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IN THIS ISSUE

NEW RULES FOR RESIDENTIAL PROPERTY INVESTORS

GST COLLECTED AT SETTLEMENT FOR NEW RESIDENTIAL PREMISES AND NEW DEVELOPED LAND

CHANGES PROPOSED FOR PRIVATE COMPANY LOANS

TAX CONSOLIDATING SME GROUPS

MKT WEBINARS - DOWNLOAD NOW!

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## NEW RULES FOR RESIDENTIAL PROPERTY INVESTORS

New legislation is now in place to deny deductions for residential property investors on travel expenses incurred in inspecting their residential rental properties and depreciation on "previously used" plant and equipment. This applies to individuals, discretionary trusts and SMSFs (but not companies) and is effective from 1 July 2017.

The first measure applies to deny deductions on travel expenses, such as motor vehicle expenses, taxi or car hire costs, airfares or public transport costs, and meals or accommodation related to the travel. Further, these expenses cannot be included in the cost base or reduced cost base of the investment property. However, property management expenses paid to real estate agents (including travel expenses incurred by real estate agents to inspect the residential rental property) are still deductible.

The new rules do not apply to taxpayers that carry on a business of property investing, a business of providing retirement living, aged care or student accommodation or property management.

The ATO has recently issued the draft Law Companion Ruling LCR 2018/D2 to provide guidance on the new rules. The Ruling states that "residential premises" has the same meaning as used in the GST Act and refers to the indicia of business identified by the courts and listed in Ruling TR 97/11 for the meaning "carrying on a business". The Ruling also states that apportionment is required if there are mixed income-producing purposes for the travel expenses and must be done on a reasonable basis.

The second measure applies to deny affected taxpayers depreciation deductions on "previously used" plant and equipment purchased after 9 May 2017. This applies where a taxpayer:

1. purchases a residential property with existing plant and equipment; or

2. has previously used the plant & equipment in their residence or for a non-taxable purpose.

However, affected taxpayers can still claim depreciation deductions on both new and previously used plant and equipment acquired ***before*** 9 May 2017 and ***new*** plant and equipment purchased after 9 May 2017. Further, if a taxpayer purchases a new residential premise, the plant and equipment installed by the developer is not taken to be "previously used" and depreciation deductions can still be claimed.

If you have any queries on the subject, please contact Peter Hong.

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## GST Collected At Settlement for New Residential Premises and New Developed Land

The new GST withholding rules for New Residential Premises are now law and will apply from 1 July 2018 on contracts entered into after this date.

Designed to counter property developers who use insolvency to avoid remitting GST on the sale of new residential premises, these new measures require purchasers of new residential premises or potential residential land to withhold an amount from the price for the supply and pay that amount to the ATO on or before settlement.

The three key areas that will be impacted are:

- Cashflow;
- New property development arrangements; and
- Settlement process.

The fact that suppliers (developers) no longer receive the GST amount for the period between settlement and BAS lodgement will reduce cash held by the business and may impact working capital requirements and banking covenants. This could take even longer if the ATO decides to conduct a BAS review. This cash flow impact should be modelled into any new residential developments that will be sold post 1 July 2018.

The new rules will also impact the way landowners and developers contract for and pay for development services such as residential property. Although transitional provisions apply for contracts entered before 1 July 2018, care must be taken for contracts entered into after this date so that sales subject to the GST withholding rules adequately provide for the withholding rules.

The settlement process will require more administration by both vendors and purchasers. Please refer to table 1 below.

**How will it work?**

Table 1 below describes how it works and the obligations for suppliers and purchasers of new residential property and potential residential land.

**Table 1 – Developer and Purchaser Obligations**

| Suppliers (Developers) | Purchasers (or their Representatives ie. Settlement agent) |
|---|---|
| **Supplier (developers) are required to notify purchasers of new residential property and potential residential land, in writing (either on the sale contract or a separate written agreement) on whether or not there is a requirement to withhold. Failure by the supplier of the property to notify the purchaser correct may result in penalties.** | Purchasers (or the representatives) is required lodge two forms to the ATO.<br><br>**Form 1: GST property settlement withholding notification online form** – enables a withheld amount to be paid to ATO. A purchaser or their representative must notify us prior to settlement the details of the parties to the contract and the property. Once the online form is submitted, we will provide a unique payment reference number (PRN) and a lodgement reference number (LRN). This form can be lodged any time after a contract has been entered into and prior to the settlement date.<br><br>**Form 2: GST property settlement date confirmation online form** – to be lodged on or before the date of settlement. The purchaser or their representative must notify the ATO (using the PRN and LRN) confirming property settlement date, and then pay the withheld amount. |
| **The supplier (developer) lodges their BAS when it is due and reports the taxable sale along with their other reported transactions.**<br><br>**When the BAS is lodged the credits in the GST property credit withholding account will be automatically transferred to the suppliers activity statement account. This will apply the withholding credits against the supplier's BAS net amount.**<br><br>**Any surplus credits from the activity statement account will be refunded (subject to normal GST refund processes) or if a further amount of GST is payable, the supplier will remit that amount if it hasn't been paid already.**<br><br>**Note: The credit will not be made available until the supplier has lodged their next BAS and it has been processed.** | Using the PRN, the purchaser will then pay the withheld amount directly to ATO.<br><br>Purchaser will receive an email confirmation once the payment is processed, as proof of payment for their records.<br><br>The credit will be transferred to the suppliers GST property credit withholding account. Once the payment has been credited, the supplier will then receive email confirmation. |

Generally, if the sale contract specifies an amount that is the price of the supply (ie. the contract price) the withholding amount is calculated as $1/11^{th}$ of the contract price. If one of the following exceptions arises, the withholding amount must be calculated as per the table below.

**Table 2. Withholding Rates/Amount Purchasers Pays to ATO**

| Withholding Situation | Amount Purchaser must pay to ATO |
|---|---|
| **Margin scheme applies** | 7% of contract price |
| **Supply between associates without consideration or for consideration at less than GST inclusive market value of the property.** | 10% of GST exclusive market value of supply |
| **Mixed supply, eg. Only partly a supply of new residential premises or potential residential land** | A reduced amount using a reasonable apportionment of the contract price or price multiplied by the applicable rate. |
| **There are multiple purchasers (not joint tenants)** | 7% (margin scheme) or 1/11th of the contract price or price for their % interest in the property. |

If you have any queries regarding the above, please contact Mimi Ngo.

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## Changes Proposed for Private Company Loans

As part of the recent Federal Budget the Government has stated that they are committed to amending the rules on loans from private companies in line with the Board of Taxation's 2015 recommendations, but will defer those changes until 1 July 2019.

As a reminder those recommendations are:

The Board has developed a reform model called the '**Amortisation Model**', which has the following characteristics:

- The maximum loan term would be 10 years (compared with the current 7 year term for unsecured loans and 25 years for secured loans).

- The prescribed maximum loan balances during the term of the loan (including any accumulated interest) would be as follows:
  - 75 per cent of the original loan still due by the end of year three;
  - 55 per cent of the original loan by the end of year five;
  - 25 per cent of the original loan by the end of year eight; and
  - 0 per cent of the original loan (that is, fully repaid) by the end of year 10.

- Similarly, interest would be able to be accrued annually but would have to be paid by the end of years three, five, eight and 10.

- There should be no requirement for a formal written agreement between the parties. However, written or electronic evidence showing that a loan was entered into must exist by lodgement day for the income year in which the loan was made.

- The required interest rate would increase to be the RBA rate for small business variable overdrafts for the month of May of the year of the loan. At May 2018 this rate was 8.65% (compared to the current 5.3% Division 7A rate).

As a result whilst all post 1 July 2019 private company loans will need to be on these terms, we understand that existing 7 year loans will automatically convert to 10 year loans, on the above terms, effectively extending the repayment period a further 3 years.

We would expect that amendments would be required to existing Division 7A Loan Agreements to effectively change the previously agreed terms to take advantage of these new terms. Obviously we will need to wait and see the detail as to how this should occur.

The devil in the detail though is the Board's recommendation that ALL loans be included in this new regime. That is, loans taken out prior to December 1997 (which are currently quarantined) together with Unpaid Present Entitlements (UPEs) existing prior to 2010. These will require some consideration given they are currently quarantined and do not require regular repayments.

If you would like to discuss how these changes might affect your private company loans please call Sean Pearce.

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### TAX CONSOLIDATING SME GROUPS

There is a common misunderstanding that the tax consolidation regime is for the "big end of town".

Whilst tax consolidation does feature in the tax structuring of larger corporates, the tax consolidation regime is not ***only*** for the big end of town, but can be effectively used by Small to Medium Enterprise Groups ("SME"), the minimum requirement to form a tax consolidated group being a resident company with at least one wholly owned subsidiary company (or unit trust).

The tax consolidation regime treats the members of a consolidated group as a single entity for income tax purposes. This means that intra-group transactions are ignored for income tax purposes and the group lodges only one income tax return for each income year. Therefore, whilst tax consolidation is a choice, for many SME corporate groups it will be a practical necessity. Some of the benefits that result from tax consolidating include the following:

- There may be an ability to increase the tax cost setting amounts of the assets of a subsidiary member. This may provide a benefit by reducing a CGT liability if the asset is sold or by increasing depreciation deductions.
- The ability to use subsidiary group losses across the entire group's income;
- The ability to utilise built up franking credits within subsidiaries for the benefit of the parent company's shareholders;
- The ability to move assets between group members without incurring a tax cost; and
- The ability to ignore other intra-group transactions, such as loans, debts, fees and services.

Importantly, the tax consolidation regime can greatly assist SME's in increasing their asset protection which is a very important commercial driver in deciding whether or not tax consolidate.

Take the following scenario which is not uncommon to an SME where tax consolidation can become very useful in assisting with asset protection:

- Mum and Dad set up Company A Pty Ltd that runs Business A;
- Over time, valuable Equipment and Buildings are acquired by Company A Pty Ltd;

- Mum and Dad become worried about the lack of asset protection as more and more value is generated by Business A; and
- Mum and Dad consider divesting by setting up subsidiaries and moving assets into subsidiaries but are concerned about CGT/balancing charges of moving assets into separate subsidiaries.

Depending upon Mum and Dad's other commercial requirements a possible solution could be the following in order to increase their asset protection:

- Incorporate Company B and Company C as wholly owned subsidiaries of Company A.
- Form a tax consolidated group with Company A as the head of the tax consolidated group.
- Move Business A to Company B and move Equipment/buildings to Company C.
- Leave Company A as a holding company that only owns shares in Company B and Company C.

The above will allow the moving of assets without any adverse tax impact as transactions within the tax consolidated group are ignored for income tax purposes (GST and duty will still need to be appropriately addressed as separate considerations).

The above should also achieve Mum and Dad's goal of increasing their asset protection by splitting the Business from the PPE/Buildings.

If you would like to discuss the benefits of tax consolidation and how the regime may impact upon your SME clients please do not hesitate to call either Ben Reynolds or Adriano Leon.

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**Coming soon! – The New Division 7A**:

In this session, Sean Pearce will run through the following:

- Identifying all existing Division 7A loans;
- Understanding the changes proposed to existing loans;
- Working through the "devil in the detail" of the Budget Night Announcement;
- Preparing for the inclusion of new "loans" into Division 7A;
- Solutions to minimise and manage new Division 7A obligations

Available to download from 15th June 2018.

*A reminder that PAN Member PD vouchers can be used to download our webinars. Please contact Nicola for the voucher codes or log in to the PAN Secure Zone on our website.*