AV CHARTERED ACCOUNTANTS

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Client Newsletter – Tax & Super

July 2018

Retired and asset rich but cash poor? The pension loans scheme may help

To help pensioners who are rich in assets but poor in income, the government launched a version of a commercially available financial product, the reverse mortgage.

About this newsletter

Welcome to **AV Chartered Accountants** client information newsletter, your monthly tax and super update keeping you **abreast of** current issues, news and changes you need to know about.

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The government's answer for pensioners who find themselves in the above situation is its pension loans scheme (PLS), whereby a pensioner can apply for a non-taxable loan using some form of real property as security. The PLS does not provide a lump sum, but a regular fortnightly payment.

At present the scheme is only open to those on a full pension, but the 2018 Federal Budget announced the government intends to open the PLS to all pension-age retirees (not just those who qualify for the Age Pension).

Also from 1 July 2019 the maximum allowable income stream (combined Age Pension and PLS) will increase

The pension loans scheme *continued*

to be 50% higher than the full pension, including supplements.

A full age pensioner may be able to apply if:

- you or your partner are of Age Pension age
- you own real estate in Australia that can be used as security for the loan (home or investment)
- you or your partner receive a rate of payment that is less than the maximum pension amount or nothing (due to either the income or assets test, but not both)
- you meet Age Pension residence rules.

There are costs associated with the scheme, which the Department of Human Services (DHS) will determine (this department administers the scheme) and send to the person seeking the loan. The current rate of interest is 5.25%, which DHS adds to the outstanding loan balance each fortnight until the loan is repaid.

The loan recipient can repay the PLS loan in part or in full at any time. If the loan recipient wants to sell a property they need to inform DHS, and they can either transfer the loan to another property including a new home or they can repay the loan on the date of settlement. If there is an outstanding amount upon the loan recipient's death, the estate or in some cases the surviving partner's estate can make repayments.

The total loan available depends on the:

- equity in the property offered as security
- equity kept in the property, and
- the age of the recipient or their partner, whoever is younger.

Applicants can get a loan up to the maximum rate of income support payment they qualify for. Loan recipients may also use real estate owned by a private company or trust as security for the loan, if they are a controller of that company or trust. If there is more than one property, they can choose which to use as security for the loan.

DHS will register a charge with the Land Titles Office on the title deed of the property used as security, with recipients paying any costs associated with this charge. A licensed valuer will value the property, however this is done at no cost to the loan recipient.

Any person seeking a PLS should contact the DHS first to ensure they are eligible and to confirm the amount they can seek. ■

2 minute quiz: **Partnerships**

How well do you understand the taxation of partnerships? Try these questions to find out.

Question 1

Which of the following is the definition of a tax law partnership?

1. An association of persons (other than a company or a limited partnership) carrying on a business in common with a view to profit
2. An association of persons (other than a company or a limited partnership) in receipt of income jointly
3. An association of persons (other than a company or a limited partnership) carrying on a business in common ***and*** in receipt of income jointly
4. An association of persons (other than a company or a limited partnership) carrying on a business in common, or in receipt of income jointly, or a limited partnership.

2 minute quiz *continued*

Answer 1

The correct answer is 4.

The tax law definition of a partnership is an association of persons (other than a company or a limited partnership):

- carrying on business as partners, or
- in receipt of ordinary or statutory income jointly, or
- a limited partnership.

Question 2

A partnership's financial records show the following:

- A capital gain arising from sale of a partnership asset
- Salaries paid to the partners
- Interest paid on a business loan from a partner
- Interest paid on capital contributed by a partner, and
- Drawings by a partner.

Which of the following amounts are taken into account in calculating a partner's share of the net income of the partnership for tax purposes?

1. The capital gain, salaries, interest on the loan and interest on the capital
2. Only the interest on the loan
3. Only the salaries
4. All of the items.

Answer 2

The correct answer is 2.

A capital gain is not included in the calculation of partnership net income. For CGT purposes, the partner is the relevant taxpayer. A disposal of a partnership CGT asset gives rise to a CGT event happening in respect of each partner's interest in the asset.

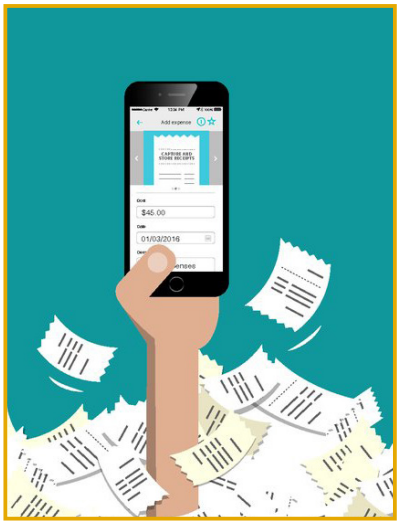
Salaries paid to partners are treated as distribution of partnership profits and not deductible to the partnership in the calculation of its net income.

Interest paid by a partnership on a loan received from a partner is an allowable deduction to the partnership (and assessable income to the partner). This is taken into account in calculating the partnership's net income.

However, interest paid on capital contributions is treated as an appropriation of profit and is not deductible to the partnership.

Drawings are not deductible to the partnership and treated as prepayments of the distribution of partnership profits.

The joint ownership of an investment property by individuals (for example, spouses) is taken to be a tax law partnership. As an administrative concession, the ATO does not require such partnerships to lodge a partnership tax return. Rather, each owner's share of the net income from the property is only required to be included in each individual's respective tax return. ■

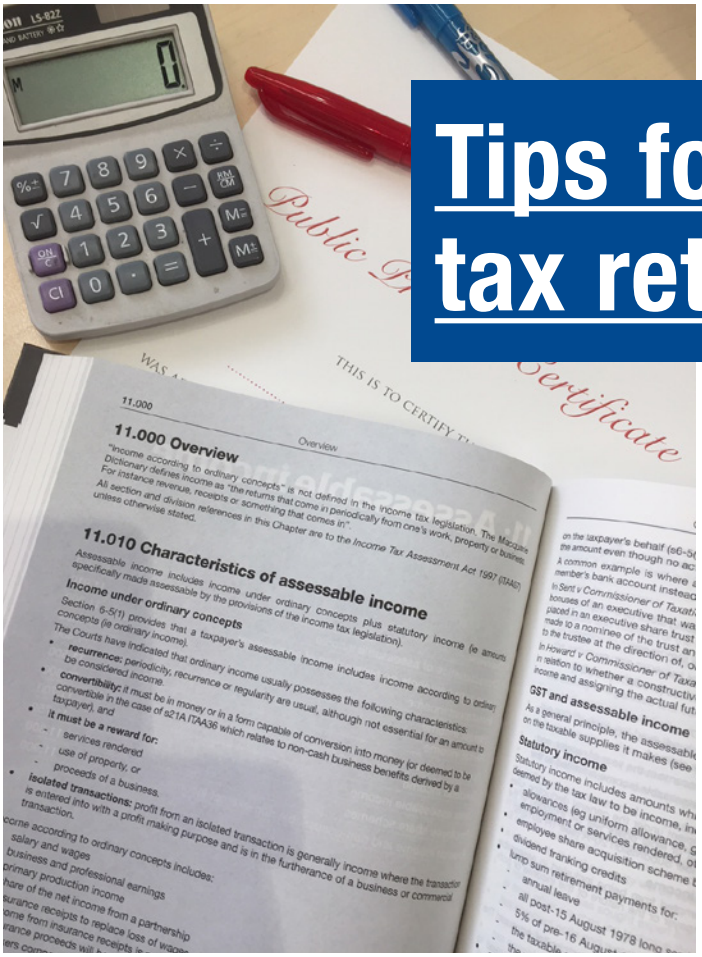


PLAN AHEAD: TIP TO BETTER PREPARE FOR TAX TIME 2019

It is highly recommended that you keep receipts for all expenses and possible tax deductions you are considering claiming for you or your business. It is also a good idea to scan and file them electronically so that they are accessible should you need them for audit purposes.

If you haven't used it already, note that the ATO has an app called myDeductions that will make record keeping easier. The tool allows you to record deductions including work-related expenses, gifts and donations, interest and dividends. It also lets you store photos of receipts and record car trips.

The myDeductions app can be used by individuals and sole traders (sole traders can use it to keep track of business income) and at tax time you can send your deduction records to us. ■



Tips for your tax return

Before we sit down with you to go over your tax return, certain information will be needed. Of course these days pre-filling takes care of a lot of the "paperwork", and if you wait until late-July or mid-August the ATO's systems will most likely be able to provide most of the information from employers, banks, government agencies and other third parties.

We will then be able to double-check the information is correct and enter any deductions you want to claim. However to be thorough, before coming in for your tax appointment here are the sorts of information needed to enable us to complete your tax return.

- **Payment summaries:** These outline the income you have received from your employer, super fund or government payments such as from Centrelink or the Department of Veterans Affairs.
- **Bank statements:** Details any interest you have earned during the period and fees you have paid.
- **Shares, unit trusts or managed fund statements:** Information on dividends or distributions you've received (dividends that you've elected to reinvest must be declared as income).
- **Buy and sell investment statements:** Needed to calculate capital gains and losses. If you bought or sold any shares you can access the details on your online broking account or you can get them from your investment adviser or stockbroker.
- **Records from your rental property:** If you use a property manager you will probably get an annual tax statement that details income and expenses, otherwise you will need to gather details of income received and expenses paid, including any capital gains or capital losses from the sale of property.
- **Foreign income:** Details of foreign pensions or other foreign income.
- **Private health insurance policy statement:** Information needed to complete the private health insurance section of your tax return.

Income that must be declared

The taxability of some forms of income may seem obvious, but in keeping with our objective of being thorough, here's a list of common types of income that must be declared on your tax return.

- Employment income
- Super pensions, annuities and government payments
- Investment income (including interest, dividends, rent and capital gains)
- Business, partnership and trust income
- Foreign income
- Income from crowdfunding (for example donations received for a venture in which you intend to make a profit)

- Income from the sharing economy (for example Airtasker, Uber or Airbnb)
- Other income, including compensation and insurance payments, discounted shares under employee share schemes, some prizes and awards. Check with us if you are unsure.

Deductions

When completing your tax return, you're entitled to claim deductions for some expenses, most of which should be directly related to earning your income (called "work-related expenses"). Naturally, a deduction reduces your taxable income, and means you pay less tax.

To claim a deduction for work-related expenses:

- you must have spent the money yourself and not been reimbursed
- it must be directly related to earning your assessable income
- you should have a record to substantiate your claim.

When your expenses meet these criteria, here's a list of the things you may be able to claim.

- **Vehicle and travel expenses:** This does not normally include the cost of travel between work and home, but if you use your car for work or work in different locations then you may be able to claim a deduction.
- **Clothing, laundry and dry-cleaning expenses:** To legitimately claim the cost of a uniform, it needs be unique and distinctive, for example it contains your employer's logo, or is specific to your occupation, like chef's pants or coloured safety vests.
- **Gifts and donations:** Only claim for contributions to organisations that are endorsed by the ATO as "deductible gift recipients".
- **Home office expenses:** Costs could include computer, phone or other electronic device and running costs such as power and an internet service. There may be scope for depreciation, and only claim the proportion of expenses that relate to work, not private use.
- **Interest, dividend and other investment income deductions:** Examples include interest, account fees, investing magazines and subscriptions, internet access, depreciation on your computer.
- **Self-education expenses:** Providing the study relates to your current job, you may be able to claim expenses like course fees, student union fees, textbooks, stationery, internet, home office expenses, professional journals and some travel.
- **Tools, equipment and other equipment:** If you buy tools or equipment to help earn your income, you can claim a deduction for some or all of the cost. The type of deduction you claim depends on the cost of the asset. For items that don't form part of a set and cost $300 or less, or form part of a set that together cost $300 or less, you can claim an immediate deduction for their cost. For items that cost more than $300, or that form part of a set that together cost more than $300, you can claim a deduction for their decline in value.
- **Other deductions:** Other items you can claim include union fees, the cost of managing your tax affairs, income protection insurance (but not if it's through your super fund), overtime meals, personal super contributions (that is, after tax) and other expenses incurred in the course of earning an income.

Of course, check with this office for more ideas. Sometimes one's circumstances will define what can and generally cannot be claimed as a deduction, so even if some of the above seem to fit your situation, it may pay to check with us first.

Off the deduction menu

The ATO is focused on helping taxpayers get their deductions right, but it's also on the lookout for red flags that identify people who are doing the wrong thing. Here's a list of deductions you usually can't claim on your tax return.

- Travel between home and work, which is generally considered private travel.
- Car expenses, with some exceptions (such as transporting bulky tools or equipment that you need to do your job and that your employer requires you to transport, or travel between jobs — ask us if you think you may have a case for such claims).
- Car expenses that have been salary sacrificed.
- Meal expenses, unless you were required to work away from home overnight.
- Private travel, including any personal travel portion of work-related travel.
- Everyday clothes you bought to wear to work (for example, a suit or black pants), even if your employer requires you to wear them.
- Self-education expenses where there is no direct connection to your current employment.
- Phone or internet expenses that are related to your own private use. ■

This information has been prepared without taking into account your objectives, financial situation or needs. Because of this, you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs.

Are you Division 7A compliant?

Division 7A is an integrity measure that was designed to prevent companies from making tax-free distributions to shareholders or their associates. This can occur where distributions of profit are disguised as loans or other transactions. This effectively allows the shareholder or their associate to have access to the corporate tax rate.

A consequence of Division 7A applying to certain loans and transactions is that an unfranked dividend is taken to be paid to the shareholder or associate in the year the loan is made or the transaction occurs.

In particular, it can apply to the following transactions involving a company:

- loans
- payments
- debts forgiven
- use of company assets (such as a holiday house)
- unpaid present entitlements from a trust, and
- guarantees and indemnities.

The definition of "loan" under Division 7A is quite broad and includes a "provision of financial accommodation". For example, the ATO has adopted the position that unpaid present entitlements arising after 16 December 2009 by a trust that are not paid (or held on sub-trust for the sole benefit of the private company beneficiary) amount to the private company providing financial accommodation to the trust.

Transactions involving unrelated parties will not generally be subject to Division 7A. However, as noted, if the transaction involves a shareholder of a private company, or an associate of a shareholder, it can be subject to Division 7A. An "associate" is very broadly defined. It can, among others, include:

- a spouse, child or relative of the shareholder
- a trust in which the shareholder or associate is a beneficiary, and
- a company under the control of the shareholder or their associate, or a partner in partnership with the shareholder.

If the shareholder in the private company is a trust, a beneficiary of the trust is also an associate of the private company, regardless of the beneficiary's level of control over the trust.

Federal budget changes

Note that the May budget stated that the government will clarify the operation of Division 7A to ensure more clarity about when unpaid present entitlements (UPEs) come within its scope. A UPE arises where a related private company becomes entitled to a share of trust income as a beneficiary, but that amount is yet to be actually paid.

Division 7A requires benefits provided by private companies to related taxpayers to be taxed as dividends

Are you Div 7A compliant? *continued*

unless they are structured as "Division 7A loans" or another exception applies. The measure will ensure the UPE is either repayed before "lodgment date" of the relevant return (see below), required to be repaid to the private company over time as a complying loan, or taxed as a dividend.

Also announced in the May budget was that the start date of other Division 7A measures is to be deferred. These amendments (see below) will be deferred from 1 July 2018 to 1 July 2019, and include:

- a self-correction mechanism providing taxpayers whose arrangements have inadvertently triggered Division 7A with the opportunity to voluntarily correct their arrangements
- new safe harbour rules, such as for use of assets, to provide certainty and simplify compliance for taxpayers, and
- amended rules, with appropriate transitional arrangements, regarding complying Division 7A loans, including having a single compliant loan duration of 10 years and better aligning the calculation of the minimum interest rate with commercial transactions.

Common Division 7A pitfalls

Typical situations encountered when dealing with Division 7A in practical terms can include the following.

Loans to associated trusts: Loans from a private company to a trust that is an associate of the company are subject to Division 7A regardless of how the loan proceeds are applied.

It is common for trusts to borrow funds for the purchase of income producing assets. In this scenario, the loan is still subject to Division 7A, notwithstanding the interest would be "otherwise deductible" to the trust. Note however that a genuine movement of cash to a business for legitimate purposes does not necessarily mean Division 7A applies.

Managing loans to avoid Division 7A: There are a number of strategies that can be adopted to ensure loans do not unintentionally result in deemed dividends, and therefore Division 7A:

- repay the loan to the company in cash before the company's lodgment day
- declaring dividends from the company to the shareholder
- transferring property to the company valued at or greater than the loan balance
- entering into a legitimate Division 7A complying loan agreement, or
- set off mutual obligations between the company and the shareholder or associate.

Minimum loan repayments must be made by 30 June each year where a Division 7A complying loan agreement is in place. Where minimum loan repayments are not made in relation to a loan, a deemed dividend is taken to be paid in the income year where the shortfall occurs. Note however that the amount of the deemed dividend cannot exceed the shortfall with respect to the unpaid minimum loan repayment.

Analyse drawings and loan accounts carefully: It is not uncommon for loan accounts to contain a range of different entries based on cash transactions, credit card purchases, journals or dividends. Each transaction posted through a loan account should be carefully analysed to determine what the underlying transaction relates to.

Significance of "before" lodgment day: Once a loan has been made to which Division 7A applies, a deemed dividend can be avoided if the loan is repaid before the lodgment day of the company's tax return for the year in which the loan was made.

For example, for loans made in the year ending 30 June 2018, the deadline for repayment of the loan or putting in place a complying loan agreement is the day before the company's tax return is due – which is 14 May 2019, if the due date is 15 May 2019.

Beware of back-to-back loans: A "back-to-back loan" arrangement will arise in situations where the shareholder or associate has an existing loan from a private company that is repaid from funds obtained from a new loan. Under Division 7A, any repayments made against a loan in such an arrangement will be disregarded.

4 traps with the "distributable surplus"

A company's distributable surplus is a central element of Division 7A because the extent of any assessable deemed dividend is limited to the distributable surplus, which is determined at the end of the relevant income year. A deemed dividend will therefore be reduced to nil if the company does not have a distributable surplus at the end of that year.

A company's distributable surplus is calculated using the formula: Net assets + Division 7A amounts – non-commercial loans – paid-up share value – repayments of non-commercial loans = distributable surplus.

When calculating the distributable surplus, it will pay to be mindful of the following:

Are you Div 7A compliant? *continued*

1/ Assuming that a deficiency of net assets means a distributable surplus of nil

The "net assets" component of the distributable surplus formula is calculated based on the company's financial position at the end of the financial year (30 June).

A common shortcut is to review the balance sheet and identify that the company has a substantial deficiency of net assets and therefore no distributable surplus, or a "negative" distributable surplus. The net assets component of the formula can only ever be nil or a positive number. Also a deficiency of net assets doesn't necessarily preclude the company from having a distributable surplus.

2/ Ignoring Division 7A amounts

"Division 7A amounts" is an addition to the formula for distributable surplus and has caught many by surprise. This was introduced in 2010 to overcome a loophole in Division 7A which allowed a private company to forgive debts before the end of a financial year in order to avoid the operation of Division 7A.

A common trap is for a loan to occur during the year, and then for the company to determine that it has no distributable surplus. As a result of there being no distributable surplus, the loan is forgiven and written off the books. However, the process of writing off the loan can in itself trigger a deemed dividend because the amount of the loan written off will be included in the distributable surplus formula as "Division 7A amounts".

3/ Quarantined non-commercial loans

The "non-commercial loans" component of the distributable surplus formula relates to amounts that are shown as loans in the company's accounting records that have already given rise to amounts of deemed dividends in the past.

It is common for companies that have advanced loans to shareholders or their associates in a year in which there was no distributable surplus to "quarantine" these loans. A potential trap is to mistakenly classify such quarantined loans as "non-commercial loans" in a subsequent year.

While the quarantined loan has technically given rise to a deemed dividend for Division 7A purposes in the past, it is the amount of the assessable deemed dividend that is relevant and not the original face value of the loan.

4/ Don't forget to recognise all of the company's liabilities

Where provisions for annual leave and long service leave are not recognised in the company's accounting records, these should be taken into consideration by subtracting them from the company's net assets for the purposes of the distributable surplus calculation.

Further, the ATO accepts that unpaid PAYG instalments and income tax liabilities amount to a "present legal obligation" and should be subtracted from the "net assets" of the company. ■

TAX DEDUCTION FOR INSURANCE PREMIUMS?

As a general guideline, the ATO will allow a deduction for certain insurance premiums if it can be shown that the insurance cover relates to earning assessable income. In other words, life insurance, trauma insurance or critical care insurance are generally out. Income protection insurance is one example of the kind of cover that ***may*** provide an allowable tax deduction for premiums – such claims have been allowed by the ATO in certain circumstances, even though having the insurance policy does not of itself "earn" income for the taxpayer.

Income protection cover however is often offered with combined death or disability cover. This means there is also a form of "capital" that is covered – this being the value allowed for the death of a person, or that person's injury or disablement, which if paid out is done so in a lump-sum. For the premium's tax deductibility, it is strictly speaking only the income protection component that is allowable, which your insurance company should be able to break-down. The ATO has been known to disallow a claim on premiums if it cannot be shown the components for the "income" and "capital" sides of the cover.

For a business, cover for "key person" or "key employee" insurance can seem a straight forward case for deduction rights on the premium, but this may not always be the case. It can be a popular insurance cover, where the loss of a key employee, even if they are temporarily out of action, can be financially damaging to a business. Premiums for such cover will be deductible if the protection is for "revenue" – such as having the policy specify that cover is for loss of profit or business revenue due to the death or otherwise of the key person insured. But if the policy is seen to be taken out to protect from losses that are more of a "capital" nature (where for example, a lump sum is paid to the key person's estate) then the premiums may not be allowed as deductions. Where both types of cover are involved in the one policy, some apportionment of premiums may be needed to work out the amount deductible. ■