



South-East Qld Office

14 Argyle Street
Breakfast Creek Qld 4010
PO Box 402, Albion Qld 4010
Telephone 07 3262 8700
Facsimile 07 3262 8166

Central + North Qld Office

First Floor, 224 Victoria Street
Mackay Qld 4740
PO Box 6, Mackay Qld 4740
Telephone 07 4968 3166
Facsimile 07 4968 3154

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Are you on the Tax Office hit list?

Small and medium sized enterprises and their executives

Three key issues exist for SMEs: the relationship between company income and your personal income; the income declared between related entities; and, GST integrity – particularly on property transactions. The first rule, regardless of who is on the hit list, is to lodge your tax return on time (or at least enabling us to lodge it on time). Late lodgers often appear as if they have something to hide. Here are a series of other areas to look at to make sure your business doesn't become an audit target:

Your income vs company income

An emerging focus for the Tax Office is how income flows between a company, its executives, and any related entities. Generally, the Tax Office has not mapped this level of interaction before unless there has been a problem. Now, technology has advanced to explore these relationships. In other words, the Tax Office will be looking at the income you declare relative to that of your business and its related entities, and then making a call as to whether you should be further investigated. One key area is company loans to shareholders.

If your business has outstanding company loans to shareholders, be wary of Division 7A. If you have a debit loan account this can be deemed an unfranked dividend in the hands of the shareholder. A debit loan account arises when the company makes payments on behalf of a shareholder or advances funds to them. Where an unfranked dividend occurs, the dividend is declared as income on the shareholder's personal tax return and taxed at their marginal tax rate.

If your company has an outstanding debit loan, you need to decide how you will manage this. You may need to document the loan agreement. If you already have an existing loan agreement then make sure that you make the minimum loan repayments before 30 June. Also, the Tax Office amnesty that enabled taxpayers to correct past loan account errors ends on 30 June. If you have not tidied up this area, now is the time.

Company losses

There are a couple of problem areas when it comes to claiming company losses. Obviously, claiming a loss where the origin of that loss cannot be proven, or where losses claimed are from a related party (that is not part of a consolidated group) are going to be denied. Another problem area is where you have a mix of carry forward capital and revenue losses and you attempt to claim all of those losses against revenue profits. Capital losses can only be offset against capital gains.

Buying or selling a business

In addition to the standard capital gains tax issues from any sale (ie making sure you declare the capital gain), the Tax Office is looking closely at mechanisms such as share buy-backs, capital reductions and the sale of shares to exit from businesses. Debt forgiveness or write off to facilitate a transfer of a business will also be in the spotlight. Nothing wrong with any of this providing it is managed correctly. The devil is in the detail.

Moving profits overseas

Another emerging Tax Office target that we are only just starting to see in the SME market is profit shifting. In particular, the Tax Office is looking closely at arrangements between Australian companies and their related offshore entities; catching out those improperly moving profits from an Australian entity into a lower taxed offshore entity. Common tactics include over-inflating the price paid by the Australian entity for goods purchased from the related offshore entity and the Australian entity carrying high debt levels from intercompany loans (and deducting the interest).

As a result, the Tax Office will target those businesses with heavily geared Australian based operations that might be overstating interest deductions, restructures and trade in the form of services.

GST integrity

GST on property transactions is a continued focus. In particular:

- Unreported property sales, particularly of new residential premises;
- Valuations used under the margin scheme;
- Incorrect reporting of adjustments arising from a change in the extent of creditable purpose; and,
- Incorrect treatment of supplies to associates.

In addition, where GST refunds are high or above an industry standard, expect a call from the Tax Office. The Tax Office has tackled a number of GST frauds of late where falsified or over-inflated invoices have been used to generate higher refunds.

The wealthy

Over the last few years we have seen a number of high profile targets such as Glenn Wheatley, fall foul of the Tax Office. While the net gain from high profile projects such as Wickenby is questionable, the recent Federal Budget provided \$256.9 million in additional funding over four years to further expand the Tax Office's ability to investigate tax compliance with a focus on companies and high wealth individuals.

Off shore tax minimisation schemes are a primary target. Wickenby recently uncovered an alleged \$100 million offshore tax evasion scheme managed by an Australian expatriate in Vanuatu. The Tax Office is conducting 80 audits linked to Vanuatu with over \$90 million in allegedly false deductions, and is writing to another 500 Australians with apparent links to Vanuatu seeking more information on their tax affairs.

Spiking Tax Office interest are schemes involving tax havens such as Vanuatu, the Bahamas, the Caribbean, Luxembourg, Switzerland, the Cayman Islands and the British Virgin Islands. In particular, where an 'international promoter' is used to set up and manage offshore trusts or companies that conceal the taxpayer's beneficial ownership of assets.

Key triggers that might make you a Tax Office target include:

- Discrepancies between lifestyle and reported income;
- Significant variations in tax payments;
- A history of aggressive tax planning by individuals or their adviser;
- Unexplained losses; and
- offshore dealings.

Last year, the tax office undertook 22 audits of high wealth individuals, netting \$280 million in revenue. This year, they will almost double the number of audits and undertake 200 'risk reviews'.

In addition to its focus on off shore schemes, the income declared by directors of public and private companies is also under scrutiny. In this area, the key triggers are:

- Where tax performance varies substantially from business performance;
- Significant variations in tax payments that are inconsistent with economic indicators;
- Unexplained losses;
- Tax outcomes that are inconsistent with the intent of newer law;
- Private assets treated as business assets;
- Non-disclosure or lack of transparency in offshore dealings, especially involving tax havens, banking secrecy and low tax jurisdictions;
- Distortions and inconsistencies in market valuations.

Contractors and the self employed

Contractors, even those working through a company structure, can fall foul of the alienation of personal services income (PSI) rules. The PSI rules are designed to ensure that contractors really are in business for themselves rather than being quasi-employees (and thus paying less tax than their salaried colleagues and receiving larger deductions). Under these rules, unless certain conditions are met, the Tax Office treats any income as income earned by you rather than income earned by the business. This means that your personal tax rates will apply to your business income and you will be denied access to a range of tax deductions normally available to business.

To qualify as a personal services business, you need to pass at least one of four tests. The first is the results test – to pass this test your contract needs to be able to demonstrate that you are contracted to produce a particular result, such as the completion of a project, you provide your own tools and equipment, and are responsible for correcting defects. If you fail this test and 80% or more of your income is from one client, there are another three tests that might apply.

Even if the rules didn't affect you in the past, this is an annual test. If your circumstances have changed, you need to make sure you are not caught.

Landlords

Landlords claim some \$3 billion a year in subsidies (with nearly 1 million landlords claiming to have lost money on rental properties and only 500,000 making money in 2005/2006). The Tax Office has been talking about rental properties for some time and earlier this year launched a new series of programs designed to try and improve compliance by educating new investors about their rights and obligations. All this means that if you get caught doing the wrong thing, don't expect the Tax Office to be gentle.

Here is the Tax office's list of common mistakes made by landlords:

- Claiming deductions for rental properties not genuinely available for rent.
- Incorrectly claiming deductions for properties only available for rent part of the year, for example a holiday home.
- Incorrectly claiming the cost of structural improvements as repairs when they are capital works deductions, such as remodelling a bathroom or building a pergola; and
- Overstating deduction claims for the interest on loans taken out to purchase, renovate or maintain a rental property. A loan can be taken for both income-producing and private purposes, like to buy a car or go on an overseas holiday. The interest on the private portion of the loan is not tax deductible.

There are two categories of rental property expenses you can claim:

- Expenses for the year you paid them, like council rates, repairs, insurance and loan interest; and
- Expenses that are deductible over a number of years, like borrowing costs, creating structural improvements and costs of depreciating assets.

Renovation costs and costs to repair damage, defects or deterioration existing on purchase cannot be claimed as an immediate deduction. These costs are capital expenditure, depending upon what is repaired or improved and must be claimed as either decline in value deductions over the asset's effective life, or as capital works deductions over 40 years.

Investors

Declaring Capital Gains is the big issue for investors and one the Tax Office is passionate about. If you have disposed of any assets (shares, property, etc) including those who disposed of assets to invest in their super fund, don't forget to declare the gain!

Quote of the month

There is no passion to be found playing small - in settling for a life that is less than the one you are capable of living.

Nelson Mandela

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