

# client alert | explanatory memorandum

October 2019

## CURRENCY:

This issue of **Client Alert** takes into account developments up to and including 23 September 2019.

## Small business income tax gap: ATO update

New figures released by the ATO estimate that almost 90% of income tax from small businesses is paid voluntarily or with little intervention from the ATO.

“This shows that the vast majority of small businesses in the tax system are trying to do the right thing,” Deputy Commissioner Deborah Jenkins said. “Considering how much small businesses have on their plate, we’re grateful for the level of work they put in to get their tax right.”

The ATO has estimated the 2015–2016 income tax gap for the small business sector to be approximately 12.5%, or \$11.1 billion, with over \$7 billion (or over 64% of the total value of the gap) being attributed to black economy behaviour. To measure this income tax gap, the ATO used findings from its random enquiry program to estimate the difference between what the ATO expected to collect, and what was actually collected for the given year. The ATO’s research program measures tax performance across all market segments, which helps to measure the effectiveness of the tax system.

Tax gap estimates are an important feature of the performance and accountability story of any modern tax authority. Small business tax gaps that have been released overseas range from 9% to 30%.

The ATO says that around 90% of small businesses use a registered tax professional to help them comply with their income tax obligations. “We recognise the important role that tax professionals have in helping small businesses get their tax right and we would not have been able to achieve this result without the support of our tax professionals”, Ms Jenkins said.

The ATO’s research shows a small percentage of businesses are deliberately avoiding their tax obligations, but by dollar value this adds up to a significant portion of the gap. This behaviour could be motivated by a desire to avoid tax, limit impacts on welfare payments, or to avoid law enforcement.

## The black economy

Since 1 July 2018, the ATO has coordinated an extensive program of work to tackle the black economy. This program of work includes a multi-faceted approach, addressing issues such as:

- deliberate under-reporting income and over-claiming expenses;
- ensuring businesses meet their employer obligations – so they don’t pay employees or contractors cash in hand, underpay wages, fail to withhold tax or fail to contribute to superannuation;
- addressing illegal phoenixing (deliberate liquidation and reforming of businesses to avoid obligations);
- preventing tax fraud;
- dealing with illicit tobacco, duty and excise evasion; and
- targeting intermediaries and agents who enable black economy behaviour.

Source: [www.ato.gov.au/Media-centre/Media-releases/ATO-reveals-almost-90--of-income-tax-paid-by-small-business-is-paid-voluntarily/](http://www.ato.gov.au/Media-centre/Media-releases/ATO-reveals-almost-90--of-income-tax-paid-by-small-business-is-paid-voluntarily/); [www.ato.gov.au/taxgap](http://www.ato.gov.au/taxgap).

## ATO sets its sights on undisclosed foreign income

Do your clients have any amounts of offshore income they haven’t declared to the ATO – perhaps interest from a foreign bank account? Even if it seems like a small amount, it must be declared. International data-sharing arrangements are making taxpayers’ overseas financial affairs increasingly transparent, so don’t let your clients get caught out.

The ATO is reminding taxpayers about their obligation to report foreign income, and it’s keen to emphasise that its techniques for detecting offshore amounts are becoming increasingly effective. Cross-border cooperation between different tax jurisdictions means Australians’ financial information is being shared more than ever before – increasing the odds of your clients’ affairs being uncovered by the ATO.

Failing to report foreign income can attract penalties and ATO scrutiny of a taxpayer’s broader tax affairs.

## How is foreign income taxed?

If your client is an Australian resident for tax purposes, they're taxed on their worldwide income. This means they must declare all foreign income sources in their return. You should ask them to consider whether they've earned any amounts from:

- investments held overseas, such as dividends, rental income from properties and interest from bank deposits;
- overseas pensions;
- overseas employment, including salary and directors' fees; and
- the sale of offshore assets (ie capital gains).

Remember, if someone has already paid tax on this kind of income overseas, they still need to declare it to the ATO. They may be able to claim an offset (subject to a certain limit if the claim exceeds \$1,000) for the tax already paid in order to prevent double taxation.

All foreign income figures must be converted to Australian dollars according to particular exchange rate rules, and amounts that were earned in countries that don't have an income year ending 30 June may need to be apportioned.

## Is your client a "resident"?

Your clients will only be subject to Australian tax on their foreign income if they are an Australian resident for tax purposes. If they are a non-resident, they will generally only pay tax on their Australian-sourced income.

Being an Australian resident for tax purposes is different to immigration concepts of residency, and nationality is generally not relevant. So even if your client isn't an Australian citizen or permanent resident, they could be a resident for tax purposes.

The main test for tax residency is whether someone "resides" in Australia. There's no single factor that determines whether this test is met. Instead, it requires a weighing up of all relevant circumstances, including things like the person's intentions, their family and living arrangements, business and employment ties, and so on.

However, even if someone doesn't currently "reside" in Australia for tax purposes, they may still be a resident for tax purposes under several alternative tests (including where both their "domicile" and permanent place of abode are maintained in Australia).

## Making a voluntary disclosure

If your client thinks they may have omitted some foreign income from a previous tax return, you can help them to make a voluntary disclosure to the ATO and arrange for them to pay any tax owed. Voluntary disclosures will often result in a reduction of the ATO penalties and interest that would otherwise apply – and the outcome is generally much more favourable if the disclosure is made before the ATO commences an audit of the taxpayer's affairs. Given the ATO's increased powers to detect offshore amounts, taxpayers with unreported income should think seriously about the benefits of proactive disclosure.

Source: [www.ato.gov.au/Media-centre/Media-releases/ATO-watching-for-foreign-income-this-Tax-Time/](http://www.ato.gov.au/Media-centre/Media-releases/ATO-watching-for-foreign-income-this-Tax-Time/);  
[www.ato.gov.au/individuals/income-and-deductions/income-you-must-declare/foreign-income/](http://www.ato.gov.au/individuals/income-and-deductions/income-you-must-declare/foreign-income/).

## ATO announces "Better as Usual" program to improve your experience

ATO Commissioner Chris Jordan has announced the launch of "Better as Usual", a new ATO program aimed at improving the client experience with the tax system. In his opening remarks at the Council of Small Business Organisations Australia (COSBOA) National Small Business Summit in Melbourne on 29 August 2019, Mr Jordan said that "Better as Usual" includes the following four parts, to be led by Jeremy Hirschhorn, Second Commissioner of Client Engagement:

- *Whole-of-system experience*: the series of interactions (or the "pipeline") a client has with the ATO that forms their whole-of-system experience. This aspect seeks to address the frustration felt by some taxpayers who may see many faces of the ATO, and sometimes feel like they have to start all over again when dealing with a new ATO area or different people. Mr Jordan said the ATO is committed to ensuring that every time a client deals with it, the ATO understands the end-to-end experience the client has. This covers lodgment to disputes and debt management, and perhaps most importantly, extends to the particular client's lodgments and interactions in future years.
- *Quality of feedback loops*: in a number of objections or complaints there is a story – something that has gone a little bit off track or been misunderstood; a mistake rather than purposeful recklessness. By better understanding and documenting past experiences, the ATO believes it can make better decisions in the future. "We have to better distinguish between things getting off track and reckless indifference or blatant evasion", Mr Jordan said.

- *Complex cases team*: the ATO has created a dedicated team to work on the most complex cases. This team will be able to devote the time and the resources necessary to deal with “prickly and complicated” affairs that fall outside the ATO’s normal processes. Businesses that are “just struggling to survive” will be treated with more empathy than those purposefully not doing the right thing, Mr Jordan said.
- *Procedural and cultural safeguards*: these will be introduced to reduce (and ultimately eliminate) any cases where ATO mistakes could have a severe impact on the client. “We know this is something that is particularly needed in the small business market, and we will focus our initial efforts in this area”, Mr Jordan said.

Source: [www.ato.gov.au/Media-centre/Speeches/Commissioner/Commissioner-s-speech-to-COSBOA-Summit-2019/](http://www.ato.gov.au/Media-centre/Speeches/Commissioner/Commissioner-s-speech-to-COSBOA-Summit-2019/).

## Salary sacrificing loopholes: are you receiving your full benefits?

Salary sacrifice strategies are a great way to boost retirement savings. But unwelcome loopholes in the law mean some workers may be getting less than they bargained for. Fortunately, the government is taking action to fix this, but in the meantime salary-sacrificing workers should be across this issue to keep an eye on their arrangement and ensure they’re not being short-changed.

Most workers understand that their employer must make compulsory super guarantee (SG) contributions of 9.5% of their salary and wages. However, things get a little tricky when an employee chooses to salary sacrifice – and it could have unintended consequences.

Under current laws, employees who sacrifice some of their salary in return for additional super contributions may end up receiving less than they expected because of the following two legal loopholes:

- Employers may choose to count the salary sacrifice contributions they make towards satisfying their obligation to make minimum SG contributions of 9.5%.
- Additionally, employers may calculate their 9.5% contributions liability based on the employee’s reduced salary after deducting sacrificed amounts, rather than the pre-sacrifice salary.

The following example demonstrates how this can adversely affect a worker’s savings strategy:

### Example

Kayla earns \$100,000 per annum from her employer. This means she’s entitled to compulsory SG contributions of 9.5% of her \$100,000 salary (ie \$9,500). She therefore earns total remuneration of \$109,500.

Kayla now arranges to salary sacrifice \$10,000 of her salary as extra contributions, reducing her salary to \$90,000. But under current laws, her employer is now only required to make compulsory SG contributions of 9.5% of \$90,000 (not \$100,000); that is, \$8,550.

Another problem is that Kayla’s \$10,000 salary sacrifice contributions can count towards her employer’s obligation to pay SG contributions. She could receive only \$10,000 in total contributions plus \$90,000 salary (meaning total remuneration of \$100,000) and her employer wouldn’t be in breach of SG laws.

When Kayla entered this arrangement she was expecting to receive contributions of \$9,500 plus \$10,000, a total of \$19,500, while maintaining total remuneration of \$109,500 (ie \$90,000 salary plus \$19,500 contributions). Clearly, the current laws produce a bad outcome for Kayla.

These loopholes possibly exist because salary sacrificing was not a widespread strategy when the SG laws were written.

In practice, many employers aren’t taking advantage of the loopholes and are instead honouring the employee’s intended contributions strategy. However, evidence suggests some employers are applying the rules differently. They may even do this inadvertently through their payroll processes.

### A fix is on the way

Proposed new laws before Parliament will close the loopholes by requiring employers to pay compulsory SG contributions at 9.5% of the pre-sacrifice amount of salary (that is, the salary actually paid to the employee plus any sacrificed salary). Further, any salary sacrifice contributions will not count towards satisfying the employer’s obligation to make compulsory SG contributions.

### What should workers and employers do?

If passed, the proposed new laws will only apply to quarters beginning on or after 1 July 2020. All salary-sacrificing workers should check their arrangements now to ensure they’re receiving the full intended benefit of the arrangement. They may need to specifically check the amounts going into their fund.

Employers should also anticipate the passage of the proposed laws and ensure their payroll will be compliant from 1 July 2020.

Source: [www.aph.gov.au/Parliamentary\\_Business/Bills\\_Legislation/Bills\\_Search\\_Results/Result?bld=r6369](http://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bld=r6369); [www.ato.gov.au/General/New-legislation/In-detail/Super/Superannuation-Guarantee---Salary-sacrifice-integrity/](http://www.ato.gov.au/General/New-legislation/In-detail/Super/Superannuation-Guarantee---Salary-sacrifice-integrity/).

## **Claiming work trips for business owners**

Your clients who are business owners can deduct the cost of work trips they need to take for business. But what happens when they mix business with some hard-earned time for relaxation? Be ready to answer their questions about how major expenses like airfares and accommodation are treated when taking mixed-purpose business trips.

When a trip is clearly for business purposes only, the rules for deducting expenses are fairly straightforward. The taxpayer can claim airfares, taxis and car hire (and fuel). They can also deduct accommodation costs for overnight travel if the business requires them to be away from their permanent home overnight. Meals are also deductible when it is a requirement to be away overnight.

The following FAQs summarise the general tax treatment approach for more mixed-purpose situations; for example, when someone has planned a holiday to coincide with their work trip, or they also see the sights or catch up with family or friends while travelling for business.

### **Can I claim my full return airfares?**

What is the tax deductibility of airfares when you combine business and private travel? Let's assume you travel to London for a two-week trade show and stay a few extra days for sightseeing. The ATO says that if the primary purpose of the trip is for business, you can claim the whole cost of the return airfares as a business deduction, as well as related costs like travel to and from the airport. In this London example, the additional sightseeing is just incidental.

If you're undertaking a significantly longer holiday – so that the primary purpose of the trip is not just the business activity – you may need to apportion your airfares. And if the primary purpose is clearly private with some merely incidental work activities (eg you attend a half-day work event while you happen to be on an extended personal holiday), you generally couldn't deduct the airfares.

### **How is accommodation treated?**

Your deductions for accommodation are limited to those nights that you're required to be away for the business purpose. This will depend on the facts of your trip. In the London example, you couldn't deduct your accommodation costs for the few extra nights you stayed for sightseeing. (Similarly, any meals and transport around London would not be deductible for the days you spent sightseeing.) This is the case even though you could deduct your full airfares.

On the other hand, if you have to be away for an extended period and some days don't involve work activities, you may still be able to claim your full accommodation costs. The ATO gives the example of being interstate for two full weeks to complete a project on-site for a client. Your accommodation costs on the middle weekend (when you're not working at the client's site) would still be deductible. Of course, private weekend activities like sightseeing, entertainment and having dinner with friends would not be deductible.

### **What is definitely not deductible?**

The following expenses (among others) are not allowed as deductions:

- travel before you start carrying on your business;
- visas, passports and travel insurance; and
- the costs of bringing family members (eg a spouse) along with you.

### **Record-keeping requirements**

Sole traders and partners must keep a travel diary if they travel for six or more consecutive nights. This must detail each business activity undertaken, the location, the date and time it began and how long it lasted.

If your business is run through a company or trust structure, the ATO says it's not compulsory to keep a diary, but it's strongly recommended. And if you're a company, be careful about your business paying for any private part of your travel as this could have consequences under the Division 7A "deemed dividend" rules about benefits for shareholders and their associates.

## **Thinking about setting up an SMSF?**

For many people, SMSFs are a great option for building retirement savings, but they may not be suitable for everyone. The following sets out some of the important differences between SMSFs and other types of funds that your clients may need information about to help them make informed decisions about their super.

## **Management**

While public offer funds are managed by professional licensed trustees, SMSFs are considerably different because management responsibility lies with the members. Every SMSF member must be a trustee of the fund (or, if the trustee is a company, a director of that company).

This is an advantage for those who want full control over how their superannuation is invested and managed. However, it also means the members are responsible for complying with all superannuation laws and regulations – and administrative penalties can apply for non-compliance. Being an SMSF trustee therefore means you need to be prepared to seek the right professional advice when required.

If you intend to move overseas for some time (eg for a job posting), an SMSF could be problematic because it may be hit with significant tax penalties if the “central management and control” moves outside Australia.

On the other hand, members of public offer funds can move overseas without risking these penalties because their fund continues to be managed by a professional Australian trustee.

## **Costs**

Costs are a key factor for anyone considering their super options. Fees charged by public offer funds vary, but are generally charged as a percentage of the member’s account balance. Therefore, the higher your balance, the more fees you’ll pay. This is an important point to remember when weighing up a public offer fund against an SMSF.

SMSF costs tend to be more fixed. As well as establishment costs and an annual supervisory levy payable to the ATO, SMSFs must hire an independent auditor annually. Additionally, most SMSF trustees rely on some form of professional assistance, which may include accounting/taxation services, financial advice, administration services, actuarial certificates (in relation to pensions) and asset valuations.

These costs may be a more critical factor for those with modestly sized SMSFs. This year, a Productivity Commission inquiry found that larger SMSFs have consistently delivered higher net returns compared with smaller SMSFs, and that SMSFs with under \$500,000 in assets have relatively high expense ratios (on average). The Commission’s report has attracted some criticism that it has overstated the true costs of running an SMSF, but in any case, anyone considering an SMSF needs to think carefully about the running costs involved and make an informed decision about whether an SMSF is right for them. For members with modest balances, an SMSF will often be more expensive than a public offer fund, but this needs to be weighed up against the other benefits of an SMSF.

## **Investment flexibility**

A major benefit of an SMSF is that the member-trustees have full control over their investment choices. This means they can invest in specific assets, including direct property, that would not be possible in a public offer fund. For example, a business owner wishing to transfer their business premises into superannuation would need an SMSF to achieve this. SMSFs can also take advantage of gearing strategies by borrowing to buy property or even shares through a special “limited recourse” borrowing arrangement.

However, with control comes responsibility. SMSF trustees must create and regularly update an “investment strategy” that specifically addresses things like risk, liquidity and diversification. And of course, the SMSF’s investments must comply with all superannuation laws. In particular, transactions involving related parties (eg leases and acquisitions) can give rise to numerous compliance traps, so SMSF trustees must be prepared to seek advice when required.

## **Insurance**

It’s possible to hold various types of insurance through your superannuation fund, including death, total and permanent disablement (TPD) and temporary incapacity.

For many Australians, using superannuation benefits to pay insurance premiums makes insurance more accessible and convenient.

While you can purchase insurance within an SMSF, large funds can generally offer cheaper premiums because of the group discounts these funds can access. Another possible advantage of large funds is that members are automatically accepted for a certain level of coverage without needing a medical exam or detailed personal information, which is more likely to be required for an SMSF-held policy. For these reasons, some SMSF members choose to keep a separate account in a public offer fund just to access the insurance.

If you’re an SMSF trustee, you’re in charge, so there are a few things to keep in mind in relation to insurance:

- As part of your SMSF’s investment strategy, you’re required to consider (and regularly review) whether the fund should hold insurance cover for its members.

- Not every type of insurance can be held in superannuation. For example, trauma policies aren't allowed, and there are restrictions on some types of TPD policies. Seek professional advice before choosing your policies.
- You should also seek advice about the tax consequences of holding insurance in the fund, including deductibility of premiums and how life insurance proceeds might affect the taxation of your death benefits.

If you're a member of a public offer fund, it's important to check what insurance you're signed up to and assess whether you're getting value for money. Many members are signed up for insurance on a default (opt-out) basis, and may be unaware they're paying for duplicate policies across multiple accounts or unnecessary coverage as part of a bundled arrangement.

### **Dispute resolution**

What happens when you're not happy with the trustee of your fund? Perhaps your claim for benefits has been mishandled, or the trustee has made an error? Members of public offer funds can complain to the Australian Financial Complaints Authority (AFCA), a free dispute resolution service that has the power to make binding decisions in order to resolve your matter.

However, dispute resolution is an entirely different matter for SMSFs. SMSF trustees may complain to AFCA about financial services problems they encounter with third parties (eg an insurance company or bank), but AFCA cannot hear a complaint about the decision or conduct of an SMSF trustee. This means that SMSF members cannot complain to AFCA about decisions that the other trustees have made (and similarly, potential beneficiaries of a deceased member's death benefits cannot complain to AFCA about how the trustees have paid out the benefits).

In these cases, the parties would need to go through the legal system to resolve the matter. This could mean alternative dispute resolution, or even court, but it must be privately funded. The SMSF's governing rules may outline dispute resolution procedures that bind the trustees, so it's worth giving this some thought in advance to ensure the trustees are as prepared as possible for any disagreement.

#### **SMSF status will change if annual returns are lodged late**

The ATO has warned that from 1 October 2019, if an SMSF is more than two weeks overdue on any annual return lodgment due date, and hasn't requested a lodgment deferral, the ATO will change the SMSF's status on Super Fund Lookup (SFLU) to "Regulation details removed".

The ATO says it is taking this approach because non-lodgment of SMSF returns, combined with disengagement, indicates that retirement savings may be at risk. This status will remain until any overdue lodgments have been brought up to date.

The ATO also noted that having a status of "Regulation details removed" means APRA funds won't roll over any member benefits to the SMSF. In addition, employers won't make any super guarantee (SG) contribution payments to that SMSF.

*Source: [www.pc.gov.au/inquiries/completed/superannuation/assessment/report](http://www.pc.gov.au/inquiries/completed/superannuation/assessment/report); [www.ato.gov.au/Super/Self-managed-super-funds/Thinking-about-self-managed-super/](http://www.ato.gov.au/Super/Self-managed-super-funds/Thinking-about-self-managed-super/); [www.moneysmart.gov.au/superannuation-and-retirement/self-managed-super-fund-smsf](http://www.moneysmart.gov.au/superannuation-and-retirement/self-managed-super-fund-smsf).*

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