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Client Information Bulletin

Non-Commercial Business Losses

Measures aimed at stopping high income earners claiming losses from non-commercial business activities took effect from 1 July 2000.

In lieu of claiming such losses against other income they are quarantined until the loss making activity starts earning profits, satisfies one of four tests, or the Commissioner exercises his discretion.

The measures are contained in Division 35 of ITAA 1997. Section 35-5(2) provides:- "This Division is not intended to apply to activities that do not constitute the carrying on of a business, e.g the receipt of income from passive investments."

Share Trading Losses

Losses incurred from negative gearing arrangements such as rental properties, share investments, etc., are not caught by these provisions. However, the ATO has stated that the provisions can apply to an individual taxpayer carrying on a business of share trading if it incurs a loss.

In such event, dividends and any imputation credits related to the shares acquired as trading stock will be regarded as assessable income earned by the business activity for the purpose of:

- Determining whether the assessable income test is passed, and
- Calculating the non-commercial business loss to be deferred.

The Four Tests

To avoid having losses quarantined under the non-commercial business loss provisions one of the following tests must be passed. These are:-

Assessable Income Test

The Business activity must have earned at least \$20,000 income (before expenses) for the year. This can involve making a reasonable estimate if the activity was not carried on for the whole year.

Profits Test

The business activity must have produced a tax profit in three out of the past five years (including the current loss year).

Real Property Test

The business activity must have used real property which has a value of at least \$500,000 (either market value or reduced cost base). A dwelling and adjacent land used for private purposes and fixtures owned by an individual as a tenant are excluded.

Other Assets Test

The business activity must have utilised other assets on a continuing basis that have a total value of at least \$100,000. The value of such assets is determined as follows: -

Depreciable assets – their written down value.

Trading stock – its taxation value.

Leased asset – the total of future lease payments less their interest component.

Trademarks, patents, copyrights, etc. – their reduced cost base.

Real property or an interest in real property which is taken into account in the *real property test* is excluded from the *other assets test*. Cars, motorcycles and similar vehicles are also excluded.

Where assets are partly used in the relevant business activity and partly for some other purpose, only that part of the value attributable to use in the business activity for the relevant year can be taken into account.

Where the business activity is undertaken in partnership, the interest of individuals in partnership income and assets must be aggregated. Separately owned assets or income can be taken into account by the individual concerned. Interests of companies and trusts are ignored.

Grouping Business Activities

Business activities of a similar kind carried on by the taxpayer can be grouped together for the purpose of passing one of the four tests. Factors indicating whether or not separate or distinct business activities are being carried on in a taxation ruling. Factors indicating separate and distinct business activities include:-

- Different activities carried on at different locations.
- Different assets used in carrying on separate activities with few or no common attributes.
- Significant differences in types of goods/services produced.
- Little or no interdependency between separate activities.
- Little or no commercial links between the separate activities.

Even though business entities may be separate or distinct, if they are of

similar kind they can be grouped for the purposes of the tests.

Exemptions

The quarantining of losses from non-commercial business activities will not apply if:-

- The activity is a primary production business or a professional arts business, and
- The assessable income for that year (excluding capital gains) from other sources is less than \$40,000.

A professional arts business is defined as a business carried on as an author of a literary, dramatic, musical or artistic work, a performing artist or a production associate.

Imputation Credits

Senior citizens and others who are not normally required to lodge income tax returns can claim a refund of imputation credits for the 2000/2001 financial year. They do this by completing the appropriate form. Dividend statements issued by the companies or managed funds will be needed.

Tax Planning

In his annual report for the year ended 30 June, 2001, Mr Michael Carmody had some trenchant comments to make about aggressive tax planning and mentioned that the ATO is targeting "higher risk tax planners" and will be focusing on their personal tax returns as well as those of their associate's family members, controlled entities and networks.

Tax planning arrangements, which are of concern to the ATO include the following:-

- Film investment schemes,

- Financial arrangements "designed to exploit the tax concessions for intellectual property",
- Some variants of linked bond financial products,
- Franking benefit transfers,
- Retirement village investments made under a Taxation Ruling before its withdrawal in April, 2000.
- Property syndications designed to generate interest deductions,
- Tax free or tax deferred income from trusts,
- Redeeming units in a trust and achieving discounted capital gains at a time when the trust would commence to distribute taxable income.

Self-Education Expenses

The Administrative Appeals Tribunal (AAT) recently held in favour of a nurse who claimed a deduction for self-education expenses in relation to a Masters course in Adult Education. The AAT found that there was a research component in the course that directly related to the taxpayers' duties and that the topics covered, enabled the nurse to perform her existing duties more proficiently.

The AAT disagreed with the ATO's argument that the course appeared to be preparing the nurse for a role beyond her current clinical duties. The AAT was satisfied that the connection between the course and her prospect for promotion within the broader nursing profession was sufficient. The AAT commented that a connection between self-education expenses and promotion or increased income was not strictly necessary.

No Deductions For Fund Raising Dinners

The Tax Office has released a fact sheet concerning the tax deductibility of fundraising dinners.

Generally, no deduction is available even where the ticket price is significantly higher than the market value of the dinner. No apportionment is allowed.

Gift deductions are only available where the payment has been made voluntarily, arising from detached generosity, and no material benefit is received.

However, the fact sheet recognises that businesses may be able to claim a deduction for related advertising costs.

Avoid Disputes: Check Loan Accounts

A common problem encountered in small business partnerships is an argument between the partners over their respective loan or equity accounts in the business.

Often one partner is charged and trusted with the responsibility for maintaining the books for the business and liaising with the accountants each year over the preparation of the accounts and tax returns. Each partner is usually presented with a copy of the accounts and some papers to sign each year.

It is very common that accounts are not carefully reviewed or questions raised before the papers are signed because there is full trust in the responsible partner and the accountants to have got it right.

However, when a dispute arises, often many years down the track, partners frequently get into arguments about their respective loan or equity account balances. These arguments, as well as being extraordinarily damaging to the partners' relationships can be very costly in time and dollars.

As most businesses will not have kept all relevant records beyond the statutory time and will have upgraded from simple cash books to more sophisticated computerised systems which themselves will have been upgraded from time to time (and prior files often are unable to be opened by the later software versions) it becomes an extremely costly process to reconstruct the accounts. Frequently it is just not possible.

Accordingly partners in business should ensure each year that they do check and understand what has been charged and credited to their loans and equity accounts before they sign them off. If the details aren't provided they should be requested and preferably separately filed away for long-term safekeeping. Ideally each partner will sign the accounts and be provided with a fully signed copy of their own.

Social Security Data Matching

The Minister for Family and Community Services has reported that the social security data matching program has saved \$550 million over three years. This program uses tax file numbers to cross match income details between Centrelink, Department of Veterans' Affairs and the ATO.

This program has involved over 200,000 payment cancellations or reductions.

Next on the list is a program to cross match information from discretionary trust returns to identify Centrelink and DVA beneficiaries who have failed to declare that they are a beneficiary of a discretionary trust.

Approximately 200,000 ATO records will be matched against Centrelink records at least twice annually.

Beneficiaries have only until 31 March 2002 to renounce their interests in trusts otherwise the deprivation provisions may apply.

Clients with concerns over this issue should contact us without delay.

Company And Superannuation Fund Tax Due

Most smaller companies and superannuation funds are required to have lodged their 2000/2001 tax returns and paid the balance of any tax due by 8 April 2002.

Clients are reminded that Notices of Assessment will not be issued and based on past experience many companies and funds will forget to make this payment and then incur a penalty.

Particularly at risk are those companies and funds whose tax returns were lodged well before the final due date.

Clients are advised to check if they have any balance of tax due for the 2000/2001 year and ensure it is paid on time.

Companies and funds should have received a letter from the ATO in the second half of 2001 advising of their lodgement and payment responsibilities and together with it was a remittance form which should be used for this purpose. The final payment cannot be added to an Activity Statement.

Dividend And Interest Statements

Company clients are reminded that 8 April 2002 is also the deadline for lodging statements advising of dividends and interest payments made during the year ended 30 June 2001.

The statements were due to be lodged by 31 October but the ATO has now twice granted extensions. The information gathered is used by the ATO for income matching purposes.

This has been a longstanding requirement which has been largely ignored for many years but the ATO has advised that it will now be enforcing it and applying the new late Failure to Lodge on Time (FTL) penalties (refer item in this edition) in the event of non compliance.

Failure To Lodge On Time (FTL) Penalties

The ATO has recently issued a reminder about the penalties which it will be applying to taxpayers who fail to lodge returns on time.

They have in particular drawn attention to the fact that as from 1 July 2002 they will commence applying these penalties in respect of overdue Activity Statements.

The FTL penalty is calculated as follows:-

Small entities are liable to a penalty of \$110 for every 28 days, or part thereof, that lodgement is overdue.

Medium entities are liable to a penalty of \$220 for every 28 days, or part thereof, that lodgement is overdue.

Large entities are liable to a penalty of \$550 for every 28 days, or part thereof, that lodgement is overdue.

The maximum penalty that can be imposed is for 5 periods.

Entity size is determined by reference to its withholding status, its assessable income or its current annual turnover for GST purposes.

Penalties will not be applied for one-off or isolated late lodgements. People genuinely attempting to do the right thing will not be penalized for isolated "slip-ups".

Victorian Employers: Opportunity To Limit Retrospective Workcover Assessments

All Victorian employers should have or soon will receive a letter from their Workcover insurers, (larger employers in late January and smaller employers in March.) Along with the letter will come a review form and the offer of a moratorium to correct any industry classification errors.

We are recommending that all employers take the opportunity by 31 May 2002 to have their industry classifications reviewed. By doing so employers will be ensuring that any retrospective premium increases are limited to the period since 1 July 2001.

Subsequent discovery of any erroneous classification resulting in higher premiums can be applied retrospectively for a period of 4 years.

Please contact us if you require any assistance in connection with this issue.

Wealth Creation / Retirement Planning

How much will you need to retire?

Years of Retirement	Capital required if invested in:		
	Australian Fixed Interest \$'000	Property \$'000	Australian Shares \$'000
50	1,587	1,074	804
40	1,380	990	766
30	1,127	865	699
20	821	680	580
10	450	406	371

Assumptions:

Fixed Interest 4.5% Property 6.6%
Equities 8.5% Tax 15%
Inflation 2.5%

The above table highlights the need to establish a substantial capital base to achieve a comfortable retirement.

Assuming a goal of \$50,000 net income per year, the table shows how much capital is needed depending on:

- How many years you will be retired
- What types of asset classes you will be investing in

For example a person retiring now with a life expectancy of 30 years desiring \$50,000 net income per year will require capital of:

- \$1,127m if invested in Australian Fixed Interest
- \$865,000 if invested in Property
- \$699,000 if invested in Australian Shares

The difference in capital levels required reflects the difference in earning rates of growth assets (shares, property) versus defensive assets (cash).

We can assist with your investment mix and retirement and planning needs.

How can you increase your retirement savings?

One of the keys to effective wealth creation is regular savings and investment.

Some ideas on how to increase savings are:

- Consolidate debt: most of us have a home loan, small personal loan, car loan or credit card debt. By consolidating debt into a more competitive home loan you will be able to save on interest costs and repayments thus increasing funds available for investment.
- Gearing plans: gearing means borrowing to invest. Many home owners have taken the opportunity to pay down their home loans during this period of low interest rates. In doing so the home owner will have developed equity in their home. This equity can be used as security for further borrowings that can be invested in higher growth investment assets. *Please contact us to discuss the wealth creation and tax saving advantages of gearing and the risks involved.*
- Education savings plans: the cost education is a major burden for most families. One way to alleviate this burden is to establish an education savings plan while you child is at an early age. Using the AMP “Cost of Education Calculator” we can estimate the cost of educating your child and how much you will need to save each month to reach this goal. *Please contact us to discuss your options.*

Rates as at 25 March 2002.

- Motor vehicle leasing from 7.35%
- Plant & equipment leasing from 7.6%
- Home loans from 5.19% (1st year rate)
- Commercial property and construction loans on application

Disclaimer: The contents of this publication are general in nature and we accept no responsibility for persons acting on information contained herein without first consulting us.