



- Unprofitable Businesses – Deductible?
- Economic Focus 2010 – The Year Ahead
- Undeclared Offshore Income – Come Clean
- ATO Income Test Changes and Tax Rulings

## **Unprofitable Businesses**

### **They may no longer be deductible against your other income**

The Government has introduced amendments that restrict access to the non-commercial loss rules for high income earners. These measures were first announced in the May 2009 Federal Budget as a means of preventing high net worth individuals who are engaged in hobby farms, such as the “Pitt Street” or “Collins Street” farmers, or other non-commercial activities from obtaining tax deductions for their hobbies under the non-commercial loss rules. The Government’s view is that these taxpayers should not be allowed to reduce their tax liabilities with losses from activities which amount to no more than a lifestyle choice. The amendments apply from 1 July 2009.

### **Non-commercial loss rules**

The non-commercial loss rules have applied since July 2000. They apply to individuals who are engaged in an unprofitable business activity. The rules prohibit these taxpayers from offsetting the losses from the non-commercial business activities against their salary and wages, investment or other assessable income in the year those losses are incurred. The losses are quarantined and may be carried forward and utilised in a future year to be offset against any profits which that particular business activity may ultimately generate.

### **Exceptions to the non-commercial loss rules**

Currently, the legislation contains four exceptions to the quarantining rule. If a taxpayer incurs a loss from a business, they will be able to use that loss to reduce other assessable income in the year the loss is incurred if the taxpayer passes one of the four objective tests of commerciality:

- Assessable income test – the business produces assessable income from the business activity of at least \$20,000 in that year. Where a business commences or ceases operation during the year, a taxpayer may make a reasonable estimate of what the income would have been if they had been in business for the year.
- Real property test – the value of land and buildings used by the business on a continuing basis exceeds \$500,000.
- Other assets test – the total value of other assets (excluding motor vehicles, land and buildings) used in the business activity on a continuous basis exceeds \$100,000. Such assets may include trading stock, the written down value of depreciable assets, and the remaining capital component of assets under lease.
- Profits test – the business activity generated a profit in at least three of the last five income years, including the current year.

There are also special concessional rules for certain classes of taxpayers, notably taxpayers conducting a primary production or performing arts business. These taxpayers can claim a deduction for losses incurred by that activity against other income (such as salary or investment income) if the income from other sources (excluding capital gains) is less than \$40,000.

### **Changes for high-income earners from 1 July 2009**

The legislation introduced into Parliament tightens the application of the non-commercial loss rules to high income individuals. From 1 July 2009, individuals with an ‘adjusted taxable income’ of at least \$250,000 will have excess deductions from their non-commercial business activities quarantined to the business activity irrespective of whether they satisfy any of the four objective tests. An individual’s ‘adjusted taxable income’ comprises the sum of their taxable income, reportable fringe benefits,



- Unprofitable Businesses – Deductible?
- Economic Focus 2010 – The Year Ahead
- Undeclared Offshore Income – Come Clean
- ATO Income Test Changes and Tax Rulings

reportable superannuation contributions and total net investment losses. In effect, this means the existing non-commercial loss rules, including the ability to access the existing four objective tests, will only apply to taxpayers with an adjusted taxable income of less than \$250,000.

## **Economic Focus**

### **2010 – The Year Ahead**

For most economists and financial market participants, 2009 has been a year of extremes. We quickly forget the complete lack of confidence earlier in the year when markets were pricing in another Great Depression and fears of a systemic collapse in the global financial system were rampant. However, it is an opportune time to look at what to expect in 2010. Will the global economy continue to recover? If so, at what pace? Or could a 'double dip recession' in the US drag the global economy back down again? Can China sustain its growth or will the bubble burst? Can share markets continue to rally or could they test the lows reached in early March 2009? Could credit markets freeze up again? Let's look into our Crystal Ball...

While the risks of another contraction in the US economy in 2010 cannot be ignored, we believe that a 'double dip recession' is unlikely. The swift and aggressive fiscal and monetary intervention by US authorities appears to be having the desired effect as economic data indicates that the US economy has bottomed. However, a return to a normal level of economic growth is expected to be gradual. US unemployment, which is at a 26-year high, must begin to fall before consumption improves. The average US consumer is making a concerted effort to reduce debt levels which is having a detrimental impact on spending as well. The US Federal Reserve's monetary policy will have a huge bearing on the economic recovery. Eventually, interest rates will have to increase again or else there will be spiralling inflation. However, if they move rates before a sustainable

recovery is established, the economy could slide into recession again.

The China juggernaut appears to be rolling again and the world is looking to the Far East, not the US, to drive the global economic recovery. Industrial production is back to pre-crisis levels, consumer demand is growing and the labour market is solid. Economic growth of 10%+ in 2010 is not an unreasonable assumption as China's massive economic expansionary programme is in full flight. It is hard not to be enthusiastic about China but the sceptics will tell you that it is one big bubble that will eventually burst. While not totally discounting the bubble theory, we believe 2010 will be a big year for China. As a major commodity producer, Australia will continue to benefit from China's expansion. Australia's more resilient housing and finance sectors helped it outperform most other developed economies over the last year and this should continue in 2010. Consistently positive economic data has forced the Reserve Bank to make three consecutive interest rate rises of 0.25%, moving the cash rate to 3.75%. Further rate hikes are expected throughout 2010 as the RBA keep growth, and inflation, at a maintainable level.

History shows us that rapid rebounds in share markets are not uncommon after sharp falls, as experienced this year. Share markets are forward looking indicators and they were pricing in 'the end of the world' which, of course, did not eventuate. This led to a return in confidence and investor's appetite for risk returned. The alternative was cash at a real rate of return of zero. The next stage in the share market recovery is a bit trickier. The average global share market price to earnings ratio is now just above the historical average, which means forward looking earnings need to improve in order for investors to feel justified in buying shares at these levels. With the corporate earnings outlook uncertain, we expect conservative gains during 2010. While the economic outlook in Australia is more positive, the ASX200 still appears to



- Unprofitable Businesses – Deductible?
- Economic Focus 2010 – The Year Ahead
- Undeclared Offshore Income – Come Clean
- ATO Income Test Changes and Tax Rulings

be closely pegged to movements in the US S&P500.

## **Undeclared Offshore Income**

### **Chance to come forward before the Tax Office crackdown**

The Tax Office has announced a new offshore voluntary disclosure initiative (OVDI). Under the OVDI, the Commissioner is providing taxpayers with the opportunity to make a voluntary disclosure in relation to their undeclared offshore income and pay reduced penalties and interest.

The OVDI is available to all taxpayers until 30 June 2010. Examples of unreported offshore income include:

- A taxpayer changes their country of residence to Australia and once in Australia they do not realise they are taxable on income from the country they came from, or
- A taxpayer has investments in offshore funds or bank accounts with income accumulating overseas, and they do not realise that income may be taxable in Australia.

### **No Names Basis Enquiries**

If you have omitted foreign income and have wanted to 'come forward to set things right', but were concerned about the consequences of doing so, particularly the potential for criminal investigation, under the OVDI you can approach the Tax Office anonymously; and the Tax Office will indicate whether it would investigate their arrangements for any potential criminal law breaches.

In considering whether to investigate a matter, the Tax Office views favourably taxpayers who make a voluntary disclosure and cooperate with them or with

law enforcement agencies. Contact us to assist in discussing your issues with the Tax Office on a no-names basis.

### **Reduced Penalties for Coming Forward**

If the taxpayer takes advantage of the OVDI and comes forward to voluntarily disclose offshore income which results in additional taxable income, the reduced shortfall penalties are as follows:

- If the taxpayer's additional taxable income is \$20,000 or less in a tax year, they will not need to pay a shortfall penalty for that year, or
- If the taxpayer's additional taxable income exceeds \$20,000 in any tax year, the shortfall penalty will be remitted to 10% of the additional tax for that year.

There will also be adjustments to the general interest charge (GIC) as follows:

- GIC will be reduced to nil for the tax years up to and including the 2002 tax year,
- GIC will be reduced to the base rate for the 2003 and 2004 tax years, and
- Shortfall interest charge applies for 2005 and later years at the normal rates.

If taxpayers have difficulties meeting payment obligations, the Tax Office will develop a payment plan taking their circumstances into consideration.

If taxpayers intentionally disregard the tax law and do not voluntarily disclose their offshore income, penalties can be up to 90% of the tax shortfall.

### **What Must Taxpayers Do To Take Advantage of the OVDI?**

To qualify for this concessional treatment taxpayers need to submit a voluntary disclosure in writing on the Offshore Voluntary Disclosure Statement which is available from the Tax Office website.



- Unprofitable Businesses – Deductible?
- Economic Focus 2010 – The Year Ahead
- Undeclared Offshore Income – Come Clean
- ATO Income Test Changes and Tax Rulings

## **Increased Tax Office Audit Activity**

The Tax Office is increasing audit activities in cases where people may try to conceal income and assets offshore, particularly in low tax and bank secrecy jurisdictions. It is important for people to take early advantage of OVDI benefits as these benefits will not be available after notification of an audit.

The Tax Office has announced it is working closely with AUSTRAC, banks and other overseas tax jurisdictions to identify people with undeclared income, including those with highly complex and sophisticated arrangements.

Further, the Tax Office is constantly expanding its ability to trace fund flows around the world and its capacity to identify Australians with income and assets hidden offshore. If you have any concerns about undeclared offshore income, contact us to discuss your options.

## **ATO Reforms to Income Tests**

### **Letters sent to 240,000 individuals**

From 1 July 2009, new laws came into effect to change the income tests used by the Tax Office and other government agencies. These changes do not affect an individual's assessable or taxable income. However, they do affect the income tests for a range of government benefits and obligations. During the first half of December 2009, the ATO wrote directly to around 240,000 taxpayers whose latest income tax return suggests that they could be directly affected by the new income tests. The letters describe the new income tests, what the taxpayer can do and where to seek more information. Please visit <http://ato.gov.au/individuals/pathway.asp?pc=001/002/069> for more information.

## **Recent Tax Rulings**

Below are some recent tax rulings and cases of interest and potential amazement. One is often bewildered by how far some take their objections.

### **Is it really a rental property?**

With summer coming on and many clients taking a rental position with "business" beach houses they would do well to take note of the ATO's view around effort expended to achieve rental income.

The Tribunal has held a taxpayer was not entitled to rental property deductions in relation to a property which remained unrented for 3 years. This was on the basis the taxpayer had not taken sufficient steps to advertise that the property was available for rent.

The taxpayer erected a sign on the property advertising its availability for rent. He did not list the property with a real estate agent because of privacy concerns. 3 years later he contacted a real estate agent to confirm the property's market rent. The taxpayer claimed interest and rental deductions for 3 years.

To be entitled to rental property deductions, clients should be advised to do everything necessary to ensure the property is available for rent. This may include advertising to the public in the newspaper, listing the property with a real estate agent, erecting a sign and actively encouraging tenants to rent the property.

It may be a tough call but nevertheless it makes a strong point. Just saying it's available is rarely enough.

### **Don't educate yourself too early!**

The taxpayer was studying for a Masters of Applied Commerce in Accounting when she obtained full-time employment as an accounts manager and personal assistant. She later worked part time to complete her studies as well as to undertake a Graduate



CRM Business Advisors Pty Ltd

## Tax Talk – December/January 2010

In this issue:

- Unprofitable Businesses – Deductible?
- Economic Focus 2010 – The Year Ahead
- Undeclared Offshore Income – Come Clean
- ATO Income Test Changes and Tax Rulings

[www.crmbusinessadvisors.com.au](http://www.crmbusinessadvisors.com.au)

### Certificate of Wealth Management.

She later claimed a deduction for self-education expenses on the basis her studies improved her skills and knowledge of accounting practice and superannuation.

The Tribunal held the taxpayer's studies were not a requirement of her employment, were not a significant factor in gaining employment and did not lead to any increase of income. The costs were incurred rather to obtain additional qualifications to enable the taxpayer to obtain different and more highly paid employment.

Therefore, it did not have the necessary connection with the taxpayer's current income earning activity as an accounts manager and personal assistant.

The course should also be a requirement of the taxpayer's employment and should be undertaken at the time or after the commencement of employment.

### Tax-Free Distributions to Shareholders

Take the case of Mr Borg, a Div 7A (Tax-Free Distributions to Shareholders) case!

The Tax Office made serious allegations against a scaffold hire business owner, Mr Doherty, and his company. The company claimed to have hired equipment from a Mr Borg, and that it had paid him cash. The company claimed a deduction for the amounts paid to Mr Borg.

The Tax Office alleged Mr Borg did not exist. The company produced a spreadsheet which supported the payments made to Mr Borg. Mr Borg was not present to support his existence.

The Tribunal found that Mr Borg did not exist, and that Mr Borg was actually Mr Doherty.

The company and Mr Doherty therefore appealed to the Full Federal Court.

The Court found all that was required to establish Division 7A applied was evidence that Mr Doherty received the money, and that he was a shareholder of the company. This evidence was clearly available, and it was sufficient to support the application of Division 7A.

## Happy 2010

The team at CRM Business Advisors hope you had a fabulous Christmas and New Year break and we wish you the very best for the year to come.

Please contact us if we can help you with any aspect of your tax, superannuation or business and investment situation.