The taxman knows your secrets

Take steps now to end up on the good side of officials

JAMES GERRARD

END OF FINANCIAL YEAR
TAX SPECIAL

As we head towards the end of another financial year we move closer to entering tax season, where some will be rewarded with a refund while others will be disappointed with a "tax to pay" notice.

As an investor there is a lot you can do to make sure you fall into the more attractive category.

In terms of doing your personal tax return, keep in mind what you do and what the ATO may already know: over the years the ATO has built impressive technological capabilities to extend its tentacles into the deep and dark corners of your financial life.

Brian Balasekeran of accountants BDO in Brisbane says: "The ATO collects data from a wide range of sources and continues to refine a sophisticated set of tools to identify and investigate tax risk."

At present, the ATO has specific data about:

- Wages you earn;
- Interest and dividends you receive;
- Private health insurance details;
- Distributions from investments; and
- An idea of potential capital gains tax events.

What's more, many people don't realise the ATO also collects data about cars, horses, artwork, houses, boats, overseas transfers and receipts and other private assets you own.

ATO personnel feed this data into their risk matrix to understand if the incomes reported by taxpayers support the accumulation of the wealth required to own these assets and use this analysis as one tool in determining taxpayers to be reviewed.

So, let's be clear, the idea is to do your tax smartly and efficiently and to engage with the system as expertly as you can manage — nobody wants an ATO audit, which will be expensive, time-consuming and potentially damaging to your reputation.

Sydney accountant Timothy Ricardo of Ricardo Accounting says: "Check your occupation code. If certain occupations wouldn't have expenses that are being claimed at the extent that you're claiming them ... they are more likely to be audited if you mistakenly use the wrong occupation code."

Also, when claiming any tax deduction, be aware of the golden rules of deductions.

First, have receipts (substantiation), make sure you have incurred the expense and it hasn't been reimbursed and, second, make sure the deduction has a link with an income-earning activity ... that's what the ATO looks at when they're auditing you.

No doubt you are already familiar with the basics of a good tax return, but I might add a few other items to your initial checklist.

- Claim everything you are entitled to — don't forget any legitimate receipt or expense you have collected through the year;
- Don't bother testing the ATO patience on items that we know are rejected in almost every situation. This would include clothing expenses for work (very rarely allowed) or travelling expenses related to investment property (this one-time allowance has been gone for nearly two years); and
- Keep the accounts for personal income and your self managed super fund entirely separate. (For more on SMSF tax returns, see Monica Rule on page 31.)

Resident tax rates 2018-19

Taxable income	Tax on this income
0-$18,200	Nil
$18,201-$37,000	19¢ for each $1 over $18,200
$37,001-$90,000	$3572 plus 32.5¢ for each $1 over $37,000
$90,001-$180,000	$20,797 plus 37¢ for each $1 over $90,000
$180,001 and over	$54,097 plus 45¢ for each $1 over $180,000

Source: Tax Office

In terms of when is best to lodge your tax return, taxpayers must lodge their return by October 31 each year unless they are represented by a tax agent.

They then generally have until May 15 in the following year to complete their return.

However, lodgement before February will mean any tax is due for payment by March 21 whereas lodgement in April or May will mean a June 5 payment date. Balasekeran says: "We recommend lodging early only where tax refunds are owed to you or where the total tax payable is lower than previous years." (See The Coach on page 31 for more on lodging your accounts.)

Shares

For any diversified investor it might be sensible to take a look across your share portfolio to determine if there are stocks that no longer suit you.

With two weeks to go, there is still enough time to make some last-minute adjustments.

Balasekeran at BDO says: "As June 30 comes up, a common tax planning concept is to consider any stocks that are currently trading below cost and sell these to crystallise losses, which may then be used to offset other gains generated in the year."

The key thing to watch here is that such a sale does not constitute a "wash" sale, which refers to where investors sell a share trading at a loss and then buy it again shortly into the new financial year — this can be done to minimise capital gains but, beware, the ATO is cracking down on this and it can determine that the tax loss created by the manoeuvre be denied.

Balasekeran adds: "If an investment is sold in June it needs to be demonstrated that there has been a search across all investments for a suitable replacement given the investor's goals, risk tolerance and assessment of market opportunities. If after that search the stock that was sold in June appears to be the best opportunity to buy, you are more likely to avoid 'wash sale' problems with the ATO."

Property

If you have an investment property of any description there are always opportunities to grab by the end of the financial year.

The recent federal election outcome was a useful development since the ALP had a long menu of tax changes that were planned for property.

However, there has still been a gradual windback in recent years of property-related deductions.

The ATO has shown a keen interest in making sure property owners are only claiming legitimate expenses against rental properties in their tax returns. A recent audit showed nine out of 10 taxpayers misunderstood the rules and made mistakes when claiming property-related tax deductions.

Balasekeran says: "Historically, we understand some of these errors are from taxpayers looking to push the boundaries of what is acceptable. The ATO is looking to cut down on inflated or fraudulent claims and this will be a key focus area by the ATO. Holiday homes that are not genuinely available for rent are in the spotlight. The ATO has seen many examples of properties that are advertised at above-market rates, with taxpayers claiming the home was advertised for rent but no one rented it, and claiming costs of ownership as a result. Also, the ATO are more likely to look at taxpayers where there is no apportionment for private use of the holiday home."

And, for all rental properties, the ATO takes a dim view on deductions claimed during periods the property is being renovated and not available for rent. For new investment property owners, be aware of claiming on initial repairs. If you buy a rental property and spend money restoring or renovating the property, those larger non-maintenance costs may be considered capital and add to the cost base. They are not allowed to be deducted against any rent derived in the year." (To read more on property tax returns, see Bradley Beer on page 31.)

Another area that escaped a bullet this year with the failure of the ALP to get its ambitious agenda across the line is trusts.

Nonetheless, trust structures are another area of interest for the ATO this coming tax season. The ATO is currently undertaking test cases of an old but underused anti-avoidance provision in relation to trust distributions.

Put simply, the risk arises where a trust declares a distribution to an individual but the cash representing the distribution is not actually distributed to the individual — simply, where low-income adult children or other non-working beneficiaries are declared trust distributions on paper, but never receive the money.

> Nobody wants an ATO audit, which will be expensive, time-consuming and potentially damaging

To mitigate the potential risk, you might consider implementing one or more of the following to evidence that a relevant beneficiary has true entitlement to their trust distribution in cash:

1: Transfer the cash distribution to the individual's bank account for their use;

2: Pay the individual's expenses directly from the trust's bank account; and

3: Pay the individual's expenses from another beneficiary's bank account and keep a clear record of such expenditure.

If you fall foul of the trust rule and the Australian Taxation Office applies the anti-avoidance provision, the distribution may be taxed at the highest marginal tax rate instead of the marginal tax rate of the beneficiary to whom the distribution was made.

Life insurance

One last thing: almost every financial adviser has one big headache this year and it is in relation to life insurance — specifically, life insurance that investors rely upon inside a large super fund such as a retail fund or industry fund.

There has been a major effort to clean up this area and a genuine attempt to halt fees on inactive accounts through what is called the "protecting your super" program. There is a risk that investors lose their life insurance.

The problem centres on inactive accounts — defined as a super account that has not had a contribution for 16 consecutive months and has less than $6000 in funds inside the account.

To stop pension fund managers clipping fees on these accounts, there is a push by the government to close down inactive accounts — the plan is to send inactive accounts over to the ATO to manage from July 1.

The issue is if you have an inactive account and you use it for life insurance, you absolutely must review your situation — either reactivate that account by putting in a contribution of any amount, or close the account down and sign up to a new provider for your life insurance.

All the major super funds are sending out correspondence on this issue, but there are always those who have changed address or changed email or simply do not read this sort of correspondence.

For any investor who might be exposed here, if your inactive account is to be closed, make a move.

Either make a contribution or log into your account and tell the fund you want to "keep my insurance" cover. Do it before July 1 ... you have been warned.

James Gerrard is the principal and director of Sydney financial planning firm www.FinancialAdvisor.com.au

How funds offer a smarter way to donate

RACHEL ROFE

If you're a high-income earner, you might be one of a growing force turning your post-election euphoria into philanthropic goodwill.

Having avoided Labor's proposed tax changes, generous Australians are looking for smart ways to share their good fortune via tax-deductible donations, and they are getting more structured about it.

More donors than ever are doing away with chequebook charity and instead donating their money into tax-efficient giving vehicles known as ancillary funds.

Ancillary funds are charitable foundations that distribute money to charity.

They attract donors who have a need for both a tax deduction and that most elusive of resources, time. You get an immediate tax deduction for the amount you donate, but also the flexibility to distribute the funds to charity later.

While you think about which charities to support, the balance is invested, and returns are tax-free, offering a style of giving that allows you to both give and grow money for charity.

Australia has two types of ancillary funds — private and public. A private ancillary fund demands a considerable investment: you need to donate at least $1 million to warrant your own private ancillary fund, and as trustee you are responsible for the fund's investment, compliance and administration.

By contrast, a public ancillary fund is a communal philanthropic structure, the public offer fund for giving. You join by establishing your own giving account, your sub-fund, with a donation starting from $20,000 (depending on the sub-fund provider).

The sub-fund acts like your own charitable giving account that sits within the larger charitable foundation. A trustee manages all the fund's operations, leaving you to simply focus on the giving, without the hassle of administration.

Swinburne University research shows that sub-funds now outnumber private ancillary funds, with more than $123m donated into sub-funds last financial year.

Chris Cuffe, the chairman and founder of the Australian Philanthropic Services Foundation, says the sub-funds are growing in popularity thanks to "accessibility, simplicity and flexibility".

Cuffe says: "You can establish a sub-fund from $20,000, meaning you don't need millions to take advantage of the benefits of structured giving. Your sub-fund donor is more likely to resemble your local business owner than Warren Buffett."

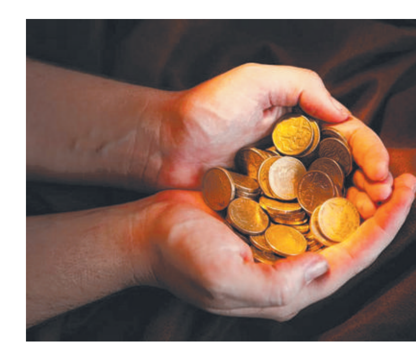
With a relatively accessible entry point, it attracts donors who often have a need for a tax deduction now but value the flexibility to distribute the funds to charity later — for example, pre-retirees who want to continue the enjoyment of giving throughout retirement but need a tax deduction while still earning income, or taxpayers finding themselves with a spike in assessable income through the sale of a business or shares.

You can set up a sub-fund in one day by making a tax-deductible donation and the deduction can be claimed in full immediately or apportioned over five years to match your income. The amount you donate is allocated to your named sub-fund and it's from here that you recommend charities to receive at least 4 per cent of the balance each year.

Australia is on the cusp of the largest intergenerational wealth transfer in history and, with an estimated $3 trillion set to change hands, parents are concerned to inspire charitable values and perspective around wealth.

A sub-fund becomes a family conversation with the children and grandchildren about the difference they can make for those less fortunate.

Across Australia more than $57m was distributed to charities from sub-funds last financial year. Only charities with Item 1 deductible gift recipient status (DGR1) can receive a grant but with over 20,000 of them, lack of choice is unlikely to be a problem.



Charity is easier through a sub-fund

Sub-fund investment earnings are tax-free, and they receive a full franking credit refund, so there is potential to see the balance grow.

It's important to examine the investment credentials behind the public foundation. Certainly, along with becoming increasingly philanthropic potential donors are applying more scrutiny on issues such as fees and investment performance so they can maximise their charitable giving over time.

With the minimum distribution of 4 per cent, and fees starting from 1 per cent of total funds (depending on provider), growth will require an investment return of at least 5 per cent plus inflation. You can also top up your sub-fund with additional tax-deductible donations.

There is now over $1 billion held in sub-funds in Australia, compared to the $100bn held in the US equivalent.

Although Australians have traditionally given far less than their US counterparts, the ease and flexibility of a sub-fund make it a popular choice for people who want a smart way to give. And with June 30 just around the corner, now is the opportune time to start.

Rachel Rofe is manager of the APS Foundation at Australian Philanthropic Services.

www.australianphilanthropicservices.com.au