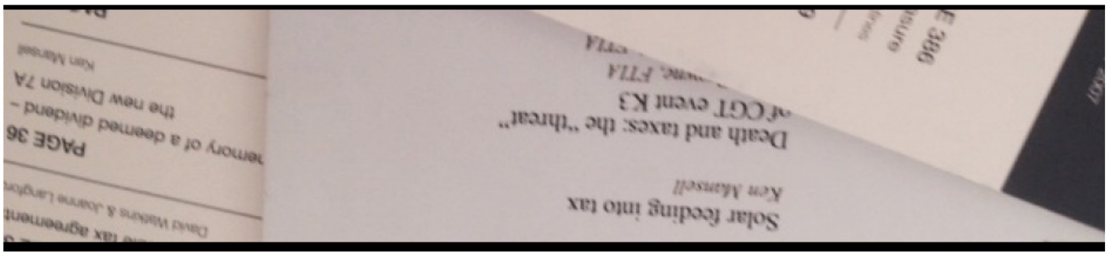
January 2022 – Pre-Budget Submission

Tax Rambling *The rants of a tax nerd*



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Change 1 – Changes to SBCGT concessions

Background

Given that we have the 50% CGT discount, why do we also have the Small Business CGT Concessions? The answer is superannuation.

If I work as an employee for 15 years my employer is required by law to make payments into my super fund that are concessionally taxed, including earnings when I retire potentially being tax free (subject to the operation of the Transfer Balance Cap). But if I am the owner of a small business there is no such requirement.

While a small business owner can make deductible (currently capped at $27,500) and non-deductible (currently capped at $110,000) contributions each year, many small business owners see their business as their retirement fund. They will sell their business and live of that in retirement. But they have not had the same tax benefits on their retirement savings that an employee has had.

Well Division 152 of the ITAA97 is designed to achieve this. Don't believe me. Then why:

- Do under 55s have to put the benefit of the retirement ($500,000 lifetime) concession into super?
- You have to be over 55 to get the 15 year exemption and you can put an amount very close to the transfer balance cap into super tax free from the CGT event that is covered by this exemption?
- You can rollover gains from one small business asset to another, until you "retire" from owning small business assets.

The Ideas

1. Remove both the small business 15-year exemption (in Subdivision 152-B) and the 50% active asset reduction (in Subdivision 152-C). This provides the funding for the second idea.

2. Make changes to the retirement concession (in Subdivision 152-D) such that it has a lifetime limit equal to the transfer balance cap (instead of the current $500,000), change the age under which the amount needs to be transferred into super to 60, and change the name of the retirement concession (as it does not require any retirement)

3. Retain the current small business roll-over (in Subdivision 152-E)

Remove the 50% active asset reduction

The small business 50% reduction can be found in Subdivision 152-C. It applies where a taxpayer satisfies all the basic conditions for the CGT small business concessions contained in section 152-10. It applies automatically if the basic conditions are satisfied, unless you choose for it not to apply.

If the 50% reduction applies then the retirement concession may only apply to the remaining assessable gain. Therefore, it may be preferable for an entity NOT to apply the 50% reduction in an entity where payment of the amount sheltered by the 50% reduction would be taxable (e.g. payment of dividend from a company).

Example

Joyco (an SBE) sells an 'active' asset giving rise to a $800k capital gain. Joyco has 2 CGT concession stakeholders, no carry-forward losses and a nil balance in its franking account. Neither of the two CGT concession stakeholders have used up any part of their $500k lifetime retirement concession limit.

If the 50% reduction applied to the gain, only $400k could be paid out to the 2 CGT concession stakeholders under the retirement concession. As the $400k sheltered from tax by the 50% reduction remains in the company, this would either be taxed upon withdrawal from the company as an unfranked dividend or a return on capital (i.e. wind-up Joyco and apply the 50% CGT discount to the shares held in Joyco by the individuals).

Example

Same facts as above except Joyco elects not to apply the 50% reduction. This election can be in the form of a note on file (does not need to be sent to the ATO). As the 50% reduction does not apply, the retirement concession can apply to the $800k gain and can be paid directly to the CGT concession stakeholders (assuming they are over 55) or into super on their behalf (if they are under 55 years of age).

The same outcome occurs for unit trusts due to the operation of the distribution of a "non-assessable amount" under CGT event E4 due to the cost base reduction that occurs. If the cost base goes to 0 on the units, then a capital gain arises.

For this reason many taxpayers elect not to apply this concession.

This concession is also the only of the current four concessions that does not have any link with superannuation. If an individual of any age owns the CGT asset directly they can hold the funds outside of super and there is no method (outside the normal contribution caps) to pass the untaxed gain into super.

Remove the 15-year exemption

This concession can be difficult to assess, primarily as **s**ection 152-105 requires the CGT event to be 'in connection with' the individual taxpayer's retirement. Similarly, section 152-110 requires the CGT event to be in 'connection with' the significant individual's retirement.

There is no definition of 'in connection with retirement' included within the legislation, and as such whether this condition will be satisfied is a question of fact and degree.
The Commissioner states there would need to be at least a significant reduction in the number of hours the individual works or a significant change in the nature of their present activities to be regarded as a retirement. However, it isn't necessary for there to be a permanent and everlasting retirement from the workforce.

> ***Example:***
>
> *Nicolas is 57 when he sells his small business. Under the terms of the sale, he agrees to be employed by the new owner for a few hours each week for two years.*
>
> *The sale of the business would be in connection with Nicholas' retirement. He has permanently or indefinitely ceased being self-employed and has begun gainful employment on a much reduced scale with another party, although still performing similar activities.*
>
> ***Example***
>
> *Mai Loan and her spouse, Diem, are both pharmacists, both over 55 years old, and carry on a small business through two pharmacies. They sell one (making a capital gain) and, accordingly, reduce their working hours from 60 hours per week each to 45 and 35 hours per week respectively.*
>
> *There has been some change to their activities in terms of hours worked and location, but there has not been a significant reduction in the number of hours or a significant change in the nature of their activities; therefore, there has been no 'retirement'.*
>
> *If, on the other hand, one spouse stopped working altogether, there would be a significant reduction in the number of hours that spouse was engaged in the business activities. Therefore, the sale would be in connection with the retirement of that spouse.*

A CGT event may be 'in connection with your retirement' even if it occurs at some time before retirement. Whether particular cases satisfy the conditions depends very much on the facts of each case. Similarly, the words 'in connection with' can apply where the CGT event occurs sometime after retirement. Again, this would depend on the particular facts, and would need to be considered on a case-by-case basis.

Removing this concession also provides the funding for the increase in the retirement concession.

Increase the retirement exemption

Although it is called the retirement exemption, there is no requirement for a taxpayer to retire in order for the exemption to be obtained. So please change its name in the Act.

If the relevant individual is under 55 years of age at the time of the choice, that part of the capital gain to which the retirement exemption applies must be rolled over into a superannuation fund and preserved until a condition of release is met. If the individual is over 55 years of age, there is no requirement to roll money over into a superannuation fund.

The maximum amount of capital gain that can be disregarded under the retirement exemption in relation to an individual is a total of $500,000 during their lifetime.

To link this to the super rules, this age should be increased to 60 and to further link this to the super rules, the $500,000 maximum cap should be linked to the transfer balance cap. In addition, those over 55 should be able to transfer the funds from this concession into super if they want to.

This would mean, with the removal of the 15 year exemption and this concession being linked to the transfer balance cap, the CGT cap could be removed and we could just say any transfer to super due to this concession does not could towards your concessional or non-concessional caps.

Rollover

The small business roll over relief allows a taxpayer to defer the making of a capital gain on the sale of an active asset if a replacement asset is acquired or a current asset is improved. The capital gain is not exempt, it is merely deferred until the replacement or improved asset is sold or two year goes by.

This allows a taxpayer to continue to build up value in their businesses that they can one day transfer into super using the (hopefully renamed) retirement concession.

Therefore, this should be retained.

Change 2 – Simplify employee deduction documentation

Background

Division 900 covers substantiation requirements for work expenses (Subdivision 900-B). These substantiation rules only apply to individuals (section 900-5), and only applies to employees or those who have similar withholding as employees (see list in section 900-12).

The most important section in this Division is section 900-15 which states that even if a "work expense" meets the conditions for a deduction, there will be no deduction unless the individual substantiates it "by getting written evidence." The written evidence must be retained for 5 years from the due day for lodging an income tax return or when the return is lodged, whichever is later (section 900-25).

In addition, subsection 900-35(1) ITAA97 states:

*If the total of all the *work expenses (including *laundry expenses, but excluding *travel allowance expenses and *meal allowance expenses) that you want to deduct is $300 or less, you can deduct them without getting written evidence or keeping travel records.*

Idea 1 - 5-year retention period vs 2-year amendment period – Section 900-25

Most employees will only have a two-year amendment period (section 170 ITAA36). Therefore, the current retention period of five years in section 900-25 could be reduced, possibly to the amendment period of the taxpayer (generally two years but in some cases 4 years). It could be directly linked to the amendment period in section 170 of the ITAA36.

This would make proving fraud and evasion outside the 2 years difficult as the requirement to retain documentation would have ended.

Idea 2 – Change the exception for small total of expenses less than $300 – Section 900-35

There is no way to know at the time of making a deductible work related expenditure whether this exemption will apply. If I was to purchase a train ticket between two places of work (deductible under section 25-100) on 1 July for $20, I will not know until the following 30 June whether my total claim for work related expenses is $300 or less and so I need to keep an invoice of the travel until this time. It is only after I have collected all the written documentation during the year that I find out at the end of the year that I do not need the written documentation under this section.

This exception from the need to hold written documentation should offer a way to assess what documentation is required at the time of the expenditure.

The Government should replace this yearly exception amount with an exemption for each transaction. Such an exemption currently exists in 900-125 but this only applies to $10 or less amounts, up to a total of $200 and you are still required to make your own written documentation. Examples of this type of documentation exemption exists in other tax acts. In the GST Act, the rules regarding having to have valid tax invoices only apply to expenditure that is greater than $75 (GST exclusive). The concerns about this idea will be expenses can be broken down into components for fall within this threshold. However, we have “set” rules in Division 40 regarding the instant assets for non-business entities where the asset is less that could be used to fix this problem (see subsection 40-80(2)).

I suggest removing the $300 substantiation exemption in section 900-35 and replace it with ant expense less than $75 (based on the tax invoice exemption in the GST Act), but require the taxpayer to be able to identify what each expense was.

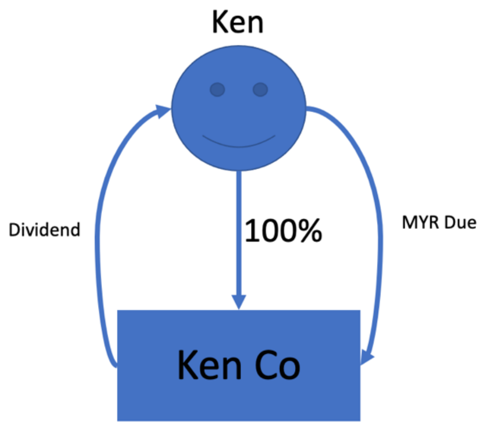
Change 3 – Division 7A administrative simplification

Background

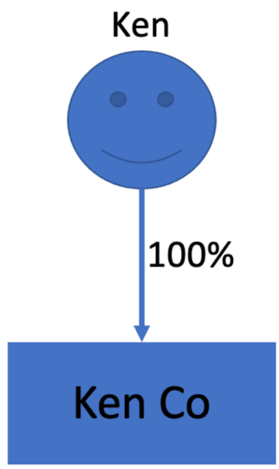
Division 7A "is intended to prevent profits or assets being provided to shareholders or their associates tax free" according to the Commissioner of Taxation. Most of the time, Division 7A means that we turn amount "taken" from company bank accounts by shareholders into 109N compliant loans to avoid them being deemed dividends. However, my guess is 90%+ of these 109N Division 7A loans are repaid without a single bank transaction. There are numerous journals, but you won't find these repayment on a bank statement. Once a client has taken the money, it almost never comes back.

They are typically repaid by way of set-off against a dividend declared by the company or made via a round-robin of payments.

> ***Example: Loan repayment by set-off against a dividend***
>
> *Ken owns 100% of Ken Pty Ltd, which carries on a business. During the 2018-19 income year, he drew an additional $285,000 as a loan (he actually just takes it from the company bank account and the accountant treats it as a loan).*
>
> *On 14 May 2020, Ken and the company executed a complying seven-year Div 7A loan facility agreement under section 109N. The company's 2018-19 tax return was due on 15 May 2020, and it was lodged on that day.*
>
> *Under the complying loan agreement, the first minimum annual repayment of ~50,000 was due by 30 June 2020.*
>
> *On 30 June 2020, Ken Pty Ltd resolved to declare a dividend of $50,000, and the company now owed Ken that amount. The dividend was fully franked at 27.5%. Ken and the company then agreed on that same day to apply the principle of mutual set-off to the extent of the $50,000 mutual indebtedness. This had the effect of the company paying Ken the $50,000 owed to him, and Ken paying $50,000 towards his outstanding Div 7A loan owing to the company.*



30 June 2020
Transaction 1. Declare dividend, creating mutually opposing obligations



30 June 2020
Transaction 2. Payments made by way of off-set

And the journals are…

Records this transaction	Date	Account	DR $	CR $
		Dividend paid	50,000	
Creation of liability owing to Ken	30-Jun-20	Dividend payable to Ken		50,000
		Dividend payable to Ken	50,000	
		Interest income		15,297
Payments by way of setting off mutually opposing obligations	30-Jun-20	Loan to Ken (Div 7A)		34,703

This is by far the most common way the operation of Division 7A is avoided. However, this is a great deal of administration… It involves:

- Completing a section 109N agreement
- Calculating the Minimum Yearly Repayment (MYR)
- Paying a dividend equal to the MYR. A dividend has to be validly declared in accordance with the company's constitution and the Corporations Act 2001. That is effected typically by the board passing a resolution to that effect at a meeting of directors, or simply a resolution in the case of a single director company. And for it to work it has to be done by 30 June each year or there is nothing to offset and no minimum yearly repayment has been made.
- Evidencing company resolutions is governed through the process of documenting minutes, which is set out in s 251A of the Corporations Act. Minutes are required to be prepared and filed in the company register within one month, and they must be signed within a reasonable time.
- Subdivision 202-E sets out the requirements for issuing distribution statements. Private companies have 4 months after their year end to provide these to shareholders, so that a company with a 30 June year end that pay a dividend during an income year is required to give a distribution statement to shareholders by 31 October after year end.

Idea 1 – Make what happens in most cases automatically happen

If most cases where Division 7A arises are solved with the taxpayer offsetting the deemed loan with either one or a series of dividends (generally a dividend each year equalling the required minimum yearly repayment) then why not make this what automatically occurs when Division 7A applies.

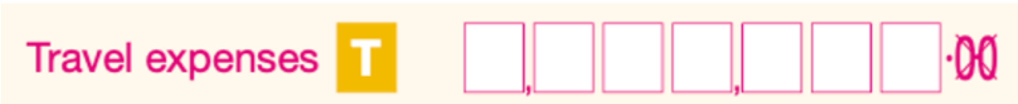
Where there is a loan that falls within Division 7A, it is deemed to be 7 dividends paid over the next 7 years, with each equal being either the respective MYR, or each being calculated by the method suggested for making Division 7A repayments under the proposed changes to Division 7A. Each year the shareholder has to return the dividend

This dividend can be franked if the directors so decide.

Change 4 – Rental Property Schedule to drive compliance

Background

On the Rental Property Schedule there is the following label:



What is interesting about this label is that subsection 26-31(1) ITAA97 states:

> *You cannot deduct under this Act a loss or outgoing you incur, insofar as it is related to travel, if:*
>
> *(a) it is incurred in gaining or producing your assessable income from the use of *residential premises as residential accommodation*

There are a few exemptions but 99% of owners of rental properties cannot claim deductions and have not been able to since 2017. However, the label is awesome as it makes it easy to work out who incorrectly claims these deductions… And I think the tax return forms should be written in a way to make it easier for taxpayers to identify not just what they need to include, but also what they need to exclude.

For example, label T should remain on the form, but it should be in a section covering amounts that are not deductible.

Back in 2019 the Commissioner released a report into a review of rental properties. He paid a third party to randomly select a series of taxpayers who were audited. In releasing the results of the review, Assistant Commissioner Gavin Siebert stated that:

> *"[a] random sample of returns with rental deductions found that nine out of 10 contained an error. We are concerned about the extent of non-compliance in this area and will be looking very closely at claims this year."*

Three of the 4 main errors they found in these returns were:

1. Claiming all the loan interest when there have been redraws on loans where the redrawn money has been used for private expenses, like drawing down on a loan that was initially for a rental property to pay for a holiday.

2. Claiming deductions for improvements, renovations that should be treated as capital works and deducted over a number of years.

3. Claiming all the loan interest when the property has been used as a holiday home for some of the time, especially where the holiday home has not been held out to the public for rent in high occupancy periods like summer holidays or family and friends are given “mates rates”.

Idea 1 - Add non-deductible labels

Why not have labels that identify these three issues on the return and explain that they are not deductible.

The easiest to add would be a label that states “Number of days property used or reserved for owners, owners relatives or other family and friends who are given special rates?” There could be a note that states “expenses occurred during these days are not deductible”.

To solve the other two problems you could have other labels, like “interest due to redraws on the initial loan not used to renovate/extend/repair the property”.

Change 5 – Trust distribution by lodgement of return

Background

Many years ago, tax practitioners had to meet with their clients before 30 June to see if they had taken any amounts out of their companies that Division 7A might apply to. To avoid Division 7A they had to either repay the amount before 1 July or put it under an agreement before 1 July.

But then sense prevailed and for years now these repayments and agreements only need to happen before the lodgement date of the company, so all of these issues can be sorted out as a part of the tax return preparation process.
However, we still have exactly the same problems with trusts. To ensure discretionary beneficiaries are presently entitled to trust income, trustees of discretionary trusts must make a resolution by 30 June. It means that we can’t wait till the tax return is prepared to sort out these issues, but we need to do it, sometimes over 10 months before we lodge the tax returns.

Interestingly the ITAA97 acknowledges having to make these resolutions by 30 June, always before any accounts have been finalised, and often before transactions in bank accounts have been finalised, can be difficult to do.

To make a beneficiary specifically entitled to a capital gain, the trustees of discretionary trusts must make a resolution in respect of that capital gain by 31 August following the income year in which the capital gain is made (actually two months after the year end).

Idea 1 – Rather than having to create PEs by 30 June, allow it to happen during the return prep process

For exactly the same reasons the process for Division 7A was deferred to tax time and due by lodgement date rather than 30 June, these processes should be moved to the lodgement date of the trust tax return.

As the trust rules in the ITAA36 use trust law concepts (like present entitlement), this would require the trust rules in the ITAA36 to be amended so that "deemed present entitlements" can occur up to the lodgement of the trust return.