**Watson Erskine & Co Pty Ltd**
CHARTERED ACCOUNTANTS

## Client Information Newsletter - Tax & Super

September 2016

# $20,000 write off is only available for small business, unless...

There is an under-used gem hidden within the small business simplified depreciation rules that in some circumstances can widen the opportunity to access this valuable deduction.

### About this newsletter

Welcome to Watson Erskine & Co's client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. Should you require further information on any of the topics covered, please contact us via the details below.

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Everyone assumes that the $20,000 instant asset write-off is exclusive to eligible small businesses. But it is possible, under certain conditions, for individuals such as employees to be able to claim the write-off for depreciating assets used in producing non-business assessable income – such as employment or investment income. The questions and answers below tease out the situations where this may be applicable.

***Isn't it only small businesses that are eligible for the $20,000 write-off?***

Yes, that's right. The instant asset write-off, which is part of the simplified depreciation regime, is only available to a

$20,000 write off extended ... *cont*

> An employee is eligible for the write-off as long as they are also a small business entity.

taxpayer that is a "small business entity". A taxpayer is a small business entity if both of the following are satisfied:

- the taxpayer carries on a business in the current year, and
- the taxpayer's aggregated turnover was less than $2 million for the previous year, or is likely to be less than $2 million for the current year.

The legislation leaves no doubt that only a small business can utilise the write-off.

### *So how can an employee claim the deduction?*

An employee taxpayer is eligible for the write-off as long as they are also a small business entity.

In other words, the individual's status as a small business entity allows them to use the $20,000 write-off. The fact that the taxpayer is also an employee is not material.

### *Isn't the $20,000 write-off only for assets used in the small business?*

Actually, no. The law is more generous with regards to this.

The small business can deduct the cost of the asset for the income year in which it starts to use the asset, or has it installed ready to use, for a taxable purpose.

The law does not restrict the concept of a "taxable purpose" only to purposes related to the business that is carried on. In fact, the expression "taxable purpose" is defined in the capital allowances rules as a very broadly stated purpose – the purpose of producing assessable income.

Income from employment (salaries and wages, commissions, bonuses, allowances and so on) is generally assessable income. For that matter, most passive investment income (dividends, net rent, interest, net capital gains) is also assessable income.

Therefore, the cost of a depreciating asset can be immediately deducted in the year incurred if:

- the taxpayer is a small business entity
- the first element of the cost base (that is, the amount you paid for the asset) is less than $20,000, and
- the asset is held for the purpose of producing any type of assessable income – whether the income is business, employment or investment income.

Where the asset is held only partially for an income-producing purpose, a corresponding proportion of the asset's cost will be deductible.

Remember that the instant write-off is only available if the total cost of the asset is less than $20,000, and not just the taxable purpose portion of the cost.

## Case study

Rosaria "carries on a business" from home as a sole trader, and meets the conditions to qualify as a "small business entity" in relation to her business activities.

Rosaria is also employed part-time by a company as a member of its management team. Due to her family responsibilities and business activities, she works in the company's offices only two days a week. On the days when she is not in the office, she fulfils her duties from home.

During 2015-16, Rosaria purchased a new desktop computer for her home for $5,000. Her records show that she uses the computer 70% for employment duties and 30% for personal purposes. She continues to use her old laptop for her home business activities. The new computer is not used for the home business at all.

In her 2015-16 tax return, Rosaria will be able to claim a total of $3,500 for the new computer under the instant asset write-off (70% of $5,000). Despite the fact that she does not use the computer in relation to her small business, she is eligible for the deduction because:

- she is a small business entity (in relation to her home business), and
- she holds the computer partly for a taxable purpose (being the purpose of deriving assessable income from employment).

## Small business entity pooling

The above commentary only looks at how the $20,000 write-off can be applied to assets used for deriving non-business income – as long as the taxpayer is a small business entity by virtue of their business activities. The same analysis applies to the general small business pooling regime within the simplified depreciation system. That is, a small business entity taxpayer may pool assets held for a "taxable purpose". ■

# What types of legal expenses are allowable as tax deductions?

When a legal expense is incurred in relation to the operation of a business for the purpose of producing assessable income, it is generally allowable as a deduction. Exceptions are when the legal fee is capital, domestic or private in nature, if it is specifically excluded by another section of income tax legislation, or is incurred in earning exempt and non-assessable non-exempt income.

For individuals incurring legal fees, the expense incurred would not be deductible unless there is a clear nexus with the expense being incurred in deriving assessable income (for example, in relation to an investment property). In other cases, the expense may be private in nature so a deduction would not be available in any case.

In addition, the following types of legal expenses are not deductible under the general deductibility provisions because they are of a capital or of a private nature. Instead they are made deductible under a specific provision in tax law:

- the preparation of an income tax return, the disputing of a tax assessment and the obtaining of professional tax advice
- the preparation of lease documents
- certain borrowing expenses, and
- certain mortgage discharge expenses.

Ask us if any of the above is relevant to your tax affairs. Other common legal expenses are considered below.

## Business lease expenses

The cost of preparing, registering and stamping a lease is deductible if the taxpayer is using or will use the property for earning assessable income. The lease payments themselves will be deductible under the general deduction rules, and are therefore subject to special prepayment rules (ask us for more information on this).

## Valuation expenses

If valuation fees are paid to help decide whether to buy a business, these are generally capital costs and not an allowable deduction. However if the valuation is used to support an application to borrow money for use in the business, those expenses can be claimed as borrowing costs immediately if under $100 or over the life of the loan, or five years from the date of the loan, whichever is shorter.

## Fines and breaches of law

Deductions are specifically denied for fines or penalties (however described) that are imposed as a consequence of a breach of any Australian or foreign law. This rule does not apply to administratively imposed penalties such as general interest charge (which the ATO applies to unpaid tax liabilities) and penalties for underestimating GST instalments. However, while the fines and penalties may be specifically disallowed, the costs incurred in defending the action may be deductible.

## Evicting a tenant

A taxpayer may acquire premises (all or a portion of) that were leased to a tenant of the former owner. Any legal expenses incurred trying to evict the tenant will not be deductible. This expense becomes part of the cost of acquiring the property and a capital expense for income tax purposes. Arguably, the expense could form part of the “cost base” of the property, being expenditure of a capital nature incurred in establishing the taxpayer’s title to, or a right over, the asset. Talk to us if this is relevant to your situation.

### EXPENSES THAT USUALLY CAN BE CLAIMED

Circumstances where legal fees are usually deductible include:

- negotiating current employment contracts (including disputes) in respect of existing employment arrangements
- defending a wrongful dismissal action brought by former employees or directors
- defending a defamation action brought against a company board
- arbitration in settling disputes (depending on the facts)
- recovering misappropriated funds of the business
- opposing neighbourhood developments that are likely to adversely affect the taxpayer’s business (depending on the facts of the case)
- evicting a rent-defaulting tenant (see above)
- recovering wages of an employee as a result of a dishonored cheque
- defending a libel action provided the case was directly related to comments in pursuit of the company’s business
- pursuing claims for workers compensation, and
- defending the unauthorised use of trademarks (depending on the facts of the case).

*(continued...)*

Deductible legal expenses ... *cont*

### LEGAL EXPENSES THAT CANNOT BE CLAIMED

Circumstances where legal fees are generally not deductible include:

- the cost of negotiating employment contracts with a new employer
- defending driving charges (regardless of whether the transgression occurred while driving on company business)
- eviction of a tenant whose term had expired
- defending charges of sexual harassment or racial vilification that occurred in the workplace
- resisting land resumption, rezoning or disputing the amount of compensation, and
- disputing a redundancy payout or seeking to increase the amount of any redundancy payout.

As can be seen, the task of determining whether a legal expense is tax deductible can be tricky – see this office if you require assistance.

# Borrowed money to pay a business tax debt? Is the interest deductible?

It's a question that the ATO has been asked very infrequently, but after the third such request it decided to issue a ruling — which still stands.

It was about 1990 when the ATO was asked about the tax deductibility of interest on a loan a business may have taken out to repay a tax debt.

It was the third time, according to ATO records, that the matter was raised. Of the two previous requests for clarification, one was made as far back as 1951 and the other even further back in time, in 1921.

The 1990 query resulted in the ATO issuing a taxation ruling to put the matter to bed, which has stood ever since. There are however curly caveats and conditions attached.

By way of background, the ATO admitted in its ruling that there were, and are, a number of "practical difficulties" associated with denying such a specific deduction for taxpayers carrying on a business. The difficulty goes right to the heart of the *Income Tax Assessment Act 1997* (ITAA97), although at the time of the ruling's issue some of the relevant sections were still in the *Income Tax Assessment Act 1936*.

Specifically, subsection 8-1(1) ITAA97 says: "You can deduct from your assessable income any loss or outgoing to the extent that it is incurred in gaining or producing your assessable income or it is necessarily incurred in carrying on a business for the purpose of gaining or producing your assessable income, except to the extent to which it is a loss or outgoing of capital, or of a capital, private or domestic nature, or incurred in relation to the gaining or production of exempt income."

The "difficulties" the ATO refers to come about due to the fact that paying a tax debt is neither of a capital nature nor done to gain "exempt" income.

The above tax ruling says: "Where a taxpayer carries on a business for the purpose of gaining or producing assessable income and, in connection with the carrying on of that business, borrows money to pay income tax (whether to preserve the assets of the business, maximise the return on them, retain sufficient money to fund the business or otherwise) then it is considered that the interest incurred on those borrowings is a normal incident of conducting that business."

"That is, such an expense is an expense incurred in carrying on that business and hence qualifies for deduction under the second positive limb of subsection 8-1(1) of the act."

Care needs to be taken however, as the ruling would not apply to interest on borrowings that are not connected with the carrying on of a business for the purpose of producing assessable income.

Note that the ruling does not consider situations where individuals borrow to pay off a tax debt.  In these cases, the ATO confirms that interest incurred by an individual on a loan to pay off a tax debt is not deductible.

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# Setting up an SMSF: What you need to know

Don't set up an SMSF to try and get early access to your super, or to buy a holiday house or sports car. The ATO's compliance (and penalty) regime has improved greatly since these sorts of stories were heard over the barbecue

There are tempting tax incentives for Australians to save for their retirement via the superannuation system, with an array of choice between superannuation funds that can manage your savings for you, but also the do-it-yourself option of a self-managed superannuation fund (SMSF).

Managing your own retirement savings however is a huge responsibility and one that should not be viewed lightly.

How you live and how comfortable your life will be when you're no longer earning an income will depend largely on your efforts of saving and the investment performance and management of your super fund.

While the hands-on aspect of setting yourself up with your own SMSF is a great way to take control of your retirement savings, this is not something that can be recommended for everyone.

There are strict rules and tangible risks to setting up an SMSF, but at the same time you can choose how to invest your fund's money as well as having greater flexibility over your investment choices.

With an SMSF, you are responsible — you are the trustee of your own fund, you need to comply with the superannuation laws and regulations, and you wear the consequences of all your investment and compliance decisions.

The ATO asks all prospective SMSF trustees to consider the following aspects before deciding whether they should manage their own super.

## CONSIDER YOUR OPTIONS AND SEEK PROFESSIONAL ADVICE

Two thirds of Australia's pre-retiree population park their superannuation savings and direct their compulsory superannuation guarantee contributions (and any extra contributions) into a large fund. These funds are pooled with the super of other members and professionally managed by the trustees of the fund.

If you set up an SMSF, you're very much in charge – you make the investment decisions for the fund, you are responsible for complying with the law, and one thing that larger APRA-regulated funds may have over SMSFs is a compensation scheme for fraud.

Deciding whether to take the SMSF route depends on your personal situation, and this is certainly one instance where professional advice and the pursuit of adequate due diligence is time and money well spent before deciding.

If you do decide to set up an SMSF, make sure it's for the right reason – saving for your retirement. Don't set up an SMSF to try and get early access to your super, or to buy a holiday house or sports car. The ATO's compliance (and penalty) regime has improved greatly since these sorts of stories were heard over the barbecue. These sorts of "investments" do not comply with superannuation law, and the ATO will come down hard on SMSFs toying with these activities.

## MAKE SURE YOU HAVE ENOUGH ASSETS, TIME AND SKILLS

You will need enough assets, time and skills to:

- make investment decisions and formulate an investment strategy that you review regularly, and
- meet all your legal obligations as a trustee.

As an SMSF trustee, your main responsibility is to ensure you have invested your superannuation fund's money appropriately.

You will need to ask yourself if you are a confident and knowledgeable investor,

Setting up an SMSF ... *cont*

**What skills will be needed?**

You will need enough assets, time and skills to make investment decisions and formulate an investment strategy (and review it regularly) and be able to meet all your legal obligations as a trustee.

and will the SMSF do as well as, or hopefully better than, other super funds after you've paid all costs? If you're not confident you can get a better result, there is always the option of a retail or industry super fund.

The cost of establishing and running an SMSF is contingent on the number of members in your fund (the law here rules that there can be no more than four members) and the complexity of the arrangements, the extent to which you make use of professional service firms, and how much of your own time you will have to spend running your fund. Remember, an annual independent audit is compulsory.

All SMSFs are also subject to an annual "supervisory levy" that is to be paid to the ATO, which is currently $259 for the 2016-17 financial year (or $518 for newly registered funds).

Time is another construct that is rarely talked about when considering SMSFs. It may take weeks or even months to set up an SMSF, depending on the institutions you are rolling over your incumbent super savings from.

Some of the steps involved in completing the setup of a new fund include applying for the fund's Australian Business Number (ABN) and tax file number (TFN), setting up a bank account for your fund, deciding on (and documenting) an investment strategy and keeping on top of all administration tasks.

The amount of time required to manage an SMSF differs from person to person. For instance, some trustees enjoy buying and selling shares, which requires frequent monitoring of the sharemarket.

Other trustees prefer to invest in assets that do not require such close attention, like investment properties. Remember, this office can always help you with the administrative tasks like record keeping and tax.

Don't forget – you will also be required to stay up-to-date with the relevant superannuation and tax laws, as well as other issues that will affect your fund, such as changes in interest rates and investment market conditions.

## UNDERSTAND THE RISKS AND LAWS

You will also need to think carefully about your investment options and how you plan to manage the associated risks.

These include the objectives of the fund and considerations of the following:

- investment risk
- the age of members, and
- the impact of loss in the fund.

Avoid risking all your retirement savings in one or a few investments. By spreading your investments – in other words, diversifying — you can help control the total risk of your investment portfolio.

But spreading risk means investing not just in different stocks but also across different asset classes. Depending on the investment strategy in place, options might include cash accounts, term deposits, managed funds, listed Australian and international shares, listed property and direct property. That way, if one or more investments perform poorly, others may help cover those losses. Of course, seek financial advice if you need to learn more about diversification.

Super funds, including SMSFs, receive significant tax concessions as an incentive for members to save for their retirement. However, you need to follow the tax and superannuation laws to receive these concessions. Failing to toe the line can also result in significant penalties. These can be severe, ranging from $900 (for not providing certain information to the ATO) to $10,800 (for not notifying the ATO of "significant adverse events").

## THE SOLE PURPOSE TEST AND OTHER OBLIGATIONS

One obligation that every SMSF must meet is to pass the "sole purpose test", which basically means the fund is legally required to be maintained for the sole purpose of providing benefits to members on retirement, or to their dependants upon the member's death. Compliance with this is fundamental; straying from it can lead to severe penalties.

*(continued...)*

Setting up an SMSF ... *cont*

If you decide to set up an SMSF, you're legally responsible for all the decisions made, even if you get professional advice

Another essential role of an SMSF trustee is to keep proper and accurate tax and superannuation records. It is always a good idea to keep accurate records, including taking minutes from meetings of all investment decisions, including why a particular investment was chosen and that all trustees agreed with the particular decision.

Additionally, you have a legal obligation to have your SMSF independently audited every year. The annual audit will require certain records to be made available, and you may also need to provide other records to the ATO to keep your fund compliant.

If you set up or join an SMSF, you will also need to consider having adequate insurance in case you pass away or are unable to work because of an illness or accident. As an SMSF trustee, you are required to consider insurance cover for fund members as part of the fund's investment strategy. However, it is not a requirement that such a policy be taken out. Life insurance can also be expensive compared to the large funds, which can buy group policies that enable them to offer insurance cover to members at a relatively low cost.

## TO 'SMSF' OR NOT TO 'SMSF'?

If you decide to set up an SMSF, you're legally responsible for all the decisions made, even if you get professional advice. Typically, an SMSF is suited for those who want greater control, but are also able to actively manage their investments while keeping up with the mandatory regulatory and compliance obligations.

Appropriate advice is highly advisable before taking the plunge. Being at the helm of an SMSF can be a very rewarding experience, and it offers innumerable benefits – from tax savings and greater estate planning certainty to more investment control and greater investment choices. Just be sure it is the option that is right for you. ■

# When is refinancing loan interest deductible to a partnership?

## About general law and tax law partnerships

A general law partnership is formed when two or more people (and up to, but no more than, 20 people) go into business together. Partnerships are generally set up so that all partners are equally responsible for the management of the business, but each also has liability for the debts that business may incur.

Tax law also provides for the notion of a "tax law partnership" – which occurs when individuals are in receipt of income jointly – such as an investment property.

See the next page for some facts about partnerships as a business structure.

## Typical financing scenario for general law partnerships

A typical scenario when launching a business based on a general law partnership structure sees each partner advance some capital to start up the enterprise. As the income years come and go, each partner takes a share of the profit and counts this as part of their personal assessable income for tax purposes.

However as the business becomes established, or better yet proves to be viable and becomes a successful operation, there is likely to come a time when its working capital — which had been financed from each partners' pocket — can be refinanced through the partnership business borrowing funds. So would the interest costs be deductible to the partnership?

*(continued...)*

Partnership claiming refinancing loan interest ... *cont*

## The refinancing principle

For such partnerships, there is a “refinancing principle” under tax law that provides some general principles governing the deductibility of loan interest in such circumstances.

As a general rule, interest expenses from a borrowing to fund repayment of money originally advanced by a partner, and used as partnership capital, will be tax deductible. This is covered in a tax ruling (you can ask this office for a copy).

The ruling states that to qualify for a tax deduction, the interest expense “must have sufficient connection” to the assessable income producing activities of the business, and must not be “of a capital, private or domestic nature”.

However interest on borrowings will not continue to be deductible if the borrowed funds cease to be employed in the borrower’s business or income producing activity. Nor will deductibility be maintained should borrowed funds be used to “preserve assessable income producing assets”. There is also a limitation on deductibility of loan interest in that borrowings to repay partnership capital can never exceed the amount contributed by the partners.

The ability to make these interest expense deductions under the “refinancing principle” is generally limited to general law partnerships — and not tax law partnerships. This principle would also not apply to companies or individuals. (There are prescribed conditions where, for example, a company may make such a claim, but under very specific circumstances.)

# Why partnerships? Facts and foibles

## Set-up costs

Partnerships can be less expensive to set up as a business structure than starting business as a sole trader, as there will likely be greater financial resources than if you operated on your own. On the flip side however, you and your partners are responsible for any debts the partnership owes, even if you personally did not directly cause the debt.

## Joint and several liability

Each partner’s private assets may still be fair game to settle serious partnership debt. This is known as “joint and several liability” – the partners are jointly liable for each other’s debts entered into in the name of the business, but if any partners default on their share, then each individual partner may be severally held liable for the whole debt as well.

## Other tax factors

Other general factors to note about partnerships include:

- the business itself doesn’t pay income tax. Instead, you and your partners will each need to pay tax on your own share of the partnership income (after deductions and allowable costs)
- the business still needs to lodge a tax return to show total income earned and deductions claimed by the business. This will show each partner’s share of net partnership income, on which each is personally liable for tax
- if the business makes a loss for the year, the partners can offset their share of the partnership loss against their other income (but beware the $250,000 threshold for non-commercial losses)
- a partnership does not account for capital gains and losses; if the partnership sells a CGT asset, then each partner calculates their own capital gain or loss on their share of that asset
- the partnership business is not liable to pay PAYG instalments, but each partner may be, depending on the levels of their personal income
- as a partner you will need to take care of your super arrangements, as you are not an employee of the business
- money drawn from the business by the partners are not “wages” for tax purposes.

Lastly, as with any business, the partnership will need an ABN and will need to register for GST if the business’s annual turnover is more than $75,000 (before GST).

See this office if you need any assistance with the above. ■