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Welcome to the BAN TACS News Flash. Our aim is to provide short but succinct updates on all tax issues

Column by Noel Whittaker

Increasing living expenses mean that many Australians who retire in the next 30 years are going to be doing it tough.

One way out is to sell the home and rent, another is to take out a reverse mortgage - a loan where there is no obligation to make repayments of principal or interest.

I like reverse mortgages, if they are used properly, but, as one man I will call Ted, found out, it's very easy to get caught. He and his wife took out a reverse mortgage in 2007 with a limit of $40,000 and drew it down by instalments to minimise the interest. To protect himself from rate rises he took an interest rate of 9% "fixed for life".

By 2011 the debt had grown to $47,000, which seemed reasonable in the circumstances, but things took a turn for the worse when his wife died and he decided to move to a more suitable property. This involved paying out the loan but he was horrified to discover that the reverse mortgage provider wanted a "break fee" of $35,000 in addition to the sum owing. This turned a $47,000 debt into an $82,000 debt. This was the price of fixing the interest rate.

If rates had gone in the other direction the breaking of the loan contract might have worked in his favour - he may have got a refund.

So what are the lessons here for anyone who has to resort to a reverse mortgage? In hindsight, the biggest risk Ted took was the fixed rate loan, which means that retirees may well be safer with a variable rate than a fixed one. If a variable rate is chosen, borrowers should delay drawing down the mortgage for as long as possible to minimise interest and to reduce the potential term of the loan.

Also, the essence of a reverse mortgage is it enables the parents to spend money that would normally be left to their children. If the children can afford it, they should chip in and pay the interest on their parents' loan, so the debt does not increase.

Noel Whittaker is a co-founder of Whittaker Macnaught Pty Ltd. His advice is general in nature and readers should seek their own professional advice before making any financial decisions. His email is noelwhit@gmail.com

Problem if Company Declares Dividend Before it Pays Tax

If you operate your business through a company it is important that you arrange for your profits to be distributed at a time when they can be franked.

First an explanation of how franking credits operate. If a company makes $100 profit it pays $30 in tax. The shareholders of the company are entitled to a tax credit for tax paid by the company when they return the profit as income. So in this example, if the company was to pay out all of its remaining profit to shareholders they would pay $70 in cash and give the shareholders a tax credit of $30. The shareholders would include $100 in their tax return, if they are in the 38.5% tax bracket their notional tax bill would be $38.50 but they would only have to pay $8.50 to the ATO because they use the tax credit for the rest.

If the company distributes its profits before it pays the tax it cannot frank the dividend (attach the tax credits to the dividend). There is an exception to this rule when the franking account is overdrawn by a minor amount but for the sake of this discussion that is irrelevant. The maximum a dividend can be franked is 30%. So if you don't frank every dividend it is quite likely that the company will have excess franking credits that it will never be able to distribute to the shareholders.

If you need to take money out of the company before franking credits are available (ie before the company has paid its tax) then this must be done as a loan with the appropriate agreement in place or the payment will be deemed to be an unfranked dividend.

Fortunately, no interest is payable in the first financial year that the loan is made and it is acceptable to pay the interest annually so no interest needs to be paid until 30th June of the following financial year. Ideally you should have paid the tax on the profit by then and have declared a franked dividend. This can then be used to pay off the loan but with the added advantage of franking credits in your tax return.

Of course if the 30th June has passed the interest payable for this financial year should be calculated and added to the amount of loan repayment. You cannot gross up the loan by the amount of interest you owe. A payment must be made. Each year the ATO sets the interest rate. Interest for the 2012 financial year is required to be charged at the rate of 7.8%.

It may be necessary to delay the payment of the dividend if the shareholder is a trustee of a trust that beneficially holds the shares for the benefit of the trust. The idea with a trust is that it distributes its profit each year to beneficiaries otherwise it will be taxed in the maximum tax bracket. The dividend and franking credit flow through. So as per the example above the beneficiary will end up receiving the $70 but declaring $100 in their tax return with a$30 tax credit towards the tax payable. The trap here is that unless a trust makes at least $1 in profit it cannot distribute the franking credits. For example a trust may have $80 in losses from another venture which it offsets against the $100 it technically receives from the company, leaving it a taxable profit of $20. The beneficiary will receive no cash and will only need to declare $20 in income from the trust but they will be entitled to a $30 tax credit which can be used to offset other tax payable or claimed back from the ATO. The problem arises when the trust has other losses that exceed the income it has received from the company. As the trust has no net profit to distribute, it cannot distribute the franking credit and it is lost forever.

So it is important that you check the tax position of the ultimate beneficiary of the dividend before it is paid. The amount paid must exceed any losses held by the shareholder if it is a trust. Accordingly, the declaration of a dividend may need to be further delayed to make sure there is enough accumulated profits to declare a dividend big enough to cover the losses of the shareholder. It is worth continuing with the loan agreement and just making interest payments in the meantime.

Once you have the loan agreement in place keep it going so you are covered should this happen in the future.

Capitalised Interest Ruling Finalised

Yep, this is the article you have been waiting for. TD 2011/D8 has been finalised as TD 2012/1 in much the same form. Many of the points raised against the draft were just brushed over and while it deserves to be challenged in the courts it is important to remember that the ruling is only on the question of whether paying off your home loan sooner can be a more dominant purpose for a loan arrangement than the tax benefit. Accordingly it is time to move onto other possible dominant purposes which will be covered later in this article.

Firstly, for readers that have not been following this saga, it is about loan arrangements where a LOC is used to cover the rental property expenses including the interest payment on the rental property loan while all available funds are directed towards the home loan which is non deductible debt. This will result in interest capitalising, namely interest being charged on the money borrowed in the LOC to pay the interest on the rental property loan.

The issue is not really what is the appropriate loan structure, that is just a side line to try and align arrangements to Harts case. Ultimately Hart's case was decided in favour of the ATO because there was bank advertising material advising of the tax benefit. Accordingly, the court found that the dominant purpose for the taxpayer entering into the arrangement was the tax benefit. It is important that the loans you use are simply accounts used by people that would not necessarily be looking for a tax benefit.

Two important absences from the ruling are:

1) There is no instruction regarding where the rent should be deposited which seems to show that the ATO know they will be overstepping the mark if they specify that the rent should be used to pay off the rental property loan.
2) While there is a requirement that an amount "might reasonably be expected to pay the interest on the investment loan", there is no definition of what a reasonable amount is. This should alarm investors with a negative cash flow property who are borrowing the difference between the rental expenses and the rent received, they would also be caught if it is seen that their dominant purpose is to benefit from the deduction for capitalised interest.

It is all about your reason for not making the interest payment on the rental property and whether that is considered by the ATO to be more dominant than the tax benefit. Some examples worthy of consideration:

1) Wanting to save for a holiday or safety net for unforeseen circumstances. Choosing to do this through the offset account attached to your home loan is practical as your only other source of funds in an emergency is the LOC used to pay rental property expenses. If this was accessed for private purposes it would create the record keeping nightmare of interest apportionment on a mixed purpose loan.
2) Your home loan is over 10 years so the repayments are high, add to this a detailed budget of your living expenses and you just can't afford the interest repayments on the rental property but fortunately, you have enough equity to secure a LOC for these borrowings.
3) You have organised the LOC so that you have all the rental property expenses recorded separately and on one statement and so that you can be sure that payments are met when due because you have so much available credit. All your income is directed to the offset account for you home loan. The question you have for the ATO is what happens when due to the order that expenses are drawn from the LOC or because the property is negative cash flow or because you are not that organised and irregularly transfer money into the LOC and then only what you feel you can afford considering possible private expenses. As a result of any of these interest will capitalise on the LOC is this also caught by Part IVA. Is the dominant purpose of your lack of attention to your accounts on a daily basis, to obtain a tax benefit?
4) It is your intention to start a family as soon as it is financially viable but it is a personal choice that during the first few years of your children's life that you will live off one wage. To be able to manage on such a reduced income you will need to be far enough ahead on you home loan to not be required to make repayments during that period. The question for the ATO is whether letting interest capitalise on you rental property while saving to have a family is a scheme with the dominant purpose of a tax benefit.
5) You had thought you could meet your financial commitments but due to a change or circumstances such as pregnancy, demotion, unemployment, sickness etc you are finding it difficult to pay your bills and are anxious about future doctor's bills unemployment etc. You wish to concentrate all your income towards you offset account to ensure you can meet your home loan repayments and emergencies. Fortunately, you have plenty of equity so can use a LOC to support the rental property. Is the ATO going to use Part IVA to force you to borrow for personal expenses rather than rental property expenses?
6) The interest rate on your private debt is higher than that on the LOC. This maybe because your private debt is a credit card or car loan. It may even be the case with your home loan. This scenario may even be the one opportunity where the way the loans are organised can affect the success of your arrangement. In this case you argue that your dominant purpose is simply to reduce your interest expense by paying the highest interest rate loan off as soon as possible.

7) If you have sufficient equity in assets other than your home to finance the growing LOC debt then the concept of paying off your home sooner has much more punch. You dominant purpose could be to make sure that only your rental properties are exposed to risk of mortgage repossession.

You will always be in a better position if you can show that it is not you intention to access the increased equity in your home to extend the line of credit (LOC). It is also ideal that the LOC is secured against your rental property which may have available equity if the original borrowings were partly secured by your own home. The LOC can also be justified as a record keeping tool because you pay all and only rental property expenses from it so you only need to refer to that account when preparing to lodge your tax return.

So dear reader the battle is far from lost TD 2012/1 while of dubious credibility, at the end of the day, simply says that the ATO does not considers the tax benefit of such an arrangement less dominant than the goal of paying off your home sooner. Time to look for more compelling reasons.

As always we recommend that you apply to the ATO for a private ruling on whether they would apply Part IVA to your particular circumstances, before you claim capitalised interest. In the meantime there is no reason not to begin capitalising interest while you wait for a response. Just make sure the interest is capitalised in a separate account from the original borrowings so you don't tarnish a perfectly deductible loan.

Reader Profile

We had a fantastic response to our question about offset accounts for SMSF loans. Following from the information received from readers I have put together a case study on the issues in the last edition of Newsflash.

It is great to know so many brokers read newsflash, please consider joining our forum. As people who's identity and qualifications we have verified can post on the forum (anyone can view it) we can develop the forum into a fast and accurate information source.

We were surprise at just how many readers are finance brokers. We would really like to get a better idea of who we are writing for. I guess we could do a fancy questionnaire but really all we need to know is what type of articles interest you so please email julia@bantacs.com.au with information about yourself such as occupation, age, areas of interest and what you would like to see more of. If you are a property investor it would be interesting to know whether you are researching before you purchase or already own a rental property.

Seminars

SMSFs Should You Have One? – 7pm to 8:30pm 20th March, 2012, Free, Guess Speaker Julia Hartman at Suite 5, 10 Pope Street, Ryde, Sydney, NSW. Light refreshments provided RSVP smsfadvisers.eventbrite.com For more details go to http://www.bantacs.com.au/seminars.php

Where is Julia?

On the road again, travelling with my puppies for my friends. I will arrive in Sydney on the 18th March.

Ask BAN TACS

For $59.95 at Ask BAN TACS you can have your questions regarding Capital Gains Tax, Rental Properties and Work Related Expenses answered. We will include ATO references to support our conclusion.

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