Key factors for rescuing a bad debt deduction

It is very often the case that unpaid debts owed to a business can have a significant impact on cash flow and the ongoing profitability of a business. In a taxation context the characterisation of a particular debt as either "doubtful" or "bad" is key as to whether or not the writing off of that debt would be deductible.

Contact Us

Welcome to our monthly newsletter. Feel free to pass it on or to contact us if it raises any questions you would like answered.

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Generally, the characterisation of a debt would be premised on the following principles:

- **Doubtful debt** – is a receivable amount that might eventuate to be a bad debt in future. Doubtful debt often represents a mere accounting provision and is not deductible for tax purposes for the current financial year but may evolve into a bad debt the following year.
- **Bad debt** – is a receivable amount that has been identified as not collectible and on being written off may well be deductible for tax purposes.

Written into the tax law are certain specific conditions that must be met in order to claim an income tax deduction

Key factors for rescuing a bad debt deduction *cont*

for bad debts written off by businesses. (Importantly, the businesses referred to are not in the business of money-lending, as money lenders can often claim a deduction for bad debts written off under the general business deduction rules as a non-capital loss necessarily incurred in the course of carrying on its business.)

In broad terms, for any other business to claim a bad debt deduction, the following requirements are posed:

1. The debt must be written off as bad during the year of income in which the deduction is claimed.
2. Except in the case of taxpayers in the business of lending money, the debt must have been brought to account by the taxpayer as assessable income.

In regard to the first requirement, it should be noted that there must be a physical writing off of the debt — not necessarily a book entry, but something in writing to indicate that the creditor has treated the debt as bad. It is not sufficient that the debt is written off when the accounts are completed after the close of the income year (in conformity with usual accounting practice) and merely relates back to the income year just closed.

Furthermore, the second requirement will not be satisfied by a taxpayer who lodges returns on a cash basis, because those debts will not have been brought to account as assessable income.

The key components of the ATO's views on the treatment of bad debts are:

- a debt must exist before it can be written off
- the question of whether a debt is bad is a matter of judgement having taken into account all relevant facts
- debt is written off as a bad debt in the year of income and deduction is claimed, and it is recommended that some form of written record is kept to evidence the decision to write off the debt
- the debt must be written-off before the financial year ends
- the amount of debt must previously have been included as assessable income.

As a matter of course, the Tax Commissioner will generally require a taxpayer to have taken appropriate steps to attempt to recover a debt, including the obtaining and enforcement of a judgement against the debtor and valuation of any securities held against the debt.

It should also be noted that, specifically for companies wanting to claim bad debt deductions, there is an additional requirement to comply with the so-called continuity of ownership test or same business test, which is also a prerequisite for the carrying forward and utilisation of company tax losses.

CASE STUDY

Ace Fitting Pty Ltd operates a business in industrial kitchen fitouts. The company provides kitchen fitouts to various cafes and restaurants. Ace acquired a new customer in August 2016. Ace quoted the job for $45,000 with an arrangement for payment upon completion of the job. The fitout of the kitchen was completed in November 2016 and invoiced accordingly with a 30 day term. The sale was recorded (August 2016) by Ace, but no payment was received within the 30 day term.

Subsequent phone calls, emails and demand letters for payment were unsuccessful. In March 2017, Ace found out that the customer had closed the business and the premises had been abandoned. The owner had fled overseas with no contact details.

Ace would be entitled to write off the relevant debt as a bad debt and could claim a deduction for the financial year ending 30 June 2017.

That is, Ace followed all available measures in order to recoup the debt of $45,000 and can, in light of the prevailing circumstances, make the decision to write off the debt as there is seemingly little or no prospect of recovering the debt. As a consequence such writing off of this debt would crystallise an income tax deduction for Ace. ■

Rental property owners lose some deductions

Legislation that came into law in the last half of 2017 makes a reality measures first announced with the 2017 Federal Budget.

The "housing tax integrity" bill solidifies the government's intention to deny all travel deductions relating to inspecting, maintaining, or collecting rent for a residential investment property. As well, second-hand plant and equipment that came with an investment property are now off the table as far as depreciation goes.

The measures will apply from July 1, 2017, so will affect returns for the current financial year. However the changes to depreciation are dependent on when assets were purchased (more below).

The change to travel claims means that travel expenditure incurred relevant to gaining or producing assessable income from housing premises used as residential accommodation will not be deductible. The travel expenditure will also not be recognised in the cost base of the property for CGT purposes.

It should be noted that the amendments do not affect deductions for travel expenditure incurred in carrying on a business, including where a taxpayer carries on a business of providing property management services.

Depreciation change

The government has also limited plant and equipment depreciation deductions to outlays actually incurred by investors. In essence, unless you as the buyer have physically purchased the items, you can no longer depreciate them. In other words, if otherwise depreciable assets came with the investment property you purchase, there will no longer be an option to continue depreciating those assets in your hands.

Being new rules however, there are calendar dates that may determine if you are affected or not. The amendments will apply from 1 July 2017 for assets purchased after 7.30pm 9 May 2017 (when they were announced in the Federal Budget 2017).

The changes apply to:

- previously used plant and equipment acquired at or after 7.30pm on 9 May 2017 unless it was acquired under a contract entered into before this time
- plant and equipment acquired before 1 July 2017 but not used to earn income in either the current or previous year.

Investors who purchase new plant and equipment will continue to be able to claim a deduction over the effective life of the asset.

Exceptions

A taxpayer may continue to deduct travel expenditure and depreciate incumbent plant and equipment if:

- the losses or outgoings are necessarily incurred in carrying on a business for the purposes of gaining or producing assessable income; or
- the taxpayer is an "excluded class of entity".

The ATO explains these as being:

- a corporate tax entity
- a superannuation plan that is not an SMSF
- a public unit trust
- a managed investment trust, or
- a unit trust or a partnership, all members of which are entities of a type listed above.

The ATO says that its aim is to "improve the integrity of the tax system by addressing concerns that some taxpayers have been claiming travel deductions without correctly apportioning costs, or have claimed travel costs that were for private purposes".

However, it is also explained that these measures are not intended to affect deductions for institutional investors in residential premises, as "the same integrity concerns do not arise for such investors". ■

When refinancing, loan interest can be deductible to a partnership

A general law partnership is formed when two or more people (and up to, but no more than, 20 people) go into business together. Partnerships are generally set up so that all partners are equally responsible for the management of the business, but each also has liability for the debts that business may incur.

PARTNERSHIP DEDUCTION FOR CERTAIN INTEREST EXPENSES

A typical scenario when launching a business based on a general law partnership structure sees each partner advance some capital to start up the enterprise. As the income years come and go, each partner takes a share of the profit and counts this as part of their personal assessable income for tax purposes.

However as the business becomes established, or better yet proves to be viable and becomes a successful operation, there is likely to come a time when its working capital — which had been financed from each partners' pocket — can be refinanced through the partnership business borrowing funds.

For such partnerships, there is a "refinancing principle" under tax law that spells out some general principles governing the deductibility of loan interest in such circumstances.

As a general rule, interest expenses from a borrowing to fund repayment of money originally advanced by a partner, and used as partnership capital, will be tax deductible. This is covered in tax ruling TR 95/25 (you can ask this office for a copy).

The ruling states that to qualify for a tax deduction, the interest expense "must have sufficient connection" to the assessable income producing activities of the business, and must not be "of a capital, private or domestic nature".

However interest on borrowings will not continue to be deductible if the borrowed funds cease to be employed in the borrower's business or income producing activity. Nor will deductibility be maintained should borrowed funds be used to "preserve assessable income producing assets". There is also a limitation on deductibility of loan interest in that borrowings to repay partnership capital can never exceed the amount contributed by the partners.

The ability to make these interest expense deductions under the "refinancing principle" is generally limited to general law partnerships — and not tax law partnerships such as those used to jointly purchase an investment property. This principle would also not apply to companies or individuals. (There are very prescribed conditions where, for example, a company may make such a claim, but under very specific circumstances.)

continued overleaf

Expanding the empire (and retaining the CGT main residence exemption)

A question that surfaces now and then in regard to capital gains is whether the main residence exemption extends to additional land acquired after the time of acquisition of the residence.

The short answer is yes — provided that certain requirements are met. It should also be noted that where the exemption applies upon satisfaction of the following requirements, it applies to both pre- and post-CGT dwellings (before and after 20 September 1985).

The requirements are:

1. the additional land (including the area of land on which the dwelling is built) is adjacent to that on which the dwelling is situated
2. the total area of land is not greater than two hectares
3. the additional land is used primarily for private or domestic purposes in association with the dwelling; and
4. the CGT event that happens in relation to the additional land also happens in relation to the dwelling (that is, your ownership interest in it).

To further explain, the ATO has provided an example.

> *Tom and Mary purchase a home in 1987 and occupy it as their main residence. The home has never been used for income producing purposes.*
>
> *In 1989, they purchase the vacant block of land that adjoins the land on which their dwelling is situated and construct a private swimming pool. The total of the area of adjacent land and the area of the land on which the home is situated is less than 2 hectares.*
>
> *In 2001, they enter into a contract to sell the home with the adjoining block. A full main residence exemption is available.* ■

When refinancing, loan interest can be deductible to a partnership ***continued from previous page***

OTHER PARTNERSHIP FACTS AND FOIBLES

Partnerships can be less expensive to set up as a business structure than starting business as a sole trader, as there will likely be greater financial resources than if you operated on your own. On the flip side however, you and your partners are responsible for any debts the partnership owes, even if you personally did not directly cause the debt.

Each partner's private assets may still be fair game to settle serious partnership debt. This is known as "joint and several liability" – the partners are jointly liable for each other's debts entered into in the name of the business, but if any partners default on their share, then each individual partner may be severally held liable for the whole debt as well.

Other general factors to note about partnerships include:

- the business itself doesn't pay income tax. Instead, you and your partners will each need to pay tax on your own share of the partnership income (after deductions and allowable costs)
- the business still needs to lodge a tax return to show total income earned and deductions claimed by the business. This will show each partner's share of net partnership income, on which each is personally liable for tax
- if the business makes a loss for the year, the partners can offset their share of the partnership loss against their other income
- a partnership does not account for capital gains and losses; if the partnership sells a CGT asset, then each partner calculates their own capital gain or loss on their share of that asset
- the partnership business is not liable to pay PAYG instalments, but each partner may be, depending on the levels of their personal income
- as a partner you will need to take care of your super arrangements, as you are not an employee of the business
- money drawn from the business by the partners are not "wages" for tax purposes.

Lastly, as with any business, the partnership will need an ABN and will need to register for GST if the business's annual turnover is more than $75,000 (before GST). ■

Can an SMSF invest in property development?

The ATO has been sending some mixed messages about property development involving an SMSF, and has indicated that it is one of the issues on its radar for 2018. So is property development an allowable investment for an SMSF? The short answer yes, but be careful. A longer answer is be very careful — it is very easy to trip up and breach one or other rules. The ATO is keeping an eye on this, and will scrutinise any fund utilising property development.

THE RISKS

The first problem you face is that in operating a property development you will likely be engaging in a business activity. While the law does not specifically prevent an SMSF from operating a business, the ATO has been very clear that while it may be allowed it is frowned upon due to the possibility of the fund straying from operating for a "sole purpose", and will likely lead to greater scrutiny.

The ATO has warned that when reviewing the carrying on of a business in an SMSF, it will be on the lookout for:

- the trustee employing a family member (it looks at things such as the stated rationale for employing the family member and the salary or wages paid)
- the business carried on by the fund having links to associated trading entities
- there are indications the fund's business assets are available for the private use and benefit of the trustee or related parties.

The next problem you face is the trust deed. Most older trust deeds would not have envisioned running a business and even some newer ones as well. The law is very clear that the trust deed must specifically allow for this — mere silence on the subject is not enough. Therefore, have your trust deed reviewed and updated if necessary. This is a legal document, so you will need to get a lawyer to look at it or get a commercially available one.

You will also need to review your investment strategy. While this need not specifically spell out that it includes property development, it would be a good idea to update it to reflect this option. It will also be prudent to review your risk appetite — property development is inherently risky, and this should be reflected in the member risk profile in the investment strategy.

If the investment uses the assets of all members, then you should also have a note setting out that the members agree to this form of investment.

Can an SMSF invest in property development? *continued*

PAYMENTS TO MEMBERS OR RELATED PARTIES

A superannuation fund is specifically prohibited from providing non-retirement benefits to members and related parties. The legislation prevents a trustee of an SMSF from providing financial assistance to members or relatives of members. Therefore if a member of the fund or a relative (possibly including "associates") receives a benefit from the fund in the form of payments towards the costs of the development, there is the potential for there to be a breach of compliance requirements.

Financial assistance will not be deemed to be provided if the member or related party is paid market rates, however if underpayment is charged then there is likely to be a form of financial assistance that breaches the rules.

Consideration must also be given to the requirement that prima facie prohibits an SMSF from acquiring assets from related parties. This becomes very difficult for a fund when engaging a related party to undertake the development. The SMSF rules permit the payment to a related party for "services" related to a property development, but prohibits building materials to be bought from a related party as these are assets of that related party.

One solution to this is for the SMSF to enter into an "agency" or "reimbursement" agreement with the related builder that states that the builder is not buying the material for themselves (and therefore becomes their asset) but on behalf of the SMSF. Again this must be crafted properly, and you can still run into the problem of the "arm's-length" requirements.

ARMS-LENGTH REQUIREMENTS

Even where your dealings with related parties are permissible, they must always be at arm's-length prices. Part of the reason for doing the development in-house rather than getting an external provider may be that it is hopefully cheaper to do so. However if payments are under or over market prices, then there will be a breach of these requirements. Therefore it is important that such transactions are well documented, and that proof exists of payments at market rates (it may be a good idea to get third-party quotes as proof).

POSSIBLE CONTRIBUTION

When dealing with property development at non-market rates there is another potential issue to contend with — payment considered to be a contribution. The relevant legislation says: In the superannuation context, a contribution is anything of value that increases the capital of a superannuation fund provided by a person whose purpose is to benefit one or more particular members of the fund or all of the members in general.

Therefore, where services are provided below market value this will in effect increase the capital of the SMSF, and can therefore be considered a contribution. The ATO also made it clear that where a related party improves an SMSF asset at no cost to that SMSF, for the purpose of benefiting the fund, this will constitute a contribution reflective of the increase in market value of the fund's assets.

CONCLUSION

If done correctly, it is possible for an SMSF to engage in property development. However given the turn in market prices recently and the increased vigilance of the ATO, make sure you get good advice before taking this on. ■

Before entering into a property development with your SMSF...

- ☑ Review your trust deed. It must specifically allow for running a business. If it does not, update it.
- ☑ Review your investment strategy. Is property development allowed? Is it in accordance with the risk profile of the fund? Does it benefit all the members?
- ☑ Talk to this office about the right structure for your fund entering into a property development.
- ☑ Keep everything at arm's-length and at market value; there are many pitfalls here so take care.
- ☑ Don't purchase directly from a related party, and make sure any related builder is buying on behalf of the SMSF or the unit trust.
- ☑ Beware of borrowing rules as costs may blow out.
- ☑ Make sure it is a good investment, don't overpay, know the local market, and beware of market trends
- ☑ Finally, document everything. The ATO has this on its radar, so expect greater ATO scrutiny if you engage in property development through your SMSF.

ATO spells out its big FBT concerns

March 31 and the end of the FBT year is around the corner, so to help taxpayers get things right, the ATO has made public the fringe benefits tax issues that attract its attention.

Broadly (not just in relation to FBT), the ATO says the following behaviours and characteristics tend to raise a red flag:

- tax or economic performance not comparable to similar businesses
- low transparency of tax affairs
- large, one-off or unusual transactions, including transfer or shifting of wealth
- tax outcomes inconsistent with the intent of tax law
- lifestyle not supported by after-tax income
- accessing business assets for tax-free private use
- poor governance and risk-management systems.

But focusing on FBT in particular, the ATO says there are specific behaviours and characteristics that attract its attention, especially in relation to certain areas of the FBT rules. These include issues involving aspects of the living-away-from-home allowance (LAFHA), car parking, employer-provided vehicles and more. The areas the ATO has stated it will be focusing on with regard to FBT are listed below.

LIVING-AWAY-FROM-HOME ALLOWANCE

Living away from home allowance (LAFHA) is an allowance an employer pays to employees to compensate for additional expenses incurred and any disadvantages suffered because the employee's duties of employment require them to live away from their normal residence.

The taxable value of the LAFHA benefit may be reduced by the exempt accommodation and food components of the allowance.

Common errors that the ATO says attracts its attention include:

- claiming reductions for ineligible employees
- failing to obtain required declarations from employees
- claiming a reduction in the taxable value of the LAFHA benefit for exempt accommodation and food components in invalid circumstances
- failing to substantiate expenses relating to accommodation and, where required, food or drink.

CAR PARKING VALUATIONS

The ATO will focus on the validity of valuations provided in relation to car parking fringe benefits. The common errors that attract its attention include:

- market valuations that are significantly less than the fees charged for parking within a one kilometre radius of the premises on which the car is parked
- the use of rates paid where the parking facility is not readily identifiable as a commercial parking station
- rates charged for monthly parking on properties purchased for future development that do not have any car park infrastructure
- insufficient evidence to support the rates used as the lowest fee charged for all day parking by a commercial parking station.

PROVIDED MOTOR VEHICLES

Another area of focus will be on situations where an employer-provided motor vehicle is used, or available, for private travel of employees. The ATO says this constitutes a fringe benefit and needs to be declared on the FBT return (if lodgment is required). There are circumstances where this may be exempt, such as where the business is tax exempt or the private use of the vehicle was exempt. There are special rules around these circumstances (ask us for more details).

The ATO has found that some employers fail to identify or report these fringe benefits or incorrectly apply exemption provisions.

EMPLOYEE CONTRIBUTIONS

A red flag is also raised in situations where employee contributions that have been paid (which reduces the FBT liability of the employer, such as where a car is supplied but the employee contributes to its maintenance).

The ATO is on the lookout for these amounts being declared on both the fringe benefits tax return (if lodgment is required) and the employer's income tax return. This helps to ensure that the employer does not:

- fail to report these contributions as income on their income tax return
- incorrectly overstate employee contributions on their fringe benefits tax return to reduce the taxable value of benefits provided. ■