

TAXWISE® BUSINESS NEWS

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SPOTLIGHT - SHAREHOLDER LOANS

A few years ago you borrowed some money from the family company. The following year, you also paid some personal expenses through the company. You were not unduly concerned at the time when all this showed up on the company's balance sheet as a loan to you as a shareholder. Sound familiar?

There is a nasty sting in the tail here. You may find yourself in receipt of a deemed dividend (unfranked and fully taxable) unless you

- fully repaid the loan by the lodgment day of your company's tax return for the year in which the loan arises; or
- repay the loan on commercial terms where the loan is for more than a tax year.

The above example is one of the situations where a deemed dividend may crop up under what are known as the Division 7A rules. These rules try to prevent private companies from making tax-free distributions disguised as loans, expense payments or forgiven debt.

One of the biggest problems with these rules is that many taxpayers are unaware they have fallen foul of them. However, there is potential relief at hand.

The Commissioner of Taxation now has a new discretion to provide relief if you are in receipt of a Division 7A deemed dividend as a result of an honest mistake or an inadvertent omission. He can exercise this discretion going back to (and including) the 2001-02 income year.

Commissioner exercises his discretion

The good news is the Commissioner has decided to exercise his new discretion. The ATO announced recently that it will disregard a deemed dividend under the Division 7A rules where:

- you take "corrective action" in cases of honest mistakes or inadvertent omissions by 30 June 2008;
- the relevant transaction or event that caused the Division 7A dividend to arise occurred from (and including) the 2001-02 income year, up to (and including) the 2006-07; and
- all the required income tax returns for the periods concerned have been lodged if necessary.

A NOTE OF CAUTION

The ATO may not share your view about what constitutes an "honest mistake or inadvertent omission". Exercise care in assessing whether you may be able to rely on this concession!

At the risk of oversimplifying the corrective action you may need to take, according to the ATO this will typically involve:

- you entering into a loan agreement with the company;
- you paying any principal and interest that may have accrued so far over the term of loan; and
- the company including these payments in its 2007 company return.

TIP

As there are a number of potential Division 7A problem situations that may come within this discretion, it's best to get advice now about whether you may have a problem in the first place and whether you may be entitled to take advantage of the ATO's offer.

It's also worth noting that a number of other welcome changes have been made to the Division 7A rules (e.g., your company's franking account will no longer be debited when a deemed dividend arises under Division 7A - this results in an overall reduction of potential penalties).

SELF MANAGED SUPER GUIDELINES

As you are aware, the ATO has full regulatory control over SMSFs, ensuring compliance not only with the relevant tax laws, but also with all other regulatory requirements.

As part of this regulatory control, there are a number of important management issues that go hand in hand with having a self managed superannuation fund (SMSF), including

- having a proper investment strategy;
- adhering to required investment and operational rules;
- auditing the fund as required;
- maintaining proper records; and
- preparing and lodging tax returns and other statutory documents.

Recently, the ATO has started to release draft rulings and determinations targeted specifically at SMSFs. These documents address a number of administrative and interpretative issues and two recent draft rulings are of particular interest:

- the sole purpose test
- giving financial assistance

The sole purpose test

Essentially, an SMSF must be run with the exclusive purpose of providing retirement or death benefits in relation its members – the sole purpose test.

In draft Self Managed Superannuation Fund Ruling 2007/D1 (SMSFR 2007/D1) the ATO has issued its preliminary views about the scope of this test.

This strict test is fundamental to the operation of an SMSF and one that causes confusion for many SMSF trustees. Practical complications arise because is it also possible for the fund's trustee to provide benefits outside those specified in the superannuation legislation without necessarily breaking the sole purpose test.

The ATO's overall position is that the provision of remote, insignificant or incidental benefits that fall outside the scope of those specified in the superannuation legislation are only likely to be acceptable if they are an inherent or unavoidable part of the legitimate activities of the SMSF.

The draft Ruling sets out a range of indicators used by the ATO to determine if your fund is compliant with the sole purpose test. To give you an idea of the types of things covered by these indicators, the Draft Ruling provides examples of the ATO's approach to incidental benefits arising in situations like:

- holiday apartments provided through a property syndicate involving incidental upgrade rights;
- shares in a golf club with assignable membership rights attached;
- the use, lease and loaning of artwork; and
- shareholder discount cards (which result in reduced dividend rights).

A WORD TO THE WISE

Working out what are acceptable benefits under the sole purpose test can be confusing and you need to tread very warily if your SMSF goes down the route of providing "remote, insignificant or incidental" benefits outside the strict scope of the superannuation legislation.

Giving financial assistance

The superannuation legislation prohibits the lending of fund money to a member of the fund or a relative of a member. This rule is also a source of confusion for many fund trustees because its scope is perhaps wider than you would expect.

In draft Self Managed Superannuation Fund Ruling 2007/D2 (SMSFR 2007/D2) the ATO has issued its preliminary views about how this rule operates. In particular, according to the ATO your SMSF may have problems under this rule if it:

- gives a gift using the resources of the SMSF to a member/relative;
- sells an SMSF asset to a member/relative for less than its market value;
- purchases an asset from a member/relative for greater than its market value;
- acquires services from a member/relative on non-arm's length terms (e.g., paying for unnecessary services or paying an amount

- for services in excess of an arm's length amount);
- provides security or a charge over SMSF assets or giving a guarantee for the benefit of a member/relative;
- forgives a debt of a member/relative, or releasing a member/relative from an obligation to the SMSF, including where the amount is not yet due and payable; or
- takes on a financial obligation of a member/relative.

A note on compliance....

It pays to keep in mind that non-compliance with regulatory requirements can have disastrous effects, including:

- the denial of tax deductions for contributions to the fund;
- taxing the funds' earnings at marginal rather than concessional rates; and
- taxing benefits paid from the fund at retirement at marginal rates.

KEEPING AHEAD OF THE TAX MAN

Since our last newsletter, the ATO has published its 2007-08 Compliance Program and micro and small businesses continue to attract significant ATO attention.

Set out below are some of the target areas currently on the ATO's agenda that you may need to think about now to make sure you are one step ahead of the tax man.

Extracting wealth from businesses

The ATO has realised a growing number of small business owners are planning to retire or sell their business in the near future. This is a new focus in the ATO's Compliance Program.

If you are in this situation, particularly in 2007-08, you should be aware that the ATO may want to look at your business to satisfy themselves that you are not trying to extract value from your business without paying the correct tax.

Some of the tax hotspots attracting the ATO's attention at present include:

- using loans, payments and debts forgiven by private companies to distribute company profits to shareholders (or their associates) in a non-taxable form; and

- using mechanisms such as share buy-backs, capital reductions and the sale of shares to exit from businesses – particularly in relation to disposing of nominally pre-capital gains tax assets (where a capital gain may still arise) and tax issues arising out of actions to enable the business to be sold, such as writing off or forgiving shareholder loans.

TIP

Keep in mind that there is nothing wrong with extracting value when you exit your business. However, you need to make sure that whatever you do does not fall foul of the law, so forward planning is essential.

Cash economy

This is always a big ticket item in the Tax Office's Compliance Program.

Typically, the compliance risk in the cash economy involves businesses or individuals under-reporting or not reporting cash income, transactions subject to GST or "cash surrogate" transactions (e.g., through barter activities).

A NEW FOCUS

In 2007-08, the ATO is taking particular interest in spending patterns that do not match reported income, paying more attention to **business-to-consumer transactions** in addition to transactions between business.

To keep a lid on the cash economy, the ATO is now systematically comparing your tax return information with data from third parties to identify taxpayers under-reporting or operating outside the norm in a particular industry.

Property disposals

If you have either purchased or sold a property during the year, the ATO may want to make sure that you have covered any potential capital gains tax and GST. This is an area where the ATO has really ramped up its compliance verification activities. At present the ATO is matching data from third parties, such as financial institutions and property registries, with your return information to identify taxpayers who have not disclosed or significantly under-reported a capital gain.

Property transactions and GST

The ATO is also on the look-out for taxpayers who:

- do not report real property sales;
- incorrectly report under the margin scheme;
- incorrectly report material GST adjustments arising from a change in the extent of creditable purpose; or
- avoid GST obligations by not lodging activity statements.

Fuel tax credits

We have previously let you know about changes to the fuel tax credits scheme. The ATO is now increasing its reviews of claims and compliance with the system, particularly in the transport industry.

Waiting for a refund?

Some of our clients understandably get anxious or upset when an anticipated tax refund is delayed. If you are in this situation, the delay does not necessarily mean that you have done something wrong. In many instances, the delay is out of our control because the ATO continues to monitor GST and income tax refunds that have been assessed by the Tax Office as high risk, unusual or simply have a high monetary value.

Paying your tax

Latest reports from the ATO show that the level of collectable debt in the micro and small business segments remains an ongoing concern.

In the 2007 Federal Budget the ATO received extra funding to reduce debts more than two years old and collect any superannuation guarantee charge debt owed by employers.

If you are having trouble keeping up with your tax payment obligations, it is best to talk to us sooner rather than later. This will enable us to negotiate with the ATO on your behalf to make sure you are treated fairly and your individual circumstances are taken into account.

ATO outsources debt collection!

The Tax Office is outsourcing some of its debt collection to four private debt collecting agencies:

- Dun & Bradstreet
- Baycorp Collection Services Pty Ltd
- National Credit Management Limited
- Recoveries Corporation Group Limited

These agencies will act on behalf of the ATO and have to follow strict privacy guidelines. They are limited only to making telephone calls and writing letters in relation to collecting debt. No other collection tactics are allowed!

ALERT

If you are contacted directly by one of these debt collection agencies, it may be in your best interests to let us know - we can assess the situation and ensure the best outcome for you.

INSTALMENT WARRANTS

Over a number of years instalment warrants have been marketed to superannuation funds, particularly to SMSFs. This practice is longstanding, in spite of the fact that regulatory authorities have not regarded instalment warrants as an allowable investment for a superannuation fund. The superannuation laws have now been changed to allow this longstanding practice to continue. However, fund investments in instalment warrants must still comply with other superannuation rules, for example

- instalment warrants must not result in fund assets being subject to a charge; and
- trustees are still required to demonstrate the appropriateness of including instalment warrants in their investment strategy.

MANAGED INVESTMENT SCHEMES

Earlier this year, the ATO had a change of heart in its approach to the income tax treatment of non-forestry agricultural investment schemes.

We can now confirm that the ATO has issued a final Income Tax Ruling (TR 2007/8), standing by its change of view. The Ruling applies to arrangements entered into from 1 July 2008, with the result that the ATO will not allow you to claim a tax deduction for your upfront investor contributions into this type of managed investment scheme. However, the ATO is expecting industry to mount a test case in the Federal Court in the near future on the matter, so things may change again.

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