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SMSF lends money to related company, pays 45% tax

The Administrative Appeals Tribunal has upheld the decision of the Tax Office (ATO) to make a self-managed superannuation fund (or 'SMSF') 'non-complying' when it breached the investment rules applying to SMSFs.

Editor: For SMSFs to access the concessional tax treatment that superannuation offers (such as the 15% tax rate), funds must be 'complying' funds. That is, the funds must comply with the superannuation law, including the restrictions on what they can invest in.

*If a previously complying fund is made 'non-complying' by the ATO, it may need to include the **full market value** of its assets in its income that year and it is all taxed at 45% (in that year and all future years the fund remains non-complying).*

Facts

In the 2004/05 income year, the SMSF (the 'Fund') made loans to a company which was a related party of the Fund.

Editor: Under the investment restrictions in the superannuation law, a loan to a related party is considered an 'in-house asset', and an SMSF is limited to basically having no more than 5% of its assets as in-house assets.

The trustee's actions resulted in the fund lending almost all of its assets to the related party, above 95% – well beyond the allowed 5%.

On 23 July 2007, the Fund's auditor lodged a contravention report with the ATO advising the Fund had contravened the in-house asset rules.

The ATO consequently issued a non-compliance notice in respect of the Fund, and the trustees appealed the decision to the Tribunal.

They argued that the Fund should still be treated as complying despite the contravention of the in-house asset rules, due to other factors, such as the declining fortunes of their business operations at the time, the chronic illness of one of the trustees (who was also the company manager), and the Queensland cyclones in 2004 and 2005.

Reasons for Decision

The Tribunal considered:

- ◆ the taxation consequences arising from treating the Fund as non-complying;
- ◆ the seriousness of the contravention (the Tribunal member considered the contravention very serious, and stated "I doubt that the (trustees) even now appreciate its seriousness"); and
- ◆ all other relevant circumstances.

However, the Tribunal held that "it was the correct decision to issue the notice of non-compliance."

The seriousness of the contravention, and the length of time taken to redress it, "weighed most heavily" against treating the Fund as complying despite the contravention of the Act.

Editor: Before issuing the non-compliance notice, the ATO rejected two repayment arrangements the trustees put forward because the timeframes were too long. Had they been able to rectify the breach in a more timely fashion, the Fund may not have been made non-complying.

Government's "tax break": Hire purchase agreements

Editor: The small business and general business tax break (also known as the 'tax break' or 'investment allowance') was originally announced by the Government on 12 December 2008 but went through a number of changes before the legislation was passed.

It basically gives small businesses a bonus deduction of 50% (30% or 10% for other businesses) for depreciating assets acquired between 13 December 2008 and 31 December 2009.

If a taxpayer wishes to claim the tax break in respect of an asset they are acquiring under a hire purchase arrangement, it is the date of the hire purchase contract that is the relevant date for establishing eligibility for the tax break, and not the time any purchase order for the asset is placed with the supplier.

For example, if a taxpayer placed an order with a supplier in August 2008 for a new depreciating asset, but did not enter into the hire purchase agreement with the financier until the asset was delivered in April 2009, then the relevant date for establishing eligibility for the tax break is April 2009, *not* August 2008.

ATO: Be careful when claiming losses on shares

The ATO recognises that the global economic downturn has decreased the value of many people's investments over the past year, and that some taxpayers may be 'confused' about the difference between capital losses (share holding) and revenue losses (share trading).

They remind taxpayers that the taxation of their investments in prior years is relevant when working out the treatment of a loss in the current year, so if there has been minimal change in the nature of their investment activity, it is likely that the same tax treatment applies in the current year.

For example, if a taxpayer has previously sold shares and claimed the 50% CGT discount, and has then realised a loss in the current year, they would be expected to claim this as a capital loss.

Taxpayers who seek to reclassify their activities may be asked to provide evidence that demonstrates a change in the nature of their activities or that they have declared their income incorrectly in the past.

Changes to the taxation of foreign employment income

From 1 July 2009, most income earned by an Australian resident individual from continuous foreign service of more than 90 days will no longer be exempt from income tax (although some income that relates to certain development projects, and charitable or government activities will continue to be exempt).

This means that:

- Foreign earnings will generally be assessable income and subject to PAYG withholding requirements.
- The foreign earnings will need to be included in the employee's income tax return, and they may be entitled to a foreign income tax offset for amounts of foreign tax paid.

Reduction of PAYG withholding amounts to take foreign tax into account

Where an employee's foreign earnings are not exempt from tax in Australia, the employer should reduce the amount of Australian tax that would normally be withheld by the Australian dollar equivalent of the amount of tax to be withheld and paid to the foreign country (and if the resulting Australian withholding amount is zero or negative, there is no amount to withhold).

FBT and changes to foreign employment income

In addition, employers with employees working in a foreign country may also need to reconsider their FBT liability from 1 July 2009, since fringe benefits provided to employees whose foreign employment income is *not* exempt may be subject to FBT.

Resident minors' effective 2009/10 tax-free threshold

The increase in the low-income tax offset to \$1,350 for 2009/10 (from \$1,200 in 2008/09) effectively means that \$3,000 can be distributed to minors tax-free in the 2009/10 year.

Ordinarily, and excluding the offset, once a minor's income exceeds \$1,307, the entire amount is taxed at 45%.

However, applying the low-income tax offset of \$1,350 means that no income tax will be payable until the minor's taxable income exceeds \$3,000, i.e., \$1,350 divided by 0.45 = \$3,000.

Please Note: Many of the comments in this publication are general in nature and anyone intending to apply the information to practical circumstances should seek professional advice to independently verify their interpretation and the information's applicability to their particular circumstances.