ATO Takes Gloves off on Overseas Income

Five years ago, the Australian Taxation Office (ATO) offered a penalty amnesty on undisclosed foreign income. Five years on, the ATO has again flagged that under-reporting of foreign income is an issue, but this time the gloves are off.

How you are taxed and what you are taxed on depends on your residency status for tax purposes. As tax residency can be different to general residency status, it is important to seek clarification. The residency tests do not necessarily work on "common sense". For tax purposes:

- **Australian resident** - taxed on worldwide income, including money earned overseas (such as employment income, director's fees, consulting fees, income from investments, rental income, and gains from the sale of assets);
- **Foreign resident** - taxed on Australian sourced income and some capital gains. Unlike Australian resident taxpayers, non-resident taxpayers pay tax on every dollar of taxable income earned in Australia starting at 32.5% although lower rates can apply to some investment income like interest and dividends. There is no tax-free threshold. Australian sourced income might include Australian rental income and income for work performed in Australia; and
- **Temporary resident** – generally, those who have come to work in Australia on a temporary visa and whose spouse is not a permanent resident or citizen of Australia. Temporary residents are taxed on Australian sourced income, but not on foreign sourced income. In addition, gains from non-Australian property are excluded from capital gains tax.

Just because you work outside of Australia for a period of time does not mean you are not a resident for tax purposes during that period. And for those with international investments, it is important to understand the tax status of earnings from those assets. Just because the asset might be located overseas does not mean they are safe from Australian tax law, even if the cash stays outside Australia. Do not assume that just because your foreign income has already been taxed overseas or qualifies for an exemption overseas that it is not taxable in Australia.

How Your Money is Being Tracked

A lot of Australians have international dealings in one form or another. The ATO's analysis shows China, the United Kingdom, Switzerland, Singapore and the United States are popular countries for Australians.

The ATO shares the data of foreign tax residents with over 65 foreign tax jurisdictions. This includes information on account holders, balances, interest and dividend payments, proceeds from the sale of assets, and other income. There is also data obtained from information exchange agreements with foreign jurisdictions.

In addition, the Australian Transaction Reporting and Analysis Centre (AUSTRAC) provides data to the ATO (and the Department of Human Services) on flows of money to identify individuals that are not declaring income or paying their tax.

It is not uncommon for taxpayers to forget to declare income from a foreign investment like a rental property or a business because they have had it for a long time and deal with it in the local jurisdiction with income earned "parked" in that country. However, problems occur when the taxpayer wants to bring that income to Australia, AUSTRAC or the ATO's data matching picks up on the transaction and then the taxpayer is contacted about the nature of the income. If the income is identifiable as taxable income (e.g. from a property sale or income from a business), you can expect the ATO to look very closely at the details with an assessment and potentially penalties and interest charges following not long after. There is no point telling the ATO the money is a gift if it was not; they can generally find the source of the transaction and will know it is not from a very generous grandmother - misdirection is only going to annoy them and ensure that there is no leniency.

What You Need to Declare in Your Tax Return

If you are an Australian resident, you need to declare all worldwide income in your tax return unless a specific exemption applies, although in some cases even exempt income needs to be reported. Income is anything you earn from:

- Employment (including consulting fees);
- Pensions, annuities and government payments;
- Business, partnership or trust income;
- Crowdfunding;
- The sharing economy (AirBnB, Uber, AirTasker, etc.);
- Foreign income (pensions and annuities, business income, employment income and consulting fees, assets and investment income, including offshore bank accounts, and capital gains on overseas assets);
- Some prizes and awards (including any gains you made if you won a prize and then sold it for a gain); and
- Some insurance or workers' compensation payments (generally for loss of income).

You do not need to declare prizes such as lotto or game show prizes, or ad hoc gifts.

Do I Need to Declare Money from Family Overseas?

A gift of money is generally not taxable, but there are limits to what is considered a gift and what is income. If the "gift" is from an entity (such as a distribution from a company or trust), if it is regular and supports your lifestyle, or is in exchange for your services, then the ATO may not consider this money to be a genuine gift.

I have Overseas Assets that I have not Declared

Your only two choices are to do nothing (and be prepared to face the full weight of the law) or work with the ATO to make a voluntary disclosure. Disclosing undeclared assets and income will often significantly reduce penalties and interest charges, particularly where the oversight is a genuine mistake.

How to Repatriate Income or Assets

Before moving funds out of an overseas account, company or trust it is important to ensure that you seek advice on the implications in Australia and the other country involved. This is a complex area, and the interaction between the tax laws of different countries requires careful consideration to avoid unexpected consequences.

If you need to clarify your residency status for tax purposes or are uncertain about the tax treatment of income, please contact us today.

Are all Your SMSF Eggs in One Basket?

The investment strategies of self-managed superannuation funds (SMSFs) are under scrutiny with the ATO contacting 17,700 trustees about a lack of asset diversity.

The ATO is concerned that "a lack of diversification or concentration risk, can expose the SMSF and its members to unnecessary risk if a significant investment fails."

This does not mean that you must have diversity in your fund. A lack of diversity might be a strategic decision by the trustees, but you need to be able to prove that the strategy was an active decision. Section 4.09 of the *Superannuation Industry (Supervision) Regulations* requires that trustees "formulate, review regularly and give effect to an investment strategy that has regard to the whole of the circumstances of the entity." To do that you need to:

- Recognise the risk involved in the investment, its objectives and the cash flow of the fund;
- Review the diversity of the investment strategy (or otherwise) and the exposure of a lack of diversity;
- Assess the liquidity of the investment and cashflow requirements of the fund;
- Assess the ability of the fund to discharge its liabilities; and
- Review and have in place appropriate insurance cover for members and assets.

Importantly, you need to be able to justify how you formulated your strategy if the ATO asks.

The 17,700 people being contacted by the ATO hold 90% or more of their fund's assets in a single asset or single asset class.

Property is one of the problem areas the ATO is looking at. With property prices at a low point, the asset value of many funds has diminished.

In addition, debt taken on by SMSFs has significantly increased. The number of SMSFs using Limited Recourse Borrowing Arrangements (LRBAs) to purchase property has increased significantly from 13,929 (or 2.9% of all SMSFs) in 2013, to 42,102 (or 8.9% of all SMSFs) in 2017. For SMSFs that have purchased property through LRBAs, on average these LRBAs represent 68% of total assets of the funds.

LRBAs are most common in SMSFs with a net fund size (i.e. total assets excluding the value of the amount borrowed) of between $200,000 and $500,000. In 2017 the average borrowing under an LRBA was $380,000 and the average value of assets was $768,600.

Rental Property Expenses – What You can and cannot Claim

It is not uncommon for landlords to be confused about what they can and cannot claim for their rental properties. What often seems to make perfect sense in the real world does not always make sense for the ATO.

In general, deductions can only be claimed if they were incurred in the period that you rented the property or during the period the property was genuinely available for rent. This means a tenant needs to be in the property or you are actively looking for a tenant. If, for example, you keep the property vacant while you are renovating it, then you might not be able to claim the expenses during the renovation period if it was not rented or available for rent during this time (there are some exceptions to this general rule). There needs to be a relationship between the money you make and the deductions you claim. Here are a few common problem areas:

Interest on Bank Loans

Only the interest on repayments for investment property loans and bank charges are deductible - not the actual loan itself. Also, if a loan facility is used for multiple purposes then only some of the interest expenses might be deductible. For example, if some of the loan is used to acquire or renovate a rental property, but further funds are drawn down to pay for a holiday then this is a mixed purpose loan and an apportionment needs to be undertaken.

Repairs or Maintenance?

Deductions claimed for repairs and maintenance are an area that the ATO is looking at very closely so it is important to understand the rules. An area of major confusion is the difference between repairs and maintenance, and capital works. While repairs and maintenance can often be claimed immediately, the deduction for capital works is generally spread over a number of years.

Repairs must relate directly to the wear and tear resulting from the property being rented out. This generally involves restoring a worn out or broken part – e.g. replacing damaged palings of a fence or fixing a broken toilet. The following expenses will not qualify as deductible repairs, but are capital works:

- Replacement of an entire asset (e.g. a complete fence, a new hot water system, oven, etc.); or
- Improvements and extensions where you are going beyond the work that is required to restore the property back to its former state.

Also remember that any repairs and maintenance undertaken to fix problems that existed at the time the property was purchased are not deductible, even if you did not find out about the problem until later.

The Sharing Economy

The deductions you can claim for "sharing" a room or an entire house are similar to rental properties. You can claim tax deductions for expenses such as the interest on your home loan, professional cleaning, fees charged by the facilitator, council rates, insurance, etc., but these deductions need to be in proportion to how much and how long you rent your home out. For example, if you rent your home for two months of the financial year, then you can only claim up to $^1/_6$ of expenses such as interest on your home loan as a deduction. This would need to be further reduced if you only rented out a specific portion of the home.

Friends, Family and Holiday Homes

If you have a rental property in a known holiday location, the ATO is likely to be looking closely at what you are claiming. If you rent out your holiday home you can only claim expenses for the property based on the time the property was rented out or genuinely available for rent and only if the property was not actually being used for private purposes at that time.

If you, friends or relatives use the property for free or at a reduced rent, it is unlikely to be genuinely available for rent and, as a result, this may reduce the deductions available. It is a tricky balance, particularly when you are only allowing friends or relatives to use the property in the down time when renting it out is unlikely.

A property is more likely to be considered unavailable if it is not advertised widely, is located somewhere unappealing or difficult to access, and the rental conditions - price, no children clause, references for short terms stays, etc. - make it unappealing and uncompetitive.

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The $11.1 Billion Small Business Tax Shortfall

Last month, the ATO released statistics showing small business is responsible for 12.5% ($11.1 billion) of the total estimated “tax gap”.

These new figures give visibility to tax compliance issues within the small business sector and indicate where we can expect ATO resources to be focussed now and in the future.

The tax gap estimates the difference between the tax collected and the amount that would have been collected if everyone was fully compliant with the law.

Australia’s small business community is doing comparatively well, with international figures showing gaps in this same sector of between 9% and 30%.

ATO Deputy Commissioner Deborah Jenkins says that some small businesses are making mistakes with their tax, but these are often unintentional errors which are easily fixed.

To combat these errors, the ATO have ramped up their visits to small businesses to monitor compliance and educate business operators on compliance expectations with the goal of reducing the black economy (estimated to be 64% of the total small business tax gap). The ATO plans to visit almost 10,000 businesses this financial year.

If the ATO turn up at your business, they may spot check how you are recording your sales and the records for the past day or so. They may also check payroll records to ensure that staff are on the books and superannuation entitlements are being met. If something does not look right in an initial assessment, it is likely the ATO will expand their enquiries to other elements of the business.

The ATO states that the three main drivers of the small business income tax gap are:

- Not declaring all income;
- Failing to account for the private use of business assets or funds; and
- Not sufficiently understanding tax obligations.

The small business tax gap estimate is based on a sample of 1,398 randomly selected businesses for the 2015/16 income year (around 0.03% of the small business population). The ATO are looking to expand that sample to 2,000 businesses. However, one of the criticisms of the tax gap analysis has been the size of the sample group, particularly given that ATO resources are allocated on a return on investment basis.

Tips to make your business ATO proof:

- Keep tax reporting up-to-date.
- Have systems in place to manage your business. Those systems should be set up correctly and you should be able to explain how those systems work.
- Keep payroll records up-to-date and accurate.
- Be able to explain and provide evidence that your invoicing or receipts system works correctly and is well maintained.