July 2018

Love & Partners News

Welcome to the 2019 financial year.

Team Updates

May and June saw a couple of very big changes for *Love & Partners*. We have said farewell to 2 of our long serving, long suffering team members.

On Thursday 17th May we said farewell to Pam Hitchins, who has been an extremely valuable member of our staff for over 20 years. Pam decided the time had come to put up her feet and enjoy a well-earned retirement.

Then on 8th June, we said farewell to Ray Algar who has been a loved and valued member of our team for almost 20 years. He too has decided to put on his retirement shoes and is planning some travels with his family.

We wish them both all the very best in their retirement years.

Then for the start of the new financial year, we have welcomed another new staff member. Kristina Brown has joined our team as a fully qualified accountant. Kristina is a local, having lived most of her life in Landsborough and completed her accounting degree at the University of the Sunshine Coast. She has been working as an accountant since the completion of her degree in 2013, and has recently acquired her full Chartered Accountant membership. Kristina enjoys helping people utilise Xero effectively to help grow their business, and will be a valuable asset to our firm.

Planning Day

On Friday 20th July the *Love & Partners* office will be closed. All staff will be attending a full day conference, planning for the year ahead. We feel this will be an invaluable day for ensuring a successful year for our firm.

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The pension loans scheme

To help pensioners who are asset rich but income poor, the government launched a version of a commercially available financial product, the reverse mortgage. The government's answer is its pension loans scheme (PLS), whereby a pensioner can apply for a non-taxable loan using some form of real property as security. The PLS does not provide a lump sum, but a regular fortnightly payment.

At present the scheme is only open to those on a full pension, but the 2018 Federal Budget announced the government intends to open the PLS to all pension-age retirees (not just those who qualify for the Age Pension). Also from 1 July 2019 the maximum allowable income stream (combined Age Pension and PLS) will increase to be 50% higher than the full pension, including supplements.

A full age pensioner may be able to apply if:

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

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

The loan recipient can repay the PLS loan in part or in full at any time. If the loan recipient wants to sell a property they need to inform DHS, and they can either transfer the loan to another property including a new home or they can repay the loan on the date of settlement.

If there is an outstanding amount upon the loan recipient's death, the estate or in some cases the surviving partner's estate can make repayments.

The total loan available depends on the:

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

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

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

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

2 minute quiz: Partnerships

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

Question 1

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

A. An association of persons (other than a company or a limited partnership) carrying on a business in common with a view to profit

B. An association of persons (other than a company or a limited partnership) in receipt of income jointly

C. An association of persons (other than a company or a limited partnership) carrying on a business in common ***and*** in receipt of income jointly

D. An association of persons (other than a company or a limited partnership) carrying on a business in common, or in receipt of income jointly, or a limited partnership.

Question 2

A partnership's financial records show the following:

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

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

A. The capital gain, salaries, interest on the loan and interest on the capital

B. Only the interest on the loan

C. Only the salaries

D. All of the items.

Answer 1

The correct answer is D.

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

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

Answer 2

The correct answer is B.

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

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

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

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

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

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

Plan ahead: Tip to better prepare for Tax Time 2019

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

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

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

Tips for your tax return

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

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

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

Income that must be declared

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

- Employment income
- Super pensions, annuities and government payments
- Investment income (including interest, dividends, rent and capital gains)
- Business, partnership and trust income
- Foreign income
- Income from crowdfunding (for example donations received for a venture in which you intend to make a profit)
- Income from the sharing economy (for example Airtasker, Uber or Airbnb)
- Other income, including compensation and insurance payments, discounted shares under employee share schemes, some prizes and awards. Check with us if you are unsure.

Deductions

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

To claim a deduction for work-related expenses:

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

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

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

- Other deductions: Other items you can claim include union fees, the cost of managing your tax affairs, income protection insurance (but not if it's through your super fund), overtime meals, personal super contributions (that is, after tax) and other expenses incurred in the course of earning an income.

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

Off the deduction menu

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

- Travel between home and work, which is generally considered private travel.
- Car expenses, unless you are transporting bulky tools or equipment that you need to do your job, and that your employer requires you to transport (and there is no secure area to store the equipment at work).
- Car expenses that have been salary sacrificed.
- Meal expenses, unless you were required to work away from home overnight.
- Private travel, including any personal travel portion of work-related travel.
- Everyday clothes you bought to wear to work (for example, a suit or black pants), even if your employer requires you to wear them.
- Self-education expenses where there is no direct connection to your current employment.
- Phone or internet expenses that relate to private use.

Are you Division 7A compliant?

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

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

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

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

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

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

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

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

Federal budget changes

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

Division 7A requires benefits provided by private companies to related taxpayers to be taxed as dividends unless they are structured as "Division 7A loans" or another exception applies. The measure will ensure the UPE is either required to be repaid to the private company over time as a complying loan or be subject to tax as a dividend.

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

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

Common Division 7A pitfalls

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

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

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

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

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

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

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

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

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

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

4 traps with the "distributable surplus"

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

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

When calculating the distributable surplus, consider the following:

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

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

A common shortcut is to review the balance sheet and identify that the company has a substantial deficiency of net assets and therefore no distributable surplus, or a "negative" distributable surplus.

The net assets component of the formula can only ever be nil or a positive number. Also a deficiency of net assets doesn't necessarily preclude the company from having a distributable surplus.

2/ Ignoring Division 7A amounts

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

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

3/ Quarantined non-commercial loans

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

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

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

4/ Don’t forget to recognise all company liabilities

Where provisions for annual leave and long service leave are not recognised in the company’s accounting records, these should be taken into consideration by subtracting them from the company’s net assets for the purposes of the distributable surplus calculation. Further, the ATO accepts that unpaid PAYG instalments and income tax liabilities amount to a “present legal obligation’’ and should be subtracted from the “net assets” of the company.

Can you claim a tax deduction for insurance premiums?

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

The deciding factor, especially for the self-employed, seems to be the “ability” to earn assessable income. In such cases this can mean that taking out disability insurance against loss of income could generate a tax deduction for the premiums. For anyone running a small business, protecting the ability to earn an income can also result in insurance premiums that can possibly be deductible for cover for fire and theft, motor vehicles, public liability and loss of profit.

It is always advisable for taxpayers to get specific advice for their situation, but deductions have been allowed for the above mentioned insurance products, even though the cover may include some capital assets – that is, the value of the item covered (such as a vehicle that is essential to keep the business running) as well as the income-earning component of that asset.

For the earlier-mentioned income protection cover however, this is often offered with combined death or disability cover. This means there is also a form of “capital” that is covered – this being the value allowed for the death of a person, or that person’s injury or disablement, which if paid out is done so in a lump-sum.

For the premium’s tax deductibility, it is strictly speaking only the income protection component that is allowable, which your insurance company should be able to break-down. The ATO has been known to disallow a claim on premiums if it cannot be shown the components for the “income” and “capital” sides of the cover. And when making a claim under such insurance, it is important to remember to declare the payout in that year’s tax return.

For a business, cover for “key person” or “key employee” insurance can seem a straight forward case for deduction rights on the premium, but this may not always be the case. It can be a popular insurance cover, where the loss of a key employee, even if they are temporarily out of action, can be financially damaging to a business.

Premiums for such cover will be deductible if the protection is for "revenue" – such as having the policy specify that cover is for loss of profit or business revenue due to the death or otherwise of the key person insured.

But if the policy is seen to be taken out to protect from losses that are more of a "capital" nature (where for example, a lump sum is paid to the key person's estate) then the premiums may not be allowed as deductions. Where both types of cover are involved in the one policy, some apportionment of premiums may be needed to work out the amount deductible.

Again, it is highly advisable for taxpayers to get specialised advice, as the combination of insurance and tax can lead to complicated situations.

Managing tax disputes can be like wrestling with a superhero

It is sometimes said that a superhero like the DC Comics character Superman can be an uninteresting character because he is, for all practical purposes, indestructible. Critics have said the knowledge that he will most likely win can make Superman's adventures monotonous.

A similar accusation could be levelled at the Federal Commissioner of Taxation (the flesh and bone personification of the ATO). To most people, including a hefty majority of small and medium businesses, the Commissioner appears to be immune from defeat. He has extraordinary powers – he can require a taxpayer to produce almost any documents even if he doesn't know whether the taxpayer has done anything wrong; his assessments (or amended assessments) are generally valid even if he doesn't follow the requirements of the taxation legislation; and, perhaps most worryingly to taxpayers, he can often (but not always) enforce those assessments and recover tax debts even if that tax is subject to a dispute.

But despite all his powers, our real life superhero (or supervillain, depending on where you stand) can sometimes be successfully opposed, if not entirely defeated. But to do this you must move quickly, know the rules of engagement and have a clear vision of the outcome.

Starting the process: Speed is key

Except in the extremely rare scenario where an amended assessment is invalid, the only way to challenge a taxation decision is to commence so called "Part IVC proceedings" (which is the part of the tax act that permits a taxpayer dissatisfied with an ATO decision to have that decision reviewed).

To do this, it is necessary to lodge an objection in the approved form and within the relevant time period (generally either two or four years for an amended assessment). This may seem a trite observation, but it is crucial that these formal requirements are met. If they are not, you may be left with no recourse against the ATO, regardless of the facts of the matter.

Even though you may in theory have up to four years to challenge a decision, in practice the time to act may be much shorter. Unless you are willing and able to pay the disputed tax before the issue is resolved (and not many people are willing to do that) you may find that the ATO can begin to insist upon payment even while you are contemplating an objection.

It is important to remember one of the ATO's most specific "superpowers" — a notice of assessment, including an amended assessment, is conclusive of the correctness of the amount shown on it. In other words, the Commissioner could sue for the amount of disputed tax at any time after it becomes due (generally 21 days after the date of the amended assessment) and the fact that you intend to dispute the assessment would be no defence to the action.

In practice the Commissioner will usually give the taxpayer a reasonable amount of time to consider their position and (if appropriate) lodge an objection before commencing recovery action. But once recovery action has commenced, it gathers a momentum that can be difficult to stop. Unless an objection is lodged in a timely manner, you will soon find yourself dealing with debt recovery officers who have no interest in hearing about upcoming objections. So if you intend to object, or even if you just intend to get advice on whether to do so, act as quickly as you can and keep the ATO informed of your intentions.

Dealing with factual disputes

Balancing the need to act quickly is the necessity of properly considering what is really at issue. This is because the notice of objection and materials that support it must properly deal with the matter in dispute. There are essentially two kinds of disputes relating to taxation decisions — factual disputes, and disputes regarding a point of law.

The first kind is a factual dispute. This may arise where an auditor or other ATO officer simply does not accept your version of events. Often people can get indignant about the resulting amended assessment and will want it rectified as a matter of principle. But, before blindly charging into an objection, consider whether there is any further evidence that can be produced to support your position.

Are there any further documents that could prove your case? Are there any independent witnesses that could provide evidence on the matter? Could the existing materials be better explained or presented? If not, you may find that the decision maker to the objection comes to the same conclusion as the original decision maker (a different tax officer to the original one is generally appointed to preside over objections).

Disputes regarding points of law

The second kind of dispute is where the facts are agreed, but there is a dispute as to the application of the relevant law. These sorts of disputes can be less emotive, but are often harder to have successfully changed on objection. This is because the objection decision maker will be bound by the ATO's position on the application of the law, as stated in its public rulings. Objection decision makers may also be influenced by so-called "non-binding decisions" that the ATO may have issued, such as "interpretative decisions".

If you are involved in this kind of dispute and wish to have any chance of succeeding at the initial objection stage (as opposed to, say, a subsequent review by the Administrative Appeals Tribunal (AAT)) you will need to demonstrate that the outcome you are looking for does not deviate from the ATO's publicly stated views.

If you can't distinguish your position from the Commissioner's public rulings, then in practice it may be necessary to accept that the initial objection decision by the ATO will be unfavourable to your preferred outcome. In such a case you should only object if you are willing to follow up with an application to the AAT for a review of the objection decision or an appeal to the Federal Court.

Litigation and compromise

If you have been unsuccessful in your objection, all is not lost. An application to the AAT for review of the objection decision is open to you, whether the dispute is factual or regarding a question of law. Such an application may be particularly appropriate if there are large amounts of penalties involved, even where the principal amount of tax is not in dispute. The AAT can sometimes be more reasonable in deciding the appropriate level of penalty or in exercising the discretion to remit penalties.

If there is a question of law at stake, an appeal to the Federal Court is also possible, however it is outside the scope of this brief article to cover the litigation process itself. However a quick word of caution is warranted — litigation tends to highlight the Commissioner's "superpowers".

First, the burden of proof is shifted; it will be up to you to prove the ATO's assessment is excessive. In practice, this means that if facts are in dispute you will rarely be able to rely on bare assertions. Documentary evidence is strongly preferable.

Further, compared to almost every ordinary taxpayer, the Commissioner has practically infinite resources. He is also required to administer the tax law according to its terms. This means that the ATO cannot, and will not, simply compromise on an arbitrary figure for the sake of saving further legal costs.

But this does not mean the Commissioner cannot compromise at all. Like every government agency, the ATO is very aware that litigation costs money that can sometimes be put to better use elsewhere. If you can demonstrate that there is a real risk to the ATO that it will lose on a particular issue, it may be willing to compromise by amending assessments in relation to that particular issue if, for example, you agree to withdraw your application in relation to other issues. There may also be some scope to compromise by reducing penalties or remitting interest in appropriate circumstances.

Do the good guys ever win?

Many taxpayers, and many of us tax practitioners, agree that the Commissioner is, in fact, "overpowered". But successive governments have chosen to accept, and often further entrench, this situation. Debating its merits is no more useful than entering into an twitter argument over whether the Incredible Hulk could defeat Superman. The best we can do is to keep what small amount of kryptonite we can get and use it very strategically once in a while.

Unpacking statute-barred debts

Various tax implications can arise when a debt becomes statute-barred. So what is statute barring and when can it be a problem?

In simple terms, a debt is statute-barred when it has reached a statutory limitation period where it can no longer be legally recovered by creditors.

Specifically, each state and territory in Australia contains its own "statute of limitation" provisions that provide a procedural basis for a lawsuit for non-payment of a debt, including a time limit, which can be used as a defence against the claim from creditors.

For debts that arise from "simple contracts", the limitation period is six years, with the exception of the Northern Territory where it is three years.

Very broadly, a "simple contract" in respect of a debt typically includes unsecured personal loans, credit card debts or debts sold or referred to a collection agency. The limitation period will be different for secured debts and debts arising "out of deed".

As the laws vary from state to state, to ensure that the debt is deemed "statute-barred", it would be prudent to seek legal advice as these laws can be complex. Once this is determined, the application of the relevant tax laws will follow.

The table at *left/right/below* summarises the broad application of the statute of limitations in each Australian state and territory.

What should you consider?

Some general points to consider when dealing with statute barred debts include:

1. Identify the governing jurisdiction

Generally, the place of the debtor's residence at the time of entering into the contract is relevant in determining the governing jurisdiction (although this can be varied in the contract itself).

2. Determine the start time for the debt

For most debts, a creditor must begin court action to recover the debt within six years (or three years in the NT) of the date:

- on which the debt became due and payable
- the last time that a payment was made, or
- that there is acknowledgement in writing that the debt is owed.

The limitation period starts from the latest event as shown in the table. As a general principle, a loan arrangement that does not expressly include repayment terms is taken to be repayable on demand. Such a loan creates an immediate debt, with the clock ticking for statute of limitations purposes from that time.

3. Confirmation of debt and renewal of limitation period

The limitation period is renewed and recommences upon confirmation of the debt. However, the relevant state legislation should be considered for correct application of the renewal period. In the ACT, NSW, WA and the NT, renewal does not occur if the confirmation happens after the initial limitation period expires. In all other states, the limitation period is renewed on confirmation irrespective of whether the limitation period has expired.

4. Acknowledgement of the debt

As noted, confirmation can be through acknowledgement in a written form and signed by the debtor or an agent. There is a body of case law that considers the issue of whether a debt has been acknowledged. For example, a debtor's signed balance sheet was held by one court to be sufficient acknowledgment of a debt. Alternatively, a payment of interest on principal or part payment of principal can also be treated as an acknowledgement.

5. Defence against creditor claims

The expiration of a limitation period precludes a remedy from being available, such that if a lawsuit is brought against the debtor then they can claim the statute as an absolute defence.

Note that the expiration of a limitation period for the debt does not mean, in most cases, that the debt ceased to exist. There may have been acknowledgement at some stage during the period, which would typically restart the limitation period.

State by state: Statute of limitations in a nutshell

State or territory	ACT	NSW	Qld	SA	Tas	Vic	WA	NT
Limitation period	6 years	6 years	6 years	6 years	6 years	6 years	6 years	3 years
Extinction of right and/or title	Title	Title and right	N/A	N/A	N/A	N/A	N/A	N/A
Limitation period extended by confirmation?	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Can period restart if there is a confirmation after initial limitation period expires?	No	No	Yes	Yes	Yes	Yes	No	No

The proportioning rule and your SMSF

When calculating a super benefit, it is necessary to identify and determine the value of the various components that make up the benefit. The law around superannuation dictates that the tax-free component and taxable components of a member's payment must be paid in the same proportion as the tax-free and taxable components of the member's interest. This requirement is known as the proportioning rule.

Think of the proportioning rule as a sort of integrity measure that prevents the "cherry picking" of the tax-free and taxable components when a payment is made from superannuation.

The tax-free component includes the contributions segment and the crystallised segment. The contributions segment generally includes all contributions made after 30 June 2007 that have not been, and will not be, included in your fund's assessable income.

The contributions segment is made up of what is commonly known as non-concessional contributions (and also includes the CGT exempt component, superannuation co-contribution benefits, and contribution splitting benefits). The crystallised segment broadly includes numerous tax-free components that existed prior to 30 June 2007 and are becoming increasingly uncommon.

The taxable component is broadly the total value of the member's superannuation interest less the value of the tax-free component. Contributions that would form part of the taxable component are generally amounts included in the assessable income of the fund. Broadly, the taxable component consists of concessional contributions, earnings, and capital appreciation from investments in the fund.

Calculating the components

The value of the superannuation interest and the amount of tax-free and taxable components of the member's interest is determined as follows:

- Determine whether the benefit is a lump sum or a pension.
- Work out the total value of the superannuation interest and the proportion of tax-free and taxable components as at the applicable time, which means:
    - if the benefit is a lump sum — just before the benefit is paid; or
    - if the benefit is a pension — on the date the pension commences (in other words, you lock in the proportion of the tax-free and taxable components on the date the pension commences, and future growth and earnings are shared proportionally between these components.)
- Apply the same proportions to the amount of benefit paid (this part is the essence of the proportioning rule).

When a pension is commenced

In an accumulation interest, the tax-free component is normally comprised of a static amount (that is, the crystallised segment and the contributions segment). Whereas the taxable component can change regularly as the investments supporting the superannuation interest fluctuate with investment markets and earnings (or losses) accrue, in some cases on a daily basis.

However, when a pension is commenced with a certain proportion of a tax-free component and the pension assets increase over time, the tax-free component will effectively grow. This is because at the time of paying pension benefits, the proportioning rule will use the same proportion of tax-free component that was locked in at the commencement of that pension.

To illustrate how the proportioning rule works in practice, in respect of pensions, look at the following example:

> In January 2017, Christopher is 66 years old, still working and is a member of an SMSF. In his SMSF, Christopher's superannuation interest consists of a tax-free component of $300,000 and a taxable component of $200,000. His total superannuation balance is $500,000. This means the proportion of his superannuation interest that consists of the tax-free component is 60% and the taxable component is 40%.
>
> Christopher commences an account-based pension with just $250,000 of his total superannuation interest. At the commencement of this pension, the tax-free component is $150,000 (or 60%) and the taxable component is $100,000 (or 40%) since his total superannuation interest before commencing the pension was 60% tax-free component and 40% taxable component.
>
> If the value of the assets supporting the pension were to rise, the percentages representing the tax-free and taxable components do not change. Thus if Christopher's pension balance, which started at $250,000, were to rise to $400,000 after three years due to his savvy investment decisions, his tax-free and taxable components would retain the same proportion as at the pension's commencement and will be as follows: a tax-free component of $240,000 (or 60%) and a taxable component of $160,000 (or 40%).

> Of course, if the value of the assets supporting the pension were to fall to say $100,000, then the proportion of the tax-free and taxable components will remain the same as at commencement ($60,000 tax-free and $40,000 taxable).

Accordingly, the following general rules should be noted:

- Where assets are going to increase in value, the tax-free component is maximised by commencing a pension sooner rather than later (locking in the tax-free component to grow proportionately).
- Where assets are going to decrease in value, the tax-free component is maximised by commencing a pension later rather than sooner (allowing the decrease in assets to erode the taxable component).

With an accumulation interest

To illustrate further the above general principles about the proportioning rule, consider the following further example:

> Again the same facts as above, but this time let us focus on Christopher's accumulation interest. Recall that he commenced his pension with $250,000 of his total superannuation interest; he therefore has $250,000 remaining in his accumulation interest. That $250,000 in accumulation would comprise of a tax-free component of $150,000 (or 60%) and the taxable component is $100,000 (or 40%). Like his pension interest, the value of his accumulation interest rises to $400,000 after three years due to his savvy investment decisions. Unlike his pension interest, his tax-free component remains static and the proportion of his taxable component increases. Christopher's tax-free and taxable components in respect of his accumulation interest are now as follows: a tax-free component of $150,000 (or 37.5%) and a taxable component of $250,000 (or 62.5%).

As the above example shows, there is no change to the tax-free component if investments in the accumulation interest increase in value. Hence, the decision to commence a pension with some or all of a member's benefits at the right time can make a significant difference to a member's interest over the course of time.

Strategic importance

A sound understanding of the proportioning rule is important as it forms the basis of many strategies that leverage off it. For example, where there is a significant tax-free component, the pension should generally be commenced as soon as practicable for a member where the fund expects to see some growth in the value of its assets. Further, when a member is contributing or rolling back a pension into accumulation, stay alert to the effect on what will happen to the tax-free and taxable components — since these two components cannot be separated to maximise each member's position once these amounts are mixed together.

Builders: Get your taxable payments report ready before August 28

Businesses in the building and construction industry, take note – the deadline is August 28, 2018 to report the total payments you made to each contractor you enlisted the services of in 2017-18. You will need to report these payments to the ATO on the *Taxable payments annual report.*

The taxable payments reporting system was initially introduced to address longstanding compliance issues by contractors in the building and construction industry. Tax compliance issues that were identified included non-lodgement of tax returns, income being omitted from tax returns that were lodged, non-compliance with goods and services tax (GST) obligations, failure to quote an Australian business number (ABN), and use of an invalid ABN.

Note that the most recent Federal Budget announced that from 2019-20 three additional industries on top of building and construction will be required to lodge taxable payments reports with the ATO — security providers and investigation services, road freight transport, and computer system design and related services.

The pointers below will help employers in building and construction, and from next financial year the above mentioned businesses, adequately prepare for the looming deadline.

Work out if you need to report

You need to report if all the following apply:

- you are a business that is primarily in the building and construction industry
- you make payments to contractors for building and construction services, and you have an Australian business number (ABN).

Contractors can be sole traders (individuals), companies, partnerships or trusts.

Examples of what is considered to be "building and constructions services" is broad. You are considered to be a business that is primarily in the building and construction industry if any of the following apply:

- for the financial year, 50% or more of your business income was derived from providing "building and construction services", or
- 50% or more of your business activity related to "building and construction services", or
- in the financial year immediately before the current financial year, 50% or more of your business income was derived from providing "building and construction services".

Note: contractors who pay other contractors for building and construction services may also be required to report if they are carrying on a business that is primarily in the building and construction industry. Remember – a contractor can be an individual, partnership, company or trust.

What to report

1) Details you need to report
   For each contractor, you need to report the following details each financial year:
   - ABN, if known
   - name
   - address
   - gross amount you paid for the financial year – this is the total amount paid, including GST
   - total GST included in the gross amount you paid.

   The details you need to report will generally be contained in the invoices you receive from your contractors. It is important to check the way you keep your contractor payment information to ensure you have the details you need to complete the *Taxable payments annual report.*

2) Payments you need to report
   You need to report payments you make to contractors for their building and construction services. Examples of occupations and activities covered by the *Taxable payments annual report* regime can be found on the ATO website at ato.gov.au/taxablepaymentsreporting.

   If invoices you received included both labour and materials, whether itemised or combined, you report the whole amount of the payment unless the labour component is only incidental.

   For instance, if a concrete truck if used to deliver concrete, and the driver merely directs the pouring of the concrete into the trenches, the driver's labour component is incidental, or minor, to the supply of the concrete. You are paying for concrete and you do not need to report the amount paid.

   If however the driver is a go-getter who pours the concrete, levels and does the formwork, then this is more than incidental. You are paying for the concrete as well as the building and construction service, and the total amount paid is reported.

3) Payments you do not report
   You do not need to report:
   - payments for building supplies and materials only – also, maintenance of equipment and tools is not a building and construction service
   - unpaid invoices as of June 30 each year – for example, if you receive an invoice in June 2018, but you do not pay that invoice until sometime in July 2018, you report that payment in the 2018-19 *Taxable payments annual report*
   - pay-as-you-go (PAYG) withholding payments – for example, payments to employees, workers engaged under a voluntary agreement to withhold, workers engaged under a labour-hire or on-hire arrangement. If amounts are withheld because a contractor didn't quote an ABN, you can choose to report the details in the *Taxable payments annual report* instead of reporting them separately in the *PAYG withholding where ABN not quoted – annual report*. If you make this choice, only report the information in one report.
   - if you are a home owner making payments to contractors for building and construction services – for example, if you are building or renovating your own home.

Consult this office for assistance on how to lodge your *Taxable payments annual report* before August 28 this year. Penalties may apply for not lodging the annual report by the due date.