client alert | explanatory memorandum

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CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 18 October 2019.

Getting the benefit of your business tax losses

Made a tax loss? If you're a sole trader or individual partner, you may be able to apply the loss against other income like salary or investment income, or carry the loss forward to a future year.

When you're starting a new business venture, it may take some time before the business becomes profitable. And there may be other situations where an established business operates at a loss in a particular year. So, what does this mean tax-wise? When your deductions in an income year are greater than your assessable income, you have a "tax loss". You generally can't receive a refund for a tax loss, but you can use it in other ways.

Using losses against other income

If you're a sole trader or individual partner, you may be able to use your business tax loss to offset other assessable income you earn personally. This includes salary and wages from employment and income from personal investments.

But watch out: if the loss is "non-commercial", you can't use it immediately to offset your other income. Instead, you must defer it (explained below). To pass the non-commercial loss rules, you generally must meet two requirements. First, your adjusted taxable income must be less than $250,000. For these purposes, you ignore your business losses, but must add any reportable fringe benefits, salary sacrifice or personal super contributions, and total net investment losses.

Second, you must pass one of the following four tests, which are designed to measure whether your business activities are sufficiently "commercial":

- your assessable income from your business activity is at least $20,000;
- your business has made a tax profit in three out of the past five years (including the current year);
- you use real estate valued at $500,000 or more in your business on a continuing basis; or
- the value of "other assets" (excluding vehicles and real estate) you use in your business on a continuing basis is at least $100,000.

If you don't pass any of these tests (or fail the $250,000 income requirement), you must defer the loss for use in future. You'll be able to apply the deferred loss against future business income when the business starts making a profit, or alternatively against other income sources when you start satisfying the non-commercial loss rules. Your losses can be deferred indefinitely until this happens.

The Commissioner of Taxation can use his discretion to allow you to apply the loss in the current year, but only in "special circumstances" or where the nature of your business is such that there will be a lead time before the business activities become profitable or sufficiently commercial.

There are also special rules for primary production and professional arts businesses. If your income from other sources (excluding any net capital gain) is less than $40,000, you can use your business tax loss against that income and you don't need to worry about the non-commercial loss rules.

Offsetting future income

What if you satisfy the non-commercial loss rules but don't have income against which you can offset your tax loss?

Sole traders and individual partners can carry forward tax losses to a later year to apply against future income. While losses can be carried forward indefinitely, you must use them to offset income at the first opportunity.

Source: https://ato.gov.au/business/income-and-deductions-for-business/losses/.

Downsizer super contributions: getting it right

"Downsizer" contributions let you contribute some of the proceeds from the sale of your home into superannuation – but there are several important eligibility requirements.

Are you thinking about selling the family home in order to raise funds for retirement? Under the "downsizer" contribution scheme, individuals aged 65 years and over who sell their home may contribute sale proceeds of up to $300,000 per member as a "downsizer" superannuation contribution (which means up to $600,000 for a couple).

These contributions don't count towards your non-concessional contributions cap and can be made even if your total superannuation balance exceeds $1.6 million. You're also exempt from the "work test" that usually applies to voluntary contributions by members aged 65 and over.

The government reports that as at June 2019 over 4,000 people around Australia had taken advantage of the scheme in its first year, representing total superannuation contributions of over $1 billion.

The downsizer scheme is a good opportunity for many Australians to boost their retirement savings, but you must ensure you're eligible before making a contribution. If you don't qualify, your contribution could count as a non-concessional contribution and cause you to breach your contributions cap. Here are some areas where the ATO is seeing mistakes with the eligibility rules:

The 10-year ownership requirement

In order to qualify, you, your spouse or a former spouse must have owned the property for the 10 years prior to the sale.

The ATO explains that it's not necessary for the same person to hold the property during those 10 years, as long as it was held by some combination of the person, their spouse and/or former spouse throughout the 10 years.

However, there's an additional requirement: the property must be owned by you or a current spouse (not a former spouse) just before you sell. This means, for example, that where a couple divorces and the property is transferred to one spouse under the property settlement, when that spouse eventually sells the property they can potentially make a downsizer contribution, but their ex-spouse cannot.

Another thing to watch is the 10-year ownership period. The ATO says that the ownership period is generally calculated from the date of settlement of purchase to the date of settlement of sale. If you signed a contract to purchase "off the plan" and the settlement occurred much later, be aware that the ownership period for downsizer purposes only starts upon settlement.

The main residence exemption requirement

Another key requirement is that the capital gain from the sale must be wholly or partially exempt from capital gains tax (CGT) under the "main residence exemption". If your home is a "pre-CGT asset" (ie acquired before 20 September 1985 and therefore not subject to CGT), it must be the case that the capital gain would hypothetically qualify for the main residence exemption, in whole or in part, if it had been acquired on or after 20 September 1985.

You won't qualify for any main residence exemption where you've never used the property as your main residence – perhaps because it's a rental property permanently leased to tenants, or your holiday home.

But thankfully, even a partial main residence exemption will allow you to make downsizer contributions. Common situations giving rise to a partial exemption include using your home to generate income (in addition to living there); where the land adjacent to your home's dwelling exceeds two hectares; or where you've only lived on the property for part of the ownership period.

The main residence requirement is not related to the 10-year ownership requirement, so it's not necessary that the property was your main residence during that 10-year period. It's only necessary that you have (or would have) at least a partial main residence exemption.

Source: https://ato.gov.au/Individuals/Super/Growing-your-super/Adding-to-your-super/Downsizing-contributions-into-superannuation/.

Health insurance and your tax: uncovered

If you don't hold private hospital cover – or are thinking about dropping it – make sure you understand the financial consequences. You could be hit with an extra tax surcharge of up to 1.5% or cost yourself extra premiums in future.

Levies, surcharges and loadings – the terminology around health insurance and tax can be bewildering! But if you don't hold private hospital cover, you need to understand how this may affect your tax.

Medicare levy surcharge

The Medicare levy surcharge (MLS) is a tax penalty you must pay if you earn above a certain amount and don't take out a sufficient level of private hospital cover for you and all of your dependants. It's designed to give you a financial incentive to insure privately. The MLS is applied by the ATO at tax time and included in your assessment.
If you're a very high income earner, holding private hospital cover to avoid the MLS makes tax sense.

If your income is lower but still above the relevant singles or families threshold (outlined below), you may want to shop around more carefully for a policy that suits your budget. Bear in mind that it's *hospital cover* that's required to avoid the MLS, not extras (so "extras only" policies are not sufficient). Of course, you also need to factor in the other non-tax benefits of holding private health insurance.

So how much extra tax does the MLS mean? It depends on your income. Your income for these purposes is not just your taxable income – it also includes things like reportable fringe benefits, extra salary sacrifice super contributions you make (or personal super contributions) and total net investment losses.

Income for MLS purposes		Rate of MLS
Singles	**Families**	
$90,000 or less	$180,000 or less	nil
$90,001 – $105,000	$180,001 – $210,000	1%
$105,001 – $140,000	$210,001 – $280,000	1.25%
$140,001 or more	$280,001 or more	1.5%

If you have two or more dependent children, the families thresholds above increase by $1,500 for the second and subsequent children.

Note that the MLS is separate to the "Medicare levy", a 2% levy on your taxable income that most Australians must pay – regardless of whether they have private health cover. So, if you have an MLS liability, you'll pay this in addition to the Medicare levy.

Lifetime health cover loading and the rebate

Lifetime health cover (LHC) loading encourages Australians to maintain private health cover from an early age. If you don't take out private hospital cover by the year you turn 31, you'll be penalised with LHC loading if and when you eventually take out cover in future. You'll pay an extra 2% of your premium for every year that you're aged over 30, and this is charged annually until you've had 10 years of continuous cover.

For example, if you first take out private cover at age 45, you'll pay annual loading of 30% (ie 2% x 15) for 10 years. (Note, the maximum possible loading rate is 70%.)

LHC loading isn't a tax, but it can affect your tax return. This is because any LHC loading portion of your premium doesn't attract the private health insurance rebate. The rebate is available to singles with income for MLS purposes of $140,000 or less and families with income of $280,000 or less. The percentage rebate available ranges from approximately 8% to 25% of your premiums, depending on your exact income level. You can receive your rebate as either reduced premiums from your insurer or a refundable tax offset from the ATO at tax time.

So, if you're over 30 and don't have private hospital cover, it's time to consider how much each year that you remain uninsured may end up costing you in future premiums.

Source: https://ato.gov.au/Individuals/Medicare-levy/Private-health-insurance-rebate/.

Small business CGT concessions: when do I qualify?

The small business CGT concessions are a great tool for business owners to transfer wealth into super. Here, we break down the two essential requirements you must first meet in order to access any of the concessions.

Have you considered the powerful tax and superannuation planning opportunities that the small business CGT concessions can offer your business? These concessions allow you to reduce – or in some cases, completely eliminate – the capital gain from the sale of a business asset, whether it's held directly by your business entity or in another related structure.

What's more, the concessions also allow you to make extra super contributions – sometimes up to $1,515,000 – in connection with the sale of business assets. This is an attractive opportunity for many small business owners heading for retirement, especially given the restrictive annual contributions caps that usually apply.

There are various concessions available, each with their own eligibility rules. However, there are two basic conditions you must meet before you can access any of the concessions.

Business size

The first requirement tests whether your business is "small" enough to qualify. There are two alternative tests: a turnover test and a net assets test.

The turnover test is met where you carry on a business and have annual "aggregated turnover" under $2 million.

This includes not just your business turnover, but also the business turnover of any entities that are "connected" or "affiliated" with you, which broadly means related entities that you control or influence. So, if you have another trust or company that carries on a separate business, its turnover will often be taken into account.

In terms of timing, you'll satisfy the test if your aggregated turnover *last income year* was under $2 million. Alternatively, it's also sufficient if your aggregated turnover this year is *likely to be* under $2 million, provided it was not $2 million or more in the previous two years.

What if you, the asset owner, don't carry on a business but passively hold the asset and it's used by another of your entities in its business? You can still qualify, provided that entity is sufficiently related to you and it passes the turnover test itself.

The alternative test is the net assets test. You meet this test if the combined net assets of you and certain assets of your "connected" and "affiliated" (ie related) entities is no more than $6 million in total. Being a "net" assets test, you can subtract the liabilities related to the assets. You can also ignore assets like your main residence (provided it's not used to produce income), personal use assets, superannuation entitlements and shares or units in your related entities.

Asset requirements

The second major requirement is that the capital gain must arise from the sale (or other CGT event) of an "active" asset. This means it must have been used or held in a business carried on by you or one of your "connected" or "affiliated" entities for the following time periods:

- if you owned the asset for 15 years or less – for at least half the ownership period; or
- if you owned it for more than 15 years – for at least 7.5 years.

What about property you hold in another structure and lease to your business? Property can be tricky because of a rule that specifically excludes assets where the asset owner's main use is to derive rent or other passive income. However, where the property is used by your "connected" or "affiliated" entity in its business, it will generally qualify as an active asset.

If you're planning to sell shares in a company (or interests in a trust), talk to your adviser about the special rules that apply to these types of assets.

Source: https://ato.gov.au/Business/Small-business-entity-concessions/Concessions/CGT-concessions/.

Unpaid super: important amnesty update for employers

Unpaid super is a big problem, and the compliance landscape is changing. If you're an employer, now is the time to take action and protect yourself against penalties.

The government is getting tough on unpaid compulsory super guarantee (SG) contributions, but fortunately for businesses it has recently announced a revised "grace period" to rectify past non-compliance. All businesses should review their super compliance to consider what action they may need to take.

How big is the unpaid super problem?

Estimates of the problem vary. Official ATO figures place the annual unpaid super "gap" at $3.26 billion (based on 2015–2016 data) before factoring in ATO intervention, or 5.7% of the super that should be paid by employers. However, some argue the problem is bigger, with Industry Super Australia placing the gap closer to $6 billion, affecting 2.85 million workers.

The extent of the problem can be obscured by "black economy" activity where workers are paid cash-in-hand, and also "sham contracting" where workers are misclassified as independent contractors to avoid paying entitlements like super contributions.

Compliance changes for businesses

The launch of Single Touch Payroll (STP) will dramatically improve the ATO's ability to monitor employers' compliance with compulsory super laws moving forward. This electronic reporting standard is now mandatory for all Australian businesses, and gives the ATO fast access to income and superannuation information for all employees.

What about past unpaid super you might already owe? You may have previously heard about an "amnesty" for coming forward and voluntarily disclosing historical underpayments of SG contributions without incurring

penalties. After many hiccups with implementing this policy in 2018 and 2019, the returned Coalition government has finally taken steps to relaunch the policy. Under proposed legislation currently before parliament, the amnesty will work as follows:

- The scheme applies to any unpaid super you still owe dating back to 1992 until the quarter starting on 1 January 2018.
- To qualify, you must not only disclose but also pay the outstanding contributions – including interest.
- You must make this disclosure to the ATO *before* it begins a compliance audit of your business (or informs you it intends to audit you).
- If you qualify, the ATO will waive certain penalties that would usually apply. You will also be able to deduct your catch-up payments, provided they are made before the amnesty ends.

If you don't come forward and you're later caught out, the ATO will be required to apply a minimum penalty of 100% on top of the amount of unpaid super you owe (although this can be as high as 200%). Additionally, catch-up payments made outside of (or after) the amnesty are not deductible.

The timing of your disclosure is important. The proposed new amnesty will cover both previous disclosures made since 24 May 2018 (under the old amnesty scheme that the government failed to officially implement) and, importantly, disclosures made up until *six months after the proposed legislation passes parliament*.

While there's a risk that the amnesty legislation may never pass parliament – which would mean the protections against ATO penalties for disclosing businesses wouldn't be guaranteed by law – businesses do face significant penalties if they're caught by the ATO, with or without an amnesty in place.

Even in the event that the amnesty does not become law, the ATO would still look favourably upon businesses who make voluntary disclosures. This may be a basis for negotiating a partial waiver of penalties.

Source: http://ministers.treasury.gov.au/ministers/jane-hume-2019/media-releases/extending-superannuation-guarantee-amnesty-reunite-members.

Selling shares: how does tax apply?

Did you know that when you sell your shares, the size of your capital gains tax bill is affected by how long you've held the shares, and how you offset your capital gains and losses? Knowing the tax rules can help you plan ahead.

Whether you own just a few listed shares or have an extensive portfolio, understanding how capital gains tax (CGT) applies when you sell your shares can help you plan your trades effectively. If you trade shares on a scale that amounts to a business of share trading, talk to your tax adviser about the different tax regime that applies.

Each time you sell a parcel of shares, you trigger a "CGT event" and you must work out whether you've made a capital gain on that parcel (where the proceeds you receive exceed the cost base) or capital loss (where the cost base exceeds the proceeds). You also trigger a CGT event if you give the shares away as a gift – perhaps to a family member. For tax purposes, you're deemed to have disposed of the shares at their full market value.

Here's how the CGT rules work: all of your capital gains for the income year are tallied and reduced by any capital losses.

This includes your gains and losses from all of your assets that year, not just shares. If you have an overall "net capital gain", this is included in your assessable income and taxed at your marginal tax rate. If you have a "net capital loss", you can't offset this against ordinary income like salary or rental income. Instead, a net capital loss can be carried forward to future years to apply against future capital gains.

The 12-month discount rule

As an individual, you can reduce your capital gain by 50% if you've held the shares for at least 12 months. This "discount" is also available to trusts (also 50%) and superannuation funds, including SMSFs (33.3%), but *not* companies. This is an important consideration when you're deciding what structure to hold investments in.

There's a further detail that may make a big difference if you have multiple gains and losses: the 50% discount is only applied *after* you subtract any capital losses for the year (and any capital losses carried forward from earlier years). Importantly, you can choose which gains to offset losses against. So, if you have any gains that don't attract the discount because you held the asset for less than 12 months, it's often best to subtract your losses against these non-discountable gains first in order to maximise the benefit of the 50% reduction to the discountable gains.

If you bought the shares before 21 September 1999, you have an alternative option of applying an indexation factor to increase the cost base (rather than applying the 50% discount). Your tax agent can help you determine which choice gives you a better tax outcome.

Working out the "cost base"

Where you bought the shares at market value, your cost base includes what you paid for the shares and also incidental costs like brokerage fees (for both the purchase and sale). Watch out for special situations like dividends you chose to reinvest as additional shares – the amount of reinvested dividends is included in those shares' cost base.

If you received the shares as a gift, you're deemed to have received them at market value on the date of the gift. What if you inherited them from a deceased estate? If the deceased acquired the shares before 20 September 1985, you must adopt the market value on the date of death. But if the deceased acquired the shares after that date, you inherit the deceased's own cost base for the shares as at the date of death.

Source: https://ato.gov.au/Individuals/Investing/In-detail/Investing-in-shares/Shares---helping-you-to-avoid-common-mistakes/.

ATO to scrutinise every return for tax time 2019

The ATO has announced that it will scrutinise every tax return lodged during Tax Time 2019 as part of its ongoing focus on "closing tax gaps".

Assistant Commissioner, Karen Foat, said taxpayers who have done the wrong thing may be subject to an audit, even if the over-claim of deductions is minor. Third party data indicating under reported income, and deductions that appear high compared to people with a similar job and income level, tend to raise concerns, Ms Foat said.

While the ATO contacts around two million people each year about their returns, in most cases, Ms Foat said an audit is not the ATO's first action. If the ATO does decide to conduct an audit, it will contact the taxpayer and/or their tax agent to make further enquiries of evidence to support the claims in question. The ATO may also request information from third parties (ie employers) to verify expenses, and depending on the behaviour of the taxpayer, it may apply penalties or seek to prosecute.

Once the ATO has been in contact with a taxpayer to review claims, "it is important to be honest and get the matter resolved quickly". The ATO notes that taxpayers are more likely to face penalties if they aren't honest. If a taxpayer thinks they may have made a mistake, or there is an error in their tax return, the best thing to do is "fess up" as soon as possible, Ms Foat said.

Case studies

The ATO has set out more detailed information by way of case studies, the outcomes of which range from refunds in the taxpayer's favour to prosecution for making false and misleading statements in tax returns. The case studies typically involve work-related deductions for travel, clothing and motor vehicles.

For example, a taxpayer had claimed $20,000 in self-education expenses related to his MBA. When the ATO contacted the taxpayer to ask for information about how his studies related to his work, the taxpayer provided receipts for expenses such as tuition and textbooks, and was able to explain how these costs related to his work as a business analyst. The ATO accepted these expenses and allowed the deductions.

However, the ATO denied other deductions claimed by the taxpayer for headphones and a sports backpack.

The taxpayer believed he was entitled to do so because he used them for study sometimes but the ATO explained that the items were private in nature and not deductible. As the taxpayer had taken reasonable to care and had made an honest mistake, the ATO did not apply a penalty but reduced his refund.

Most of the time the ATO will be looking for documentation or evidence to support your deductions or claims. It may even contact third parties such as your employer to verify certain deductions (ie clothing/uniform, possible reimbursed expenses, or whether the expense was related to earning your income). Therefore, good record keeping throughout the year is essential to defend against any audit.

You may be wondering why the ATO is targeting such small fry when multinational companies get away with paying minimal tax. According to the ATO, it understands that most taxpayers over-claim by a little, but small amounts of overclaiming by a large number of people adds up to $8.7bn less each year in revenue collected. So, by its thinking, it really is a case of a every little bit counts.

If you're subject to an audit, it's not always doom and gloom. In some cases, you may get a higher deduction if the ATO discovers that you haven't claimed something you're entitled to. For example, you may be entitled to a deduction for depreciation on a laptop or other technology used for work but had incorrectly calculated the claim or omitted it altogether.

In the event of an audit and you're found to have over-claimed, the ATO may apply penalties depending on your behaviour. If you're found to have over-claimed based on a genuine mistake, for example, if you've

claimed the costs which are private and domestic in nature that are sometimes used for work or study (eg sports backpack or headphones), the ATO may choose not to apply penalties.

However, in cases of fraudulently claimed deductions, the ATO will apply penalties in addition to requiring the repayment of any refunds issued. It notes in extreme cases, prosecution through the courts may be pursued. The ATO gives an example where a taxpayer was convicted of making false and misleading statements in their tax return which resulted in the repayment of the refunds totalling $45,000, a fine of $3,000, penalties totalling $20,000 as well as court costs. The claims related to travel, clothing, and work-related expenses which were paid by the employer, as well as charitable donations to an organisation that was not registered as a DGR.

Source: https://ato.gov.au/Media-centre/Media-releases/Stress-less-if-you-have-nothing-to-confess/.

Beware of insurance changes in superannuation

You may have heard a lot recently about super funds providing either opt-in or opt-out insurance and have wondered how will affect you and your retirement savings. Perhaps you've heard horror stories about super funds cancelling people's insurance. Don't fret, in most cases cancellation of insurance only happens in limited instances, and your fund will most likely notify you before any cancellation occurs. As for opt-in and opt-out insurance, the changes are coming, but not until 1 April 2020, so if you're affected you'll have plenty of time to prepare.

Insurance within superannuation has always been a mixed blessing, good for some who enjoy having cheaper insurance, while others see as an erosion of their super balances. It doesn't matter which camp you fall into, the recent changes to the way super funds provide insurance may impact you depending on your super balance, age, and when your last contribution was.

Since July this year, super funds have been required to cancel insurance on accounts that have not received any contributions for at least 16 months unless the member elects to continue the cover. In addition, inactive super accounts with balances of under $6,000 will either be automatically consolidated by the ATO with other accounts you may hold or transferred to the ATO. If your super is transferred to the ATO, any insurance will also be cancelled.

This applies to life insurance, total and permanent disability (TPD) insurance and income protection (IP) insurance that you may have with your super fund. Before cancelling your insurance, your super fund will most likely notify you, although if you're worried about your insurance being cancelled, you can contact your super fund to discuss your options.

Remember, once your insurance is cancelled, you can no longer make a claim and it doesn't matter how long you had held the policy previously. Whilst this change is designed to stop people from paying unnecessary insurance premiums, it can have unintended consequences for those on longer periods of leave such as parental leave and long-term sick leave. The best thing to do is to engage with your super fund regularly to ensure that an adequate level of insurance is maintained and you're not paying too much for insurance cover you don't need.

Another change coming to super funds in the not too distant future of 1 April 2020 is opt-in insurance for members under 25 years old and those with account balances of less than $6,000. From that date, members under 25 who start to hold a new choice or MySuper product will need to explicitly opt-in to insurance. Currently, the onus is on the member to opt-out of insurance if they do not want it. This change is designed to protect younger people on their first jobs from super balance erosion stemming from unnecessary insurance but may disadvantage those who assume that they will automatically have insurance based on previous rules.

For members with active super account balances less than $6,000, super funds will be required to notify them of the change in the opt-in insurance requirements by 1 December 2019. This will give members plenty of opportunity to opt-in to the relevant insurance policies by 1 April 2020 if they choose to do so.

However, if you work in a "dangerous occupation" such as a member of the police force, fire service or ambulance service, among other occupations, the change in the opt-in insurance requirement will not apply to you even if you're under 25 years or have balances below $6,000.

The insurance changes may be good for some and not so for others, it is difficult to strike the right balance between the two camps. The best thing you can do for yourself is have an awareness of your superannuation, including fees, insurance and other outgoings. After all, it is your hard-earned money and you want it to be working hard for your retirement.

Source: https://aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bId=r6331.

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