BARRETT WALKER

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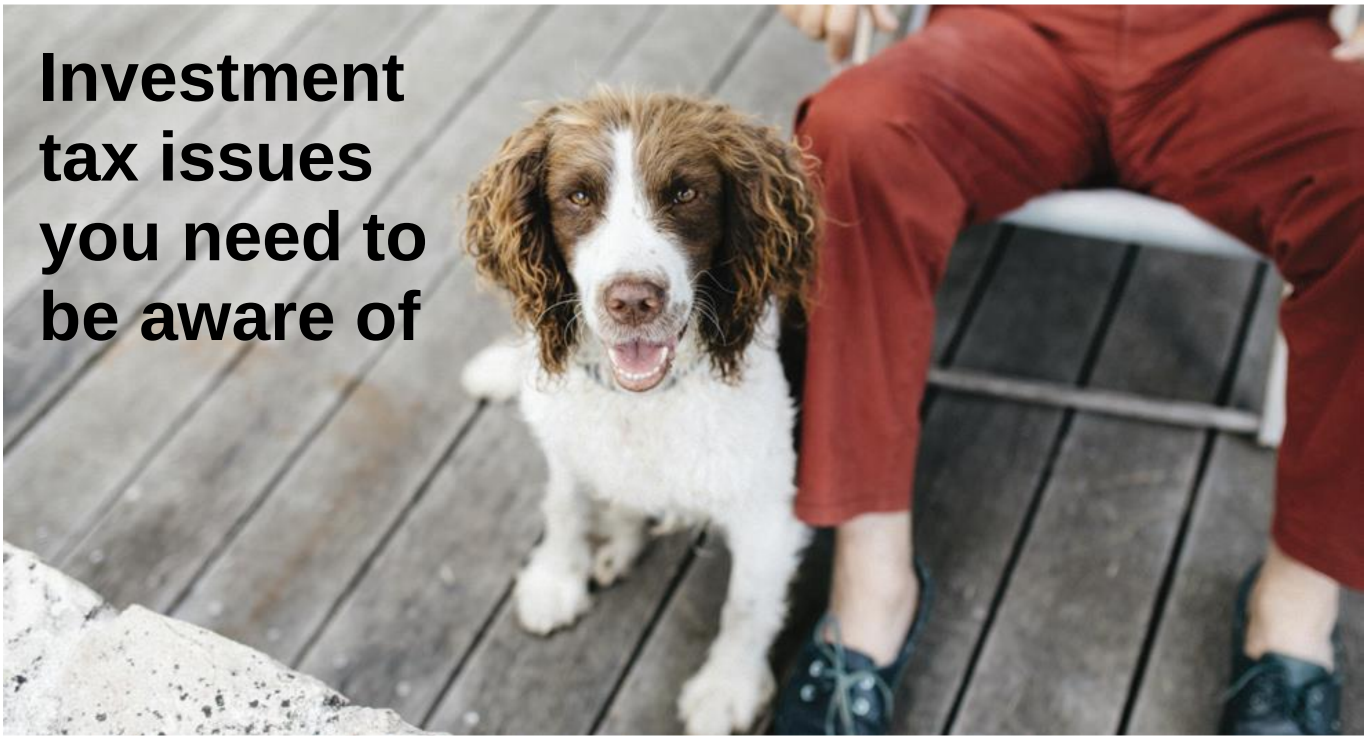
E: advice@barrettwalker.com.au
www.barrettwalker.com.au

A: Suite 8, 150 Chestnut Street, Cremorne
P: (03) 9428 1033

Investment tax issues you need to be aware of



Investors must consider a range of tax laws dealing with income, assets and deductions. Even that term ”income”, the meaning of which most of us would assume, can take on nuanced shades of meaning when considered in regard to investment. For example, investment income earnings such as dividends and interest are typically considered ordinary income. Franking credits, net capital gains and net trust distributions are “statutory” income.

Ordinary income is typically income that is regular, periodic or recurrent. Returns on property such as interest, rent or dividends are considered ordinary income. Statutory income is income that is not ordinary income but is recognised as income because of a provision of the tax law (such as the circumstances mentioned above).

Taxpayers with investments have been found to occasionally make some common mistakes when preparing their income tax returns, including, but not limited to, the following:

- cash management trust income is often declared in the income tax return as interest rather than a trust distribution. Cash management trusts distribute net income in the same manner as other trusts. A statement should be obtained at year end from the financial service provider indicating the gross distribution and any management fees deducted attributable to the tax year
- listed investment trust dividends often include a listed investment company capital gain. A deduction is available to investors that have access to the CGT discount rate. The deduction is equal to 50% of the capital gain for individuals and trusts and 331/3% for superannuation funds
- trust distributions often record the taxable distribution on the annual tax statement using the 50% CGT discount. However the statement may not accurately reflect an investing taxpayer’s investment structure and period of ownership. Make sure that:
    - you have held the asset for at least 12 months
    - you are eligible to use the 50% CGT discount rate, and
    - the capital gain is grossed up in the tax return before the discount is applied.

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Also be aware that those who receive franked distributions often fail to consider the "holding period rule" when determining their entitlement to franking credits. The holding period rule requires you to continuously hold shares "at risk" for at least 45 days (90 days for certain preference shares) to be eligible for the franking tax offset.

A related issue is where taxpayers often incorrectly apply the "small shareholder exemption" to entities other than individuals when determining eligibility to franking credits. Under the small shareholder exemption the holding period rule does not apply if your total franking credit entitlement is below $5,000.

Also, investors often fail to adjust the cost base of their units in a unit trust or managed fund for tax deferred distributions received.

Other issues

There are certain other tax issues facing those in receipt of investment income — not every investor, but enough to warrant keeping an eye on the following issues just in case they may affect your tax outcome.

Promoter penalties

Penalties apply to promoters of tax avoidance and tax evasion schemes, otherwise known as tax exploitation schemes. The rules impose substantial penalties to individuals and corporations that market a scheme and receive consideration in respect of that marketing.

While promoter penalties do not apply to investors in a particular scheme, any tax benefits realised by investors can potentially be cancelled by the ATO's anti-avoidance rules.

Foreign tax issues

In some instances, investments by residents in one country made in another country may be taxed in both countries (subject to any "double tax agreement" between the relevant countries). To prevent double taxation, Australian taxpayers are entitled to claim a non-refundable foreign income tax offset for foreign tax paid on an amount included in their assessable income, referred to as a "double-taxed amount" for the purposes of this tax offset.

The foreign tax offset is limited to the lesser of foreign income tax paid and the "foreign tax offset cap". The cap is calculated by determining the Australian tax payable on the taxpayer's double-taxed amounts. As an alternative to calculating the cap, the taxpayer can choose to use a $1,000 minimum cap.

Goods and services tax

Share traders are generally not required to register for GST. Although share traders are carrying on an enterprise, because GST turnover is defined to exclude "input taxed" supplies (generally share sales are input taxed), the requirement to register will only exist if taxable supplies from other sources exceed the $75,000 GST registration threshold. Where an enterprise is being carried on, an investor can register for GST voluntarily where the registration threshold is not met. However, there may be limits on the refund of input tax credits for financial supplies.

Losses

Current year income losses arising from the negative gearing of investment income can generally be offset against other current year income. If current year income is insufficient to fully use the investment losses, income losses may be carried forward to be offset against future income subject to certain loss rules (such as for a trust or company). Capital losses may only be offset against capital gains. If there are insufficient capital gains in a year to absorb a capital loss, the excess capital loss may also be carried forward and used in later years.

Non-resident withholding

Non-residents are not required to provide a TFN to investment bodies as TFN withholding rules do not apply. However, they will need to advise the investment body that they are a non-resident.

Non-residents are subject to non-resident withholding tax on specified types of income. Withholding tax is payable on interest, unfranked dividends, royalties or fund payments to non-resident unitholders of managed funds. Generally the payer is responsible for withholding, reporting and remitting the amounts to the ATO.

Records and substantiation of expenses

Taxpayers are required to keep records for taxation purposes for five years. Typically the records to be retained include receipts, accounts, property records and other documents that relate to assessable income (for example, PAYG payment summaries, interest and dividend statements). Failure to keep records may attract a penalty from the ATO.

Tax file number (TFN)

Australian taxpayers in receipt of investment income who lodge returns with the ATO are allocated a TFN. Non-resident investors from a country that has a double tax agreement with Australia will have withholding tax deducted at the applicable tax rate, which is typically lower than for residents of a country with which Australia has no double tax agreement. An Australian TFN is not required if the investment income relates to interest, dividends or royalties or certain managed fund distributions. Non-residents in receipt of this type of income do not usually prepare

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an Australian tax return. This differs from investments in other types of income, such as income from real property where a TFN and tax return are required.

Tax file number withholding

Investment bodies such as banks are required to withhold tax from investment earnings where the taxpayer does not quote a TFN or Australian business number. TFN withholding tax is refundable on provision of a valid TFN or on lodgement of the income tax return.

NOTE: Closely-held trusts (including a family trust) need to withhold amounts from trust distributions at the top marginal tax rate where beneficiaries have not provided a TFN to the trustee by the time of the entitlement. The trustee is required to report to the ATO the TFN details of beneficiaries who become presently entitled to trust income.

Wash sales

A wash sale is an arrangement in which essentially the same asset is sold and immediately repurchased, or where an asset is sold to an associated taxpayer such as a spouse or family trust so that, broadly, the investor's economic position is unchanged. Where the dominant purpose of a "wash sale" is to crystallise a capital loss, the ATO indicates that its "Part IVA" may be applied to deny a deduction for the loss. (Basically, Part IVA is an umbrella clause in the tax rules so that the ATO can deny a tax benefit where an arrangement is entered into with the obvious sole or dominant purpose of gaining that benefit.)