like deductions.

It is not a factor a business should consider when they determine whether a worker is an employee or contractor.

5. Past use of contractors

Myth: "My business has always used contractors, so we do not need to check whether new workers are employees or contractors."

Fact: Before engaging a new worker (and entering into any agreement or contract), a business should always check whether the worker is an employee or contractor by examining the working arrangement. Unless a working arrangement (including the specific terms and conditions under which the work is performed) are identical to previous arrangements, it could change the outcome of whether the worker is an employee or contractor.

Sometimes a business may also have incorrectly determined their worker is a contractor. Continuing to rely on the original "contractor" decision would mean the business is incorrectly treating all future workers as contractors when they are employees.

6. Registered business name

Myth: If a worker has a registered business name, they are a contractor.

Fact: Having a registered business name makes no difference to whether a worker should be an employee or contractor for a particular job. Just because a worker has registered their business name does not mean they will be a contractor for every job or working arrangement.

7. Contracting on different jobs

Myth: If a worker is a contractor for one job, they will be a contractor for all jobs.

Fact: If a worker is a contractor for one job, it does not guarantee they will be a contractor for every job. The working arrangement and specific terms and conditions under which the work is performed will determine whether a worker is an employee or contractor for each job.

Depending on the working arrangement, a worker could be an:

- employee for one job and a contractor for the next job
- employee and a contractor if completing two jobs at the same time for different businesses.

8. Paying super

Myth: "My business should only take on contractors so we do not have to worry about super."

Fact: A business always needs to look at the working arrangement and examine the specific terms and conditions under which the work is performed to determine whether a worker is an employee or contractor. A business cannot decide to treat a worker as a contractor when they are an employee.

Additionally, businesses may be required to pay super for their contractors. If you pay an individual contractor under a contract that is wholly or principally for the labour of the person, you have to pay super contributions for them.

9. Specialist skills or qualifications

Myth: Workers used for their specialist skills or qualifications should be engaged as contractors.

Fact: If a business takes on a worker for their specialist skills or qualifications it does not automatically mean they are a contractor. A worker with specialist skills or

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Employee or contractor? 12 common myths (cont)

qualifications can either be an employee or contractor depending on the terms and conditions under which the work is performed. Qualifications or the level of skill a worker has (including whether they are "blue" or "white" collar) makes no difference to whether a worker is an employee or contractor.

10. Worker wants to be a contractor

Myth: "My worker wants to be a contractor, so my business should take them on as a contractor."

Fact: Just because a worker has a preference to work as a contractor does not mean your business should engage them as such. Whether a worker is an employee or contractor is not a matter of choice, but depends entirely on the working arrangement and the specific terms and conditions under which the work is done.

If you give into pressure and agree to treat an employee as a contractor, you can face penalties, interest and charges for not meeting your tax and super obligations.

11. Using invoices

Myth: "If a worker submits an invoice for their work, they are a contractor."

Fact: Submitting an invoice for work done or being "paid on invoice" does not automatically make a worker a contractor.

To determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed. If based on the working arrangement a worker is an employee, submitting an invoice or being paid on the basis of an invoice will not change the worker into a contractor.

12. Contracts

Myth: "If a worker's contract has a section that says they are a contractor, then legally they are a contractor."

Fact: If a worker is legally an employee, a contract saying the worker is a contractor will not make the worker a contractor at law. Businesses and workers will sometimes include specific words in a written contract to say that the working arrangement is contracting in the mistaken belief that this will make the worker (who is an employee) a contractor at law.

If a worker is legally an employee, a contract specifying the worker is a contractor makes no difference and will not:

- override the employment relationship or change the worker into a contractor
- change the PAYG withholding and super obligations a business is required to meet. ■