client alert | explanatory memorandum

March 2024

CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 23 February 2024.

Are you receiving personal services income?

Do you earn personal services income (PSI)? While most people may think that it only applies to builders or tradies, the truth is that may also apply to any instance where individuals work and earn income using their personal effort or skills. This includes professionals working in IT, finance or the medical sector. If you earn PSI during the income year, the deductions that can be claimed will be limited to the deductions that you could have claimed if you were an employee and the income earned was salary and wages. To avoid that outcome, individuals/personal services entities (PSEs) can self-assess whether they conduct a personal services business (PSB).

PSI generally only applies to individuals who receive more than 50% of their ordinary or statutory income from a contract as a reward for their personal effort or skills. An example that most people would be familiar with is a sole trader tradesperson using their skills to earn income, either directly or through an interposed entity (a PSE). However, PSI can apply to any industry, trade or profession where individuals use their personal effort or skills. This includes so-called “white collar” professionals in IT, finance and medicine, in addition to the construction industry and related trades.

If you earn PSI during the income year, the deductions that can be claimed will be limited to the deductions that you could have claimed if you were an employee (rather than an individual earning PSI) and the income earned was salary and wages. This means that, for example, you would be unable to deduct rent, mortgage, interest, rates or land tax in relation to a residence or part of a residence that you use to gain or produce your PSI. This rule applies to all PSI, regardless of whether it is earned as a sole trader or through a company, partnership or trust. This also largely applies to PSEs in relation to the “test individual”.

To avoid having the PSI rules apply, individuals and PSEs can self-assess whether or not they conduct a PSB against four tests. If any one of the four tests is met during an income year, the PSI rules will not apply to limit the deductions available to the individual or PSE:

- The *results test* can be satisfied if at least 75% of a test individual’s PSI in an income year is for producing a result as well as being responsible for the cost of rectifying all defects. The individual is also required to supply the plant, equipment and tools of trade needed to do the work.
- The *unrelated clients* test can be met if an individual or a PSE gains or produces income during the year from services for two or more entities that are not associates of each other (or associates of the individual or PSE). The services must be provided as a direct result of making offers/invitations (eg advertising) to the public at large or a section of the public.
- The *employment test* is met where the individual or PSE engages one or more entities to perform at least 20% (by market value) of the individual or PSE’s principal work. Note, however, that test individuals of the PSE do not count towards the employment test.
- The *business premises* test can be satisfied if the individual or PSE maintains and uses business premises at all times during the income year that meet certain conditions, such as being physically separate from premises used for private purposes.

However, if more than 80% of the PSI or PSE’s income is from one source (ie services to the same entity and/or its associates), then only the results test can be used to self-assess whether a PSB is being conducted. The ATO has also proposed to continue the existing method for estimating net amounts that will be included in an individual assessable income in relation to a PSE. It is important to note that income generated principally from supply or sale of goods, supply and use of income-producing assets, or by specific business structures are not captured under the PSI rules.

Source: www.ato.gov.au/businesses-and-organisations/income-deductions-and-concessions/personal-services-income
www.ato.gov.au/calculators-and-tools/income-personal-services-income-tool
www.ato.gov.au/law/view/view.htm?docid=%22TXR%2FTR20223%2FNAT%2FATO%2F00001%22

How much does negative gearing really cost?

With the chorus of voices advocating for changes to negative gearing growing stronger, how much is the measure really costing the nation? Part of this answer can be found in the Expenditures and Insights Statement released by the Federal Treasury each year. While the figures contained in the statement are estimates on a "revenue forgone" basis which cannot be used as estimates of the revenue impact on the Federal Budget if the tax expenditure were to be removed, it is still useful to see the proportion of taxpayers utilising negative gearing.

Since the government's announced changes to the Stage 3 tax cuts to give lower income earners more benefits, the chorus of voices advocating for changes to other aspects of the tax system, such as negative gearing, has grown steadily stronger. So how much does negative gearing actually cost the nation each year? The answer to this can be gleaned from the 2023–24 Tax Expenditures and Insights Statement (TEIS) which, somewhat confusingly, contains figures relating to the 2020–2021 financial year.

Put simply, a tax expenditure arises where the tax treatment of a class of taxpayer or an activity differs from the standard tax treatment or the tax benchmark. These expenditures include tax exemptions, some deductions, rebates and offsets, concessional or higher tax rates applying to a specific class of taxpayers, and deferrals of tax liability.

The figures contained in the TEIS are estimates provided on a "revenue forgone" basis which reflects the existing utilisation of a tax expenditure and does not incorporate any behaviour response which might result from a change in or removal of the existing tax treatment. Therefore, the figures cannot be used as estimates of the revenue impact on the Federal Budget if the tax expenditure were to be removed (ie due to a policy or legislative change).

Keeping that in mind, the TEIS contains detailed breakdown of various categories including rental property deductions. The ATO estimates that some 2.4 million rental property investors claimed deductions for expenses associated with maintaining and financing property interests, including interest, capital works and other deductions. Collectively for the 2020–2021 financial year, $48.1 billion worth of rental deductions were claimed, resulting in a total tax reduction of $17.1 billion.

However, not all deductions are considered equal! Only around half, or 1.1 million, of these rental property investors had a rental loss (ie negative gearing), which added up to total rental losses of $7.8 billion and provided a tax benefit of around $2.7 billion for the 2020–2021 income year. Drilling down into the specifics of the deductions, the other rental deductions category (eg property maintenance, council rates etc) accounted for more than 50% of the amount claimed, with the next largest deduction being interest expenses, coming in at 39%.

The fact that only half of rental property investors are currently engaging in the practice of negative gearing, while the other half are presumably paying tax on the income they derive from investment properties, could perhaps lead to the conclusion that getting rid of negative gearing may not have as large of an impact on the nation's Budget as proponents hope.

Further analysis of the $2.7 billion negative gearing tax benefit (or tax reduction) reveals that 80% went to individuals with above median income (ie those earning above $41,500) and 37% went to individuals in the top income decile (ie those earning over $128,000). While a single individual earning over $128,000 could be classified as a high-income earner, that same individual's income would not be considered high where they are the sole income earner of a family.

Although the TEIS does not provide data on the status of those claiming rental deductions, this can be somewhat inferred by the ages of those claiming the deduction. According to the ATO, more than half of the total negative gearing tax reduction went to individuals between the ages of 40 and 59 years old. Presumably a majority of individuals in this cohort have families, and a good proportion may be either the sole income earner or the primary income earner in their family. This means the bulk of the commentary regarding negative gearing benefiting the rich may be on shaky ground.

However, these contentions aside, with the tax reduction on rental deductions expected to blow out to $28.2 billion by the 2026–2027 income year (from $17.1 billion in the 2020–2021 income year) and it being the second largest tax expenditure (second only to concessional taxation of employer super contributions), it's likely the calls for changes to negative gearing will only grow stronger in time.

Source: https://treasury.gov.au/publication/p2024-489823
www.ato.gov.au/individuals-and-families/investments-and-assets/residential-rental-properties/rental-expenses-to-claim

Estate planning considerations

Estate planning is a complex area which requires careful consideration of tax implications. These can vary widely depending on individual circumstances and the state or territory in which a person lived. Many issues that affect the distribution of assets to beneficiaries will need to be considered before an individual dies, to ensure undesirable tax consequences are avoided for both the individual and their potential beneficiaries. These include the timing on the transfer of the assets, potential gifts, transfer duties and the use of testamentary trusts.

Typically in terms of capital gains tax (CGT), the transfer of assets upon the death of an individual does not immediately trigger a CGT event; rather, a CGT "rollover" applies. This means that the beneficiaries of the estate do not have to pay CGT at the time of inheritance. Instead, CGT implications are deferred until the beneficiary decides to dispose of the asset.

Generally, beneficiaries inherit the deceased's assets at their market value as of the date of death, which becomes the cost base for future CGT calculations when the asset is eventually sold. One important exemption to note is the main residence exemption, which can fully or partially shield the deceased's primary home from CGT, provided certain conditions are met.

While gifts can be made as a part of estate planning before an individual dies, remember that if the gift is an asset (eg property, cryptoassets, shares, etc), CGT will still apply. For example, if an individual decides to gift a property to a relative before the individual's death, the transaction would be treated the same, for tax purposes, as if the individual were selling the property. This means that CGT would apply, but the main residence exemption (if available) would also apply to reduce the amount of CGT payable.

Another consideration in terms of the timing of transfers (in particular, of property) is the transfer duty involved at the state or territory level. For example, in New South Wales, if property is received from a deceased estate in accordance with the terms of a will, the beneficiary will pay transfer duty at a concessional rate of $100. However, if the transfer occurs before an individual's death or not in accordance with a will, normal rates of transfer duty will apply. In that scenario, it would be better to wait to transfer the property. The rules for each state and territory differ, so it is important to check before making decisions.

For individuals looking to exert more control after their own death, a testamentary trust may be one way of providing a flexible and tax-efficient way to manage and distribute the assets of the estate to beneficiaries. Generally, the terms and conditions of the testamentary trust are outlined in the will of the deceased, including the appointment of trustees and beneficiaries and how the trust assets are to be managed and distributed. The trust itself comes into existence upon the death of the person making the will, and it is separate from the deceased estate for legal and tax purposes.

A testamentary trust offers tax benefits such as income distributed to minor beneficiaries being taxed at adult individual income tax rates and having a higher tax-free threshold. This applies if they only receive excepted income or are an excepted person. A testamentary trust also has the added advantage of asset protection, in that assets held within the trust are out of reach from claims by creditors, legal actions, and in some cases, family law disputes.

However, it should be noted that establishing and managing testamentary trusts can involve significant costs, and there is a requirement to carefully draft the trust deed so it includes clear instructions for the establishment and operation of the testamentary trust, in order to avoid possible future disputes. There may also be ongoing legal, accounting and administrative expenses, making testamentary trusts the most complex route to head down.

The specific tax implications of estate planning can vary widely depending on individual circumstances and the state or territory in which an individual lived. This is a complex area where seeking professional advice tailored to the situation is crucial, not only to save money on taxes, but also to ensure that significant issues are avoided in the future.

Source: www.ato.gov.au/individuals-and-families/deceased-estates
https://moneysmart.gov.au/living-in-retirement/wills-and-powers-of-attorney

FBT electric vehicle home charging rate

With the rise in businesses purchasing electric vehicles (EVs) for the use of their employees, the ATO has finalised its guidelines setting out the methodology for calculating the cost of electricity for FBT purposes when an eligible EV is charged at an employee's or an individual's home. The rate of 4.20 cents per kilometre now applies (from 1 April 2022 and for later FBT years). To use this rate, employers will need to keep a record of the distance travelled by the car, and a valid logbook must be maintained if the operating cost method is used.

Since the introduction of EV incentives by various state governments to encourage the uptake of EVs and other zero emissions vehicles, the market share of EVs has significantly increased, from around 0.78% in 2022 to 7.2% in 2023. According to the Federal Chamber of Automotive Industries, while EV sales only account for a small proportion of overall vehicle sales in Australia, the sales have increased 185% since 2022 (80,446 sales in 2023 versus 33,410 sales in 2022).

Due to the increasing number of EVs being used for business purposes, the ATO released a draft practical compliance guideline in 2023 setting out the methodology for calculating the cost of electricity when an eligible EV is charged at an employee's or an individual's home. This draft guideline has now been finalised and applies from 1 April 2022.

According to the guideline, in terms of FBT, the employer has the choice of either using the methodology outlined in the guideline or determining the cost of the electricity by determining the actual cost incurred. Once made, this choice applies to each vehicle for the entire year, although the choice can be changed from one FBT year to another.

It should be noted that the guideline only applies to zero emission electric vehicles and not to plug-in hybrid vehicles which have an internal combustion engine. It also does not apply to electric motorcycles or electric scooters. For FBT purposes, the guideline may only be relied on to calculate electricity costs of charging an EV at an employee's home if an employer:

- provides the EV to an employee or their associate for private use resulting in the provision of either a car fringe benefit, a residual fringe benefit or an expense payment benefit;
- provides the EV to an employee or their associate who charges the EV using electricity at a residential premises, where the electricity cost directly attributable to charging the EV cannot be practically segregated from the cost of running other electrical appliances in the home; and
- is required to calculate the taxable value as a part of FBT obligations (ie car fringe benefit, residual fringe benefit, car expense payment benefit or reportable fringe benefits amount).

The rate that the ATO will accept for calculating electricity costs of charging an electric vehicle at a residential premises for FBT purposes for the FBT year commencing 1 April 2022 and later FBT years is 4.20 cents per kilometre travelled in the EV. A transitional approach applies for the 2022–2023 and 2023–2024 FBT years, whereby if odometer records have not been maintained, a reasonable estimate may be used based on service records, logbooks or other available information. After the transitional period ends, employers will need to keep a record of the distance travelled by each car and a valid logbook must be maintained if the operating cost method is used.

Employers are reminded that even if an EV is eligible for an FBT exemption, the benefit is still required to be included in an employee's reportable fringe benefits amount. Therefore, the taxable value must be determined, and where the employee home-charged the EV throughout the year and paid their electricity bills and provided the employer with the necessary declaration for electricity costs, the home charging electricity cost will form a part of the recipient contribution amount.

Source: www.ato.gov.au/law/view/document?docid=COG/PCG20242/NAT/ATO/00001

Superannuation: pension transfer balance cap 2024–2025

The transfer balance cap which limits the amount of capital that can be transferred into a tax-exempt retirement phase will not increase for the 2024–2025 income year, based on the release of December 2023 consumer price index (CPI) numbers from the Australian Bureau of Statistics (ABS). This means the figure will remain at $1.9 million for the 2023–2024 and 2024–2025 income years. Where an individual exceeds their personal transfer balance cap, the excess is required to be commuted and excess transfer balance tax needs to be paid.

The transfer balance cap was originally introduced in 2017 as a way to limit the amount of capital that can be transferred into a tax-exempt retirement phase. This was implemented in response to criticism that the superannuation system was being used by the wealthy for estate planning purposes rather than for retirement, and that the soaring cost of tax concessions for fund members threatened the sustainability of the entire super system.

As originally introduced, the transfer balance cap was set at $1.6 million; however, indexation applied to the general transfer balance cap from 1 July 2021 in line with the CPI in $100,000 increments. As a result, the current transfer balance cap for the 2023–2024 income year is $1.9 million. Based on the release of CPI index numbers from the ABS, this figure of $1.9 million will also apply for the 2024-25 income year, as the CPI figure for December 2023 was not large enough to trigger a $100,000 increase.

It should be noted that the transfer balance cap is a lifetime limit on the amount an individual can transfer into one or more retirement phase accounts. Individuals will have a personal transfer balance cap equal to the general transfer balance cap when a retirement phase income stream is commenced for the first time. For example, if an individual commences a retirement stream in the 2024–2025 income year, their personal transfer balance cap will be $1.9 million.

According to the Association of Super Funds Australia (ASFA), the lump sum needed at retirement to support a comfortable lifestyle is $690,000 for a couple or $595,000 for a single person (assuming a partial Age Pension). Therefore, a personal transfer balance of $1.9 million, where an individual can transfer that amount into a retirement phase and have the earnings on the assets be tax-free, would support a more-than-comfortable lifestyle.

For individuals who started their retirement phase income stream in an earlier year with a lower general transfer balance cap, if the full amount of the personal transfer balance cap was never used, proportional indexing may apply. This means the individual's personal transfer balance cap will be indexed based on the highest ever balance in the transfer balance account.

Example

Grace started a retirement phase income stream with a value of $595,000 on 1 January 2022, when the general transfer balance cap was $1.7 million. Assuming no other movements in her transfer balance account, the unused cap percentage is $595,000/$1.7 million = 0.35 or 35%, meaning Grace is using 35% of the cap.

Her unused cap percentage is therefore 100% – 35% = 65%.

Grace's personal transfer balance cap will then be indexed by 65% of the increment it has increased by. The cap for the 2023–2024 and 2024–2025 years is $1.9 million, so that increment is $200,000 ($1.9 million – $1.7 million); and $200,000 × 65% = $130,000

All of this means that Grace's personal transfer balance cap for either the 2023–2024 or the 2024–2025 income year will be $1.83 million ($1.7 million original transfer balance cap + $130,000 indexation).

It should be noted that if Grace commenced a retirement income stream to the value of $1.7 million on 1 January 2022, she would not now be entitled to any indexation as the value of her income stream equalled the general transfer balance cap at the time the stream commenced. This would be the case even if she commuted the pension, in part or in full.

Where an individual exceeds their personal transfer balance cap, the excess is required to be commuted and excess transfer balance tax needs to be paid. The ATO will generally send out an excess transfer balance determination to advise taxpayers who have exceeded their personal transfer balance. Among other things, the determination will set out the due date for commutation. Once the excess is removed, the ATO will send an excess transfer balance tax assessment indicating the amount of excess transfer balance tax owed.

Source: www.ato.gov.au/individuals-and-families/super-for-individuals-and-families/super/withdrawing-and-using-your-super/retirement-withdrawal-lump-sum-or-income-stream/transfer-balance-account
www.ato.gov.au/individuals-and-families/super-for-individuals-and-families/super/withdrawing-and-using-your-super/retirement-withdrawal-lump-sum-or-income-stream/calculating-your-personal-transfer-balance-cap

Australia's love affair with SMSFs continues

Establishing a self managed superannuation fund (SMSF) offers a variety of benefits, so it is perhaps no surprise that in the latest data released by the ATO, the number of SMSFs in Australia continues to grow as more people seek to take advantage of control and flexibility offered. However, taxpayers seeking to establish SMSFs should also be aware of the challenges and considerations that can significantly impact these funds' suitability for individual retirement planning, such as the complexity and responsibilities involved.

Establishing a self managed superannuation fund (SMSF) offers a variety of benefits, chief among them being the unparalleled control and flexibility this type of fund can afford its members over their retirement savings. This control extends to the ability to tailor investment strategies to personal financial goals, risk tolerance and preferences, with access to a broader array of investment options than those typically available in retail or industry super funds. Such options include not just traditional stocks and bonds but also direct property, precious metals and even cryptocurrencies, allowing for a highly diversified investment portfolio.

Beyond investment choices, SMSFs provide significant tax advantages. Members can employ strategic tax planning to minimise liabilities and enhance their retirement nest egg, benefiting from the ability to manage the timing of tax events and utilise imputation credits. In addition, SMSFs can offer enhanced estate planning flexibility, enabling members to specify how their assets are distributed upon their death, which can be particularly beneficial in complex family situations.

The pooling of resources in an SMSF, which can include up to six members, allows for increased buying power, making it easier to invest in assets like real estate that might otherwise be out of reach for a single individual. Additionally, the direct ownership of investment assets through an SMSF can provide a sense of security and personal involvement not found in other superannuation arrangements.

It is perhaps no surprise then that in the latest data released by the ATO, the number of SMSFs in Australia continues to grow as more people seek to take advantage of all the benefits offered. In the five years to 30 June 2023, the ATO estimates that there were on average 24,000 establishments and only 13,800 wind-ups of SMSFs, leading to an overall growth rate of 9%. As at 30 June 2023, there were 610,000 SMSFs holding roughly $876 billion in assets, which accounts for around 25% of all super assets.

However, taxpayers seeking to establish SMSFs should also be aware of the challenges and considerations that can significantly impact this type of fund's suitability for individual retirement planning. One of the primary concerns is the complexity and responsibilities involved in managing an SMSF, as trustees must navigate a maze of financial, legal and tax regulations to ensure compliance with the ATO. This complexity is compounded by the potentially high costs associated with setting up and running an SMSF, including auditing, tax advice, legal advice and investment fees, which can erode investment returns, especially in funds with smaller balances.

The autonomy in investment decision-making, while a key advantage, also introduces significant investment risks – trustees' lack of experience or knowledge can lead to poor investment choices. It should also be noted that not all investments are created equal. SMSFs need to meet the sole purpose test, which means the fund's investments are required to be for the sole purpose of providing retirement benefits to the fund's members. The sole purpose test may be contravened if a related party to the fund obtains a financial benefit (directly or indirectly) when making investment decisions. The SMSF will also fail the sole purpose test if it provides a pre-retirement benefit to an individual, for example, if one of the members engages in personal use of a fund asset.

In addition to these potential drawbacks, there is the time commitment required to research investments, monitor fund performance and stay updated on regulatory changes; liquidity challenges for funds investing in real estate or other illiquid assets; and in most cases, more expensive or complex insurance (ie life, total and permanent disability [TPD], income protection) access to consider when starting an SMSF. Taxpayers thinking about starting an SMSF should carefully weigh these potential drawbacks against the benefits, and consult relevant qualified advisers for further advice where required.

Source: www.ato.gov.au/individuals-and-families/super-for-individuals-and-families/self-managed-super-funds-smsf/smsf-newsroom/highlights-smsf-quarterly-statistical-report-december-2023
www.ato.gov.au/individuals-and-families/super-for-individuals-and-families/self-managed-super-funds-smsf/in-detail/smsf-resources
https://moneysmart.gov.au/how-super-works/self-managed-super-fund-smsf

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