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# TNR BUSINESS NEWS

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## INSIDE THIS EDITION …



## Tips and Traps for SMSFs Investing in Property

Many SMSF trustees contemplate investing in real property as part of the fund's investment strategy. However a recent Tax Office notification raised its concerns that some trustees may not fully consider the risks and issues associated with holding a real property investment and how this can affect other aspects of the fund, such as benefit payments.


The Tax Office's notification alerted trustees to consider the following issues.

### INVESTMENT STRATEGY

Trustees are required to invest in accordance with the investment strategy of the fund, including giving regard to liquidity. When deciding whether to invest in property, trustees should consider if this meets the diversification and liquidity requirements of their fund. For example, when members retire and start receiving pensions, there needs to be sufficient money in the fund to meet minimum pension payment requirements.

### BORROWING

Superannuation law allows a fund to borrow only in limited circumstances.

When an SMSF borrows money to invest in property, it needs to do so via a limited recourse borrowing arrangement (LRBA). These borrowings need to be made on commercial terms to avoid adverse income tax consequences, such as income being deemed non-arm's length income that would attract non-concessional tax rates.

### RELATED PARTY TRANSACTIONS

In the case of the property being leased to a related party, trustees need to ensure compliance with the super laws, such as:

- In-house asset rules;
- Sole purpose test; and
- Arm's length requirements.

### USE OF PROPERTY IN RETIREMENT

When an SMSF starts to pay a pension, all property investments must continue to be maintained in accordance with super laws, in particular the sole purpose test and in-house asset rules. For example, members are not able to occupy or lease residential property on retirement without the asset first being sold or transferred to the member(s) as a benefit payment. Trustees need to keep in mind that the transfer of any asset from an SMSF to a member must also be permitted under the governing rules of the fund and that a capital gains tax (CGT) event may occur, with possible taxation implications for the fund.


### OFFSHORE INVESTMENTS

The Tax Office warns that the risks and issues that are associated with property investments may be heightened when these investments are located in an offshore jurisdiction.

The Tax Office notification says that there is no specific guidance, other than the rules of the superannuation laws as to what trustees can investment in regarding to real property, and also emphasised that it is not its role to provide investment advice.


It is important to be mindful that the trustees of any SMSF are ultimately responsible for managing the super fund, so appropriate research and scrutiny should be applied when making investment decisions. The Tax Office encourages trustees to seek professional advice.

### INSURANCE

SMSF trustees also need to seriously consider insurance for their fund to cover unforseen events. This cover can include:

- General insurance - trustees should ensure they have adequate insurance to cover property repair or replacement costs in the event that the property is damaged.
- Third-party liability insurance - trustees should be aware that as a property owner, the fund can be sued. This may put the fund's assets at risk.
- Death or total and permanent disability insurance - trustees should consider the benefit of policy proceeds to assist in meeting ongoing obligations, including where the property is business real property used in a family business.

## The Taxation Implications of "Debt Forgiveness"


"Pardon" is a word that can sound somewhat archaic – which could be why the term "debt forgiveness" is barely mentioned in discussions on "bankruptcy", even though the two concepts are related. Bankruptcy is dramatic, Hollywood; debt forgiveness seems dated, even mildly medieval.

In reality, debt forgiveness, on the face of it, is a means by which commercial debts are wiped away, at least in part. In Australia debt forgiveness protocols are designed to help entities that cannot pay all of their loans, restructure so they can repay as much as possible. Often, but not always, debt forgiveness is a precursor to or a result of bankruptcy.

Tax considerations go along with any forgiven debt. They don't disappear. Tax law has mechanisms to make sure people who have bad debts forgiven still honour their tax obligations to the revenue and can't manipulate the system to get an unfair advantage. So an important take away point is that entities that have debts pardoned will generally see a commensurate decrease in their future tax breaks.

Debt forgiveness provisions exist to help curb hairy bookkeeping and arbitrage opportunities as a result of bad debts. Debt forgiveness would typically provide the creditor with a revenue loss (or in some cases, a capital loss). Meanwhile in the absence of debt forgiveness rules, the debtor may not have been assessed on any gain, and could continue to claim deductions for revenue and capital losses, as well as other deductible costs.

This kind of situation could constitute a doubling-up of tax breaks between the two taxpayers. So the commercial debt forgiveness provisions take aim at duplications by applying the forgiven amount with a view to reducing certain future deductions.

### The Nitty-Gritty

The legislation lists a few "circumstances" under which debts may be forgiven:

- The creditor's obligation to pay the debt (or part of it) is released, waived, or otherwise extinguished other than by repayment in full;
- The debtor loses its right to sue for recovery of the debt because of the operation of a statute of limitations;
- The creditor enters into an arrangement with the debtor, where the obligation to pay the debt ends at a mutually agreed time and the creditor pays only a token amount, if anything;
- "Debt parking" occurs (certain assignments to third parties); and
- A subscription for shares occurs to enable the debtor to discharge some or all of the debt with the subscription monies.

**DIVISION 7A**

Division 7A is one of the many sizeable banners that come within the ambit of the debt forgiveness rules. This is because a forgiven debt could be deemed to be a dividend paid to a shareholder (and therefore, taxable), unless certain conditions are met. It applies to debts forgiven on or after 4 December 1997, being the date Division 7A took effect.

### How do the Commercial Debt Forgiveness Rules Work?

A commercial debt is defined as a debt in respect of which interest, (or amounts akin to interest), if it was paid or payable in respect of the debt, would be deductible.


The debtor's "net forgiven amount" can be calculated using a simple equation. Gross forgiven amount of the debt, less:

- Amounts included in assessable income as a result of the forgiveness;
- Reductions in allowable deductions as a result of the forgiveness; and
- Reductions in cost bases of CGT assets as a result of the forgiveness;

= net forgiven amount of the debt.

Where the debtor and creditor are companies under common ownership, the debtor's net forgiven amount can be reduced to the extent that the creditor agrees to forego their revenue deduction or capital loss arising from the debt forgiveness.

The total net forgiven amount is then applied successively to:

- Carry forward tax losses and capital losses;
- Tax written down values of depreciating assets, and balances of the amounts deductible over time; and
- Reduce cost bases of CGT assets.

Once all of these amounts are reduced to nil, any remaining net forgiven amount simply disappears forever.

As with CGT, market value rules may apply to determine consideration in respect of the forgiveness of a "non-money" debt. Specific rules also apply to determine consideration for the purposes of the debt forgiveness provisions where debt parking applies or where there is a debt for equity swap.

### EXCLUSIONS TO DEBT FORGIVENESS PROVISIONS

Debt forgiveness provisions do not apply to debts forgiven:

- If the debt waiver constitutes a fringe benefit;
- If the amount of the debt has been, or will be, included in the assessable income of the debtor:
- Under an act relating to bankruptcy;
- Where forgiveness is affected by will; or
- For reasons of natural love and affection.

There are other exclusions to be mindful of as well, such as where the forgiven debt can be seen to be in respect of employment. In these cases, the benefit of being forgiven a debt will typically constitute a fringe benefit, and be taxed as such. Exclusions may also apply if the forgiven amount sees it included in the assessable income of the debtor. This can happen (as detailed above) where a private company is deemed to have paid a dividend (under Division 7A) where a debt owed to the company is forgiven.

There are even situations where the forgiven debt gives rise to ordinary income. For example this can occur when a taxpayer's resulting gain from a released debt deemed to have arisen from the ordinary activities of the taxpayer, or it otherwise displays generally accepted characteristics of ordinary income (such as if such gains are periodic, recurrent and/or expected).


A few years ago taxpayers saw an unprecedented result out of the global financial crisis – a huge increase in the number of loans written off or compromised. Forgiveness in those circumstances may not be so prevalent now, but it's important taxpayers remain conscious of the broad definitions of "forgiveness" listed in tax law. Making sure the consequences of a forgiveness is understood before it takes place – in no small part by consulting the myriad of laws on the subject – is vital, and don't forget that the creditor will also have vested interests in the details of the arrangement as they will bear tax consequences too.

## Employee or Contractor? 12 Common Myths

The Tax Office says that it has encountered several myths and assumptions adopted by both workers and employers when it comes to trying to decide the tax status of a job appointment. It found that employers continually rely upon some inaccurate factors when making distinctions about what makes a worker an employee or contractor — and therefore the tax treatment that applies in these cases.

Here are 12 common myths the Tax Office says can often get both businesses and workers into hot water.

### 1. Having an Australian business number (ABN)

**Myth**: If a worker has an ABN they are a contractor.

**Fact**: Just because a worker has an ABN does not mean they will be a contractor for every job. Whether the worker has or quotes an ABN makes no difference and will not change the worker into a contractor. To determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed.

### 2. Common industry practice

**Myth**: "Everyone in my industry takes on workers as contractors, so my business should too."

**Fact**: Just because "everyone" in an industry uses contractors does not mean they're correct. Don't use "common industry practice" to make determinations.

### 3. Short-term work

**Myth**: Employees cannot be used for short jobs or to get extra work done during busy periods.

**Fact**: The length of a job (short or long duration) or regularity of work makes no difference to whether a worker is an employee or contractor. Both employees and contractors can be used for:

- Casual, temporary, on call and infrequent work;
- Busy periods; or
- Short jobs, specific tasks and projects.

To determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed.

### 4. The 80% rule

**Myth**: A worker cannot work more than 80% of their time for one business if they want to be considered a contractor.

**Fact**: The 80% rule, or 80/20 rule as it is sometimes called, relates to personal services income (PSI) and how a contractor:

- Reports their income in their own tax return; and
- Determines if they can claim some business-like deductions.

It is not a factor a business should consider when they determine whether a worker is an employee or contractor.

### 5. Past use of contractors

**Myth**: "My business has always used contractors, so we do not need to check whether new workers are employees or contractors."

**Fact**: Before engaging a new worker (and entering into any agreement or contract), a business should always check whether the worker is an employee or contractor by examining the working arrangement. Unless a working arrangement (including the specific terms and conditions under which the work is performed) are identical to previous arrangements, it could change the outcome of whether the worker is an employee or contractor.

Sometimes a business may also have incorrectly determined their worker is a contractor. Continuing to rely on the original "contractor" decision would mean the business is incorrectly treating all future workers as contractors when they are employees.

### 6. Registered business name

**Myth**: If a worker has a registered business name, they are a contractor.

**Fact**: Having a registered business name makes no difference to whether a worker should be an employee or contractor for a particular job. Just because a worker has registered their business name, does not mean they will be a contractor for every job or working arrangement.

### 7. Contracting on different jobs

**Myth**: If a worker is a contractor for one job, they will be a contractor for all jobs.

**Fact**: If a worker is a contractor for one job, it does not guarantee they will be a contractor for every job, The working arrangement and specific terms and conditions under which the work is performed will determine whether a worker is an employee or contractor for each job.

Depending on the working arrangement, a worker could be an:

- Employee for one job and a contractor for the next job; and
- Employee and a contractor if completing two jobs at the same time for different businesses.

## 8. Paying super


**Myth**: "My business should only take on contractors so we do not have to worry about super."

**Fact**: A business always needs to look at the working arrangement and examine the specific terms and conditions under which the work is performed to determine whether a worker is an employee or contractor. A business cannot decide to treat a worker as a contractor when they are an employee.

Additionally, businesses may be required to pay super for their contractors. If you pay an individual contractor under a contract that is wholly or principally for the labour of the person, you have to pay super contributions for them.

## 9. Specialist skills or qualifications

**Myth**: Workers used for their specialist skills or qualifications should be engaged as contractors.

**Fact**: If a business takes on a worker for their specialist skills or qualifications it does not automatically mean they are a contractor. A worker with specialist skills or qualifications can either be an employee or contractor depending on the terms and conditions under which the work is performed. Qualifications or the level of skill a worker has (including whether they are "blue" or "white" collar) makes no difference to whether a worker is an employee or contractor.

## 10. Worker wants to be a contractor

**Myth**: "My worker wants to be a contractor, so my business should take them on as a contractor."

**Fact**: Just because a worker has a preference to work as a contractor does not mean your business should engage them as such, Whether a worker is an employee or contractor is not a matter of choice, but depends entirely on the working arrangement and the specific terms and conditions under which the work is done.

If you give into pressure and agree to treat an employee as a contractor, you can face penalties, interest and charges for not meeting your tax and super obligations.

## 11. Using invoices

**Myth**: "If a worker submits an invoice for their work, they are a contractor."

**Fact**: Submitting an invoice for work done or being "paid on invoice" does not automatically make a worker a contractor.

To determine whether a worker is an employee or contractor, you need to look at the whole working arrangement and examine the specific terms and conditions under which the work is performed. If based on the working arrangement a worker is an employee, submitting an invoice or being paid on the basis of an invoice will not change the worker into a contractor.

## 12. Contracts

**Myth**: "If a worker's contract has a section that says they are a contractor, then legally they are a contractor."

**Fact**: If a worker is legally an employee, a contract saying the worker is a contractor will not make the worker a contractor at law. Businesses and workers will sometimes include specific words in a written contract to say that the working arrangement is contracting in the mistaken belief that this will make the worker (who is an employee) a contractor at law.

If a worker is legally an employee, a contract specifying the worker is a contractor makes no difference and will not:

- Override the employment relationship or change the worker into a contractor; or
- Change the PAYG withholding and super obligations a business is required to meet.

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If you have any questions or would like to discuss this newsletter, please do not hesitate to contact TNR:

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