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Penalty interest *can* be deductible, under specific conditions

A new ruling has been released by the ATO on the deductibility or otherwise of “penalty interest”. The term penalty interest refers to an amount payable by a borrower under a loan agreement when the lender agrees to an early repayment of a loan. The amount payable is commonly calculated by reference to the number of months of interest payments that would have been received but for the early payment.

The ATO ruling stresses that the deductibility or otherwise of penalty interest needs to be determined based on case-by-case circumstances. The ATO also emphasises that different provisions of the tax law will also influence a taxpayer’s deduction claim outcomes.

What this can mean in practical terms is that where, for example, the cost of a penalty interest charge may not be deductible under the general deductions rules, it may indeed be found to constitute a legitimate deduction under other tax rule provisions — those that cover “expenses of discharging a mortgage” for example, or under the tax rules related to debt deductions relating to foreign sourced income.

About this newsletter

Welcome to Ibbotson + Moscatelli’s client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. We invite you to read our monthly update and contact our office if you have any queries.

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Penalty interest can be deductible, under specific conditions *continued*

GENERALLY DEDUCTIBLE

The ruling says that penalty interest is generally deductible where:

- the borrowings are used for gaining or producing assessable income or in a business carried on for that purpose, and
- it is incurred to rid the taxpayer of a recurring interest liability that would itself have been deductible if incurred.

Penalty interest that is incurred to discharge a mortgage may be deductible to the extent that borrowed funds were used to produce assessable income. Deductibility for penalty interest is not affected by the cost being capital or revenue in nature (more below).

NO DEDUCTIBILITY

Apart from the above, penalty interest is not deductible to the extent that it is a loss or outgoing of capital, or of a capital, private or domestic nature. Although called “penalty interest”, the ATO emphasises that these costs are not paid for the use of the lender’s money, which covers the usual meaning of “interest”, but is paid to make up for a borrower *not committing* to that interest. This is where such costs can be deemed to take on a “capital” nature.

Also there is no deduction available if penalty interest is framed as a cost of borrowing in establishing a loan, as the cost is incurred after the money is borrowed. Note that penalty interest is not viewed by the ATO as being naturally attributable to a balancing adjustment event in relation to a depreciating asset, so the cost in these cases may or may not be eligible to be included in the asset’s cost. Case-by-case application may be required.

ALSO TO BE CONSIDERED

Other penalty interest considerations revolve around capital gains tax, and in some cases foreign sourced income.

If the outgoing is incurred to acquire a CGT asset this may be an incidental cost that can form part of the cost base of that asset. Again the term used requires a reminder that the cost is not a “penalty” in the usual sense, so should not be excluded from a cost base on that basis.

WORKED EXAMPLES

As is frequently found, case studies and examples can help explain the application of the law. The following are provided by the ATO.

Changing lender

John can refinance his rental property at a lower interest rate. In order to refinance, John pays out the first loan early. He incurs penalty interest calculated on the basis of one month’s interest for each year of the loan period remaining.

The advantage sought in practical terms by repaying the first loan early and incurring penalty interest is future interest savings from a lower interest rate. Penalty interest is of a revenue character and deductible under the general deduction rules.

Alternatively, where refinancing affects the discharge of a mortgage securing the first loan, the penalty interest is deductible under those rules.

Selling up

Sally sells her rental property, repays the loan to discharge the mortgage over the property and incurs penalty interest.

The penalty interest is a necessary incident of the sale of the property. A payment so connected to the realisation of a capital asset will be on capital account and not deductible under the general deduction rules. As the penalty interest is not a cost of borrowing incurred in establishing the loan, it is also not deductible under the cost of borrowing provisions. It is however deductible under the rules pertaining to expenses incurred when discharging the mortgage.

The beach house

Alex obtained an unsecured loan to purchase a beach house to use solely as a holiday house for his family. Alex and his family move interstate for work. Alex sells the beach house, immediately repays the loan early and incurs penalty interest.

Penalty interest is incurred in connection with selling a private-use asset; the expenditure is private in nature and not deductible under the general deduction rules. As the loan is unsecured, the rules governing discharging a mortgage cannot apply.

The penalty interest is an incidental cost that relates to the sale of the beach house and may be included in the cost base or reduced cost base — however if the loan is not repaid immediately it would be difficult to demonstrate that the penalty interest is an incidental cost. ■



Carrying forward concessional super contributions

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The income year of 2019-20 has just ticked over, which is also the first year in which an individual is able to make additional catch-up contributions to super through the application of unused concessional (before tax) contributions.

These are “unused” if the fund member made less than the legislated cap on such contributions, which was reduced to \$25,000 per year from 1 July 2017.

The rules that allow for a catch-up started to take effect one year later. From 1 July 2018, if a fund member had a total super balance of less than \$500,000 on the previous 30 June, and they make or receive concessional contributions (CCs) of less than the “basic cap” of \$25,000 a year, they have been able to accrue unused amounts for use in subsequent financial years.

These CC amounts that started to accrue from July 2018 have therefore become carried-forward unused cap amounts that are available to be used from 1 July 2019. Unused cap amounts can be carried forward for up to five years.

New rules, new limits

These are relatively new rules, which are generally referred to as the “unused concessional cap carry forward” rules. As mentioned, they permit individuals who have a total super balance of less than \$500,000 just before the start of a financial year (that is, 30 June of the prior year) to increase CCs for a particular year by unused amounts of their CC caps from earlier years.

It is only the member’s total super balance on 30 June of the year prior to the contributions being made that is relevant here. This means an individual who may

not qualify in a financial year, due their super balance exceeding the \$500,000 threshold, may become eligible in a future year if their balance falls below \$500,000.

Basically, the amount of an unused concessional cap is the difference between the CCs made by the individual in a financial year and the basic CC cap for that year. An individual may therefore be entitled to contribute more than the basic CC cap for the year and make additional CCs for any unused amounts without exceeding (breaching) their cap. The unused concessional cap is therefore the individual’s CC cap as modified by the unused concessional cap carry forward rules, not the “basic CC cap” for the year.

It is important to note that only the unused concessional cap for 2018-19 and future financial years can be carried forward. For instance, if an individual with a total super balance of less than \$500,000 makes CCs totalling \$3,000 in 2018-19, they would have an unused concessional cap amount of \$22,000 in that year. This amount could then be carried forward and contributed, say, in the 2023-24 year (in addition to the basic CC cap for that year) without the member breaching their available cap.

So assuming no indexing of the basic CC cap of \$25,000 and no CCs being made in previous years, it is possible for an individual with a total super balance of less than \$500,000 to contribute up to \$150,000 (that is, $\$25,000 \times 5 + \$25,000$) in a financial year without exceeding their cap. This strategy would benefit someone who has been unable to use their CC cap in full in previous years, such as women who took maternity leave or individuals with periods of high and low income (for example, primary producers).

continued overleaf →

Carrying forward concessional super contributions *continued*

Important background facts

The ability to make CCs is not limited by the size of the individual's total super balance, meaning an SMSF member can still make CCs of up to \$25,000 each financial year, regardless of their total super balance. Note that while the basic CC cap is indexed by average weekly ordinary time earnings (AWOTE) in increments of \$2,500, the \$500,000 total super balance threshold is not indexed.

CCs include personal deductible contributions and contributions (including salary sacrificed contributions) for which an employer claims a tax deduction. As CCs are paid before tax is applied, they are included in the assessable income of the super fund that receives them. They are taxed at the fund rate of 15%, forming part of the taxable component of a member's interest in a super fund.

Furthermore, from 1 July 2017, the 10% maximum earnings condition for personal deductible contributions no longer applies. This means individuals may be able to make their own personal contributions to super and receive a full deduction for the entire amount of personal CCs made (should they have sufficient personal income to offset the deduction).

Given the tax deduction claimed cannot create a tax loss, it is only the amount of personal super contributions that the ATO allows an individual as a deduction in their income tax return that will count towards their CC cap. The remaining amount will count towards the individual's non-concessional contribution cap.

Before 1 July 2017, only self-employed people whose predominant income was not from employment and those who were not employed could generally meet the 10% maximum earnings test and claim a tax deduction for their personal super contributions.

Tax planning considerations

The abolition of the 10% test from 1 July 2017 has offered more flexibility and help with tax planning. Given not all employers offer salary sacrifice agreements, this has allowed all employees up to age 75 to make personal contributions to super and claim a tax deduction for the contributions (subject to having enough income to offset the deduction).

When both the employer and the employee make CCs to super, consideration needs to be given to what CCs have been made by the member's employer (or employers) during the year to avoid exceeding the reduced CCs cap. Those who have more than one job are likely to have multiple employers paying their contributions into more than one super fund, so they should check what CCs have been made to all their super funds during the year before arranging for any additional personal CCs to be paid into their super account.

With the lowering of the CC cap from 1 July 2017, it is important that members are aware of all the amounts being contributed to their fund(s) by their employer. This includes checking whether the employer pays any costs (such as insurance premiums or super administration fees on behalf of the fund) as those amounts will also count towards the member's CC cap.

It is not enough to use payslips to track employer contributions, as they do not take into account any amounts paid by the employer towards insurance premiums and administration fees on behalf of the fund or when the contributions are received by the fund. For example, a contribution deducted from an employee's pay in June 2018 may not have been paid into the employee's fund until July 2018, causing the contribution to be counted towards the member's CC cap in the 2018-19 financial year.

Salary sacrifice agreements should have been revisited to ensure that the total amount of contributions made by the member and their employer do not exceed the lowered CC cap of \$25,000.

It is also important to note that while individuals will not be required to meet the "10% test" from 1 July 2017, they will still need to continue to give the trustee a "Notice of intent to claim a deduction" indicating how much they intend to claim by way of a tax deduction for the year the contribution is made. The trustee of the fund must also provide the individual with an acknowledgement of receipt of the notice. ■

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Business trading structures: What's best for your business?

When you have plans for starting a new business, one of the central decisions is which business trading structure will work best for your venture.

The general problem however can be that there are both pros and cons with the main options available, so considerations need to be given with regard to the overall situation as well as the specific conditions presented with any business venture. To explain the options, we can look at one example that has typical conditions found in many businesses.

THE TRADING VEHICLE

The crucial issues for them both to consider include:

- the nature of the business
- their intentions for the business
- funding requirements
- exposure of personal assets to creditors of the business
- ease of admittance of new business partners and the departure of existing ones
- taxing of profits
- considerations for specific structures that may avail them of tax concessions.

The main options that could be considered include a partnership, a company, and a unit trust.

A PARTNERSHIP

Paul and Jenny essentially come together as two individuals, working together to pursue a joint venture. Points to consider here are:

- **Joint and several unlimited liability:** The partnership is not a separate entity and both Paul and Jenny will be entering into contracts with third parties in their personal capacities. This means that each will be liable for the other's actions in the conduct of the business and their liabilities to third parties are joint and several (meaning that third parties can pursue each of them for the full amount owed even though Paul and Jenny may be 50-50 partners in the venture).
- **Cannot draw a salary:** They cannot be employees of the partnership and they can only be remunerated in the form of profits distributed to them. If Paul intends to be the chief operator and brain behind the creation and delivery of the meals, and Jenny only works part time to bring in leads, then this structure will create problems for them. However, this problem could be rectified by allowing Paul to draw a salary as a first cut of profits, which would

Take for example the case of Paul and Jenny, who want to purchase an existing food catering business together. They are considering the best business structure that should result in the best conditions for success.

Paul is a nutritionist and has expertise creating customised nutritionally balanced meals for a variety of customer needs. He is also a qualified chef and has management experience having worked as an executive chef in a major hotel chain in Singapore. However, he does not have any experience in Australia. Even though he has the right skills set to operate a catering company, he'll need help from someone who is familiar with the local food industry to help him build his business.

Jenny, on the other hand, has more than 20 years' experience in the Australian food industry, having worked in and managed various sized retail food outlets and also at a central kitchen facility for a franchisor. She has the relevant contacts to enable the business to grow after its acquisition. She intends to continue with her current consulting role for her private company.

PURPOSE OF THE ACQUISITION

Both Paul and Jenny want to expand on the business that they are acquiring, which currently only has a very small commercial kitchen preparing pre-packaged (nutrition/calorie controlled) meals for fitness centres. The business is mainly wholesale but they are planning to cater for retail customers as well and eventually have a retail store selling not just pre-packaged meals but fresh, healthy food and beverages on site. They will need funding for the proposed expansion very soon after the acquisition of the business.

Business trading structures: What's best for your business? continued

not be a deductible expense for the business, before the 50-50 split of profits. Paul and Jenny would also need to have this arrangement clearly specified in their partnership agreement.

- **Funding obstacles:** Paul and Jenny will need to resort to personal assets as security for any debt funding required for the business. Equity funding is possible with the admission of new partners, but issues will arise on the taxation front because this will involve a disposal of the partnership assets to the new partner, with the attending tax consequences. The 50% CGT discount however is available to Paul and Jenny if the disposal occurs after 12 months of the business acquisition.
- **Profits distributed from the partnership will be taxed in the hands of Paul and Jenny:** As Jenny is continuing with her existing consulting role, she may be subject to a higher marginal tax rate than if profits are taxed at company rates.

A COMPANY

- **Limited liability:** Paul and Jenny's liabilities will be limited to any unpaid amount on shares issued to them.
- **Remuneration:** Paul and Jenny can be paid a salary commensurate with the time and efforts they devote to the business.
- **Continuity:** The company is a perpetual entity and will not be affected when either Paul or Jenny leaves the business or when new principals are admitted.
- **Reinvestment of profits:** It is a cost effective way to reinvest earnings into the business to meet growth and operational needs, as companies can retain earnings.
- **Security for funding:** Funding can be accommodated by issue of new shares (without requiring a disposal of existing partners' interests as is the case with a partnership) or debt financing where the company's assets can be used as security. In practice, however, financiers will still require the directors to put up their personal assets as security.
- **Tax rate:** Company tax rate is fixed at 27.5% (presently) for the proposed business (as this is a base rate entity).
- **CGT 50% discount:** Not available to companies when they sell their assets. In the current scenario, it is unlikely that the company will accumulate significant assets that will be sold later for significant capital profits. Therefore, in reality, the benefit that may flow from this concession to Paul and Jenny is very limited. However they will need to form a view about whether they consider the goodwill may increase significantly in value over time and this may influence their choice of structure.

- **Small business CGT concessions** could be considered at the time of sale.

A UNIT TRUST

- **Limited liability is possible:** A unit trust with a corporate trustee will give Paul and Jenny limited liability as in the case if using a company structure.
- **Reinvestment of profits not as cost efficient:** All profits of the unit trust will need to be distributed (to avoid being taxed at the highest rate) to the unitholders and taxed in the unitholders' hands first. Post tax profits can then be loaned back to the business.
- **CGT 50% discount:** Available to unitholders, but the nature of Paul's and Jenny's business means that they will not derive much benefit from this concession.

ADMINISTRATION AND MAINTENANCE COST DIFFERENCES

Partnership: Usually requires a partnership agreement (which can be verbal, but to avoid future disputes between the partners it is advisable to have a partnership agreement prepared). The partnership will need to file a tax return even though it does not pay any tax itself.

Company: Involves registration and set up costs, costs of annual reporting and preparation of tax returns. Administrative work is also required to keep the company register and ASIC data up to date. To better document the rights and obligations of the shareholders to avoid future disputes, a shareholders agreement is recommended.

Unit trust: Established by a unit trust deed and, where a corporate trustee is appointed, the costs of setting up a company will need to be included. The relationship document between the various unit holders will be a unit holders agreement.

KEY TAKEAWAYS

When exploring the various business structures, the following will need to be taken into account:

- the new business's objectives
- revenue and duty implications
- how funding can be achieved under each structure, and what are the different forms of financial or security arrangements
- the possible need for the advice of other professionals, such as lawyers, financial planners, mortgage brokers or insurance brokers.

Please consult with this office should you need further guidance or help. ■



Event-based reporting mistakes lead to more SMSF audits

Photo by Sarah Kilian on Unsplash

In the year since event-based reporting (EBR) started for SMSFs (from 1 July 2018) the ATO says an unprecedented number of transfer balance cap reports have required re-reporting.

The transfer balance account report (TBAR) is used to report certain events and is separate from the SMSF annual return. The TBAR enables the ATO to record and track an individual's balance for both their transfer balance cap and total superannuation balance.

The ATO says the regulations in place do not provide it with a discretion for "special circumstances" regarding contraventions of the transfer balance cap, and that it is particularly important for all SMSF trustees and members to self-monitor and ensure that no member exceeds the cap.

The re-reporting incidents, says the ATO, has mostly been in response to determinations and commutation authorities it has issued. It says that in some instances the amended reporting indicates:

- the member was not actually receiving a pension during 2017-18
- the pension was commuted on 1 July 2017 so that the member was never in excess
- the member had commuted the pension before 1 July 2017 to avoid being in excess, and the trustees had incorrectly included the commuted amount in their original reporting
- the member commenced a pension during 2017-18, however the initial value reported to the ATO was

amended so that the individual no longer exceeded their transfer balance cap.

The amended reporting usually results in the determination or commutation authority being revoked. ATO records show that approximately 39% of commutation authorities issued to SMSFs in the 12 months since were revoked, including commutation authorities issued to APRA funds after SMSFs had corrected reporting errors.

What to carefully check

Due to the large number of amended TBARs it is receiving for SMSFs, the ATO is reminding SMSFs that it is important to check the following in the case where a member received a pension during an income year:

- that an appropriate condition of release was met
- that the pension is valued correctly in financial statements
- the commencement date of the pension and any commutations have been properly documented
- exempt current pension income (ECPI) has been correctly calculated with respect to the pension and any commutations that occurred during the year have been considered
- the payments from the pension have actually been paid
- the minimum pension payment requirements have been met.

The ATO has also announced that any TBAR re-reporting by SMSF trustees for future income years will be closely monitored, and that it may request evidence of relevant documents and calculations to substantiate the TBAR amendment. ■



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Businesses get increased access to losses

In the first quarter of this calendar year, legislation was passed that will supplement the ATO's current "same business test" for losses with a more flexible "similar business test". The new test will expand access to past year losses when companies enter into new transactions or business activities.

The similar business test allows a company (and certain trusts) to access losses following a change in ownership where its business, while not the same, is similar, having regard to:

- the extent to which the assets that are used in its current business to generate assessable income were also used in its former business to generate assessable income
- the extent to which the activities and operations from which its current business is generating assessable income were also the activities and operations from which its former business generated assessable income
- the identity of its current business and the identity of its former business

- the extent to which any changes to the former business resulted from the development or commercialisation of assets, products, processes, services, or marketing or organisational methods of the former business.

As a test for accessing past year losses, the similar business test will only be available for losses made in income years starting on or after 1 July 2015.

The ATO has announced that same business test and similar business test will be collectively known as the "business continuity test". ■

This information has been prepared without taking into account your objectives, financial situation or needs. Because of this, you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs.