GIBSON & PARTNERS
CHARTERED ACCOUNTANTS

Welcome to Gibson & Partners' Newsletter March 2024

Are you receiving personal services income?

Do you earn personal services income (PSI)? While most people may think that it only applies to builders or tradies, the truth is that may also apply to any instance where individuals work and earn income using their personal effort or skills.

PSI generally only applies to individuals who receive more than 50% of their ordinary or statutory income from a contract as a reward for their personal effort or skills. An example that most people would be familiar with is a sole trader tradesperson using their skills to earn income, either directly or through an interposed entity (a PSE). However, PSI can apply to any industry, trade or profession where individuals use their personal effort or skills. This includes so-called “white collar” professionals in IT, finance and medicine, in addition to the construction industry and related trades.

If you earn PSI during the income year, the deductions that can be claimed will be limited to the deductions that you could have claimed if you were an employee (rather than someone earning PSI) and the income earned was salary and wages. This means that, for example, you would be unable to deduct rent, mortgage, interest, rates or land tax in relation to a residence or part of a residence that you use to gain or produce your PSI. This rule applies to all PSI, regardless of whether it is earned as a sole trader or through a company, partnership or trust. To avoid that outcome, individuals/personal services entities (PSEs) can generally self-assess whether they conduct a personal services business (PSB) against four tests. If any one of the four tests is met during an income year, the PSI rules will not apply to limit the deductions available to the individual or PSE.

How much does negative gearing really cost?

Since the government’s announced changes to the Stage 3 tax cuts to give lower income earners more benefits, the chorus of voices advocating for changes to other aspects of the tax system, such as negative gearing, has grown steadily stronger. So how much does negative gearing actually cost the nation each year? The answer to this can be gleaned from the 2023–24 Tax Expenditures and Insights Statement (TEIS) which, somewhat confusingly, contains figures relating to the 2020–2021 financial year.

Put simply, a tax expenditure arises where the tax treatment of a class of taxpayer or an activity differs from the standard tax treatment or the tax benchmark. These expenditures include tax exemptions, some deductions, rebates and offsets, concessional or higher tax rates applying to a specific class of taxpayers, and deferrals of tax liability.

The TEIS contains detailed breakdown of various categories, including rental property deductions. The ATO estimates that some 2.4 million rental property investors claimed deductions for expenses associated with maintaining and financing property interests, including interest, capital works and other deductions. Collectively for the 2020–2021 financial year, $48.1 billion worth of rental deductions were claimed, resulting in a total tax reduction of $17.1 billion.

Only around half, or 1.1 million, of these rental property investors had a rental loss (negative gearing), which added up to total rental losses of $7.8 billion and provided a tax benefit of around $2.7 billion for the 2020–2021 income year. The other rental deductions category (eg property maintenance, council rates etc) accounted for more than 50% of the amount claimed, with the next largest deduction being interest expenses, coming in at 39%.

Further analysis of the $2.7 billion negative gearing tax benefit (or tax reduction) reveals that 80% went to individuals with above median income (those earning above $41,500) and 37% went to individuals in the top income decile (those earning over $128,000).

Although the TEIS doesn't provide data on the status of those claiming rental deductions, this can be somewhat inferred by the ages of those claiming the deduction. According to the ATO, more than half of the total negative gearing tax reduction went to individuals between the ages of 40 and 59 years old. Presumably a majority of individuals in this cohort have families, and a good proportion may be either the sole income earner or the primary income earner in their family. This means the bulk of the commentary regarding negative gearing benefiting the rich may be on shaky ground.

However, these contentions aside, with the tax reduction on rental deductions expected to blow out to $28.2 billion by the 2026–2027 income year (from $17.1 billion in the 2020–2021 income year) and it being the second largest tax expenditure (second only to concessional taxation of employer super contributions), it's likely the calls for changes to negative gearing will only grow stronger in time.

Estate planning considerations

Estate planning is a complex area which requires careful consideration of tax implications. Many issues that affect the distribution of assets to beneficiaries will need to be considered before an individual dies, to ensure undesirable tax consequences are avoided for both the individual and their potential beneficiaries. These include the timing on the transfer of the assets, potential gifts, transfer duties and the use of testamentary trusts.

Typically in terms of capital gains tax (CGT), the transfer of assets upon the death of an individual does not immediately trigger a CGT event; rather, a CGT "rollover" applies. This means that the beneficiaries of the estate do not have to pay CGT at the time of inheritance. Instead, CGT implications are deferred until the beneficiary decides to dispose of the asset.

Generally, beneficiaries inherit the deceased's assets at their market value as of the date of death, which becomes the cost base for future CGT calculations when the asset is eventually sold. One important exemption to note is the main residence exemption, which can fully or partially shield the deceased's primary home from CGT, provided certain conditions are met.

While gifts can be made as a part of estate planning before an individual dies, remember that if the gift is an asset (eg property, cryptoassets, shares, etc), CGT will still apply.

Another consideration in terms of the timing of transfers (in particular, of property) is the transfer duty involved at the state or territory level. For example, in New South Wales, if property is received from a deceased estate in accordance with the terms of a will, the beneficiary will pay transfer duty at a concessional rate of $100. However, if the transfer occurs before an individual's death or not in accordance with a will, normal rates of transfer duty will apply. In that scenario, it would be better to wait to transfer the property. The rules for each state and territory differ, so it's important to check before making decisions.

For individuals looking to exert more control after their own death, a testamentary trust may be one way of providing a flexible and tax-efficient way to manage and distribute the assets of the estate to beneficiaries. Generally, the terms and conditions of the testamentary trust are outlined in the will of the deceased, including the appointment of trustees and beneficiaries and how the trust assets are to be managed and distributed. The trust itself comes into existence upon the death of the person making the will, and it is separate from the deceased estate for legal and tax purposes.

However, establishing and managing testamentary trusts can involve significant costs, and there is a requirement to carefully draft the trust deed so it includes clear instructions for the establishment and operation of the testamentary trust, in order to avoid possible future disputes. There may also be ongoing legal, accounting and administrative expenses, making testamentary trusts the most complex route to head down.

The specific tax implications of estate planning can vary widely depending on individual circumstances and the state or territory in which an individual lived. This is a complex area where seeking professional advice tailored to the situation is crucia.

FBT electric vehicle home charging rate

With the rise in businesses purchasing electric vehicles (EVs) for the use of their employees, the ATO has finalised its guidelines setting out the methodology for calculating the cost of electricity for FBT purposes when an eligible EV is charged at an employee's or an individual's home. The rate of 4.20 cents per kilometre now applies (from 1 April 2022 and for later FBT years). To use this rate, employers will need to keep a record of the distance travelled by the car, and a valid logbook must be maintained if the operating cost method is used.

In terms of FBT, the employer now has the choice of either using the methodology outlined in the guidelines or determining the cost of the electricity by determining the actual cost incurred. Once made, this choice applies to each vehicle for the entire year, although the choice can be changed from one FBT year to another.

TIP: These ATO guidelines only apply to zero emission EVs and not to plug-in hybrid vehicles which have an internal combustion engine, or to electric motorcycles or electric scooters.

A transitional approach applies for the 2022–2023 and 2023–2024 FBT years, whereby if odometer records have not been maintained, a reasonable estimate may be used based on service records, logbooks or other available information. After the transitional period ends, employers will need to keep a record of the distance travelled by each car and a valid logbook must be maintained if the operating cost method is used.

Employers are reminded that even if an EV is eligible for an FBT exemption, the benefit must still be included in an employee's reportable fringe benefits amount. Therefore, the taxable value must be determined, and where the employee home-charged the EV throughout the year and paid their electricity bills and provided the employer with the necessary declaration for electricity costs, the home charging electricity cost will form a part of the recipient contribution amount.

Superannuation: pension transfer balance cap 2024–2025

The transfer balance cap which limits the amount of capital that can be transferred into a tax-exempt retirement phase will not increase for the 2024–2025 income year, based on the release of December 2023 consumer price index (CPI) numbers from the Australian Bureau of Statistics (ABS). This means the figure will remain at $1.9 million for the 2023–2024 and 2024–2025 income years.

The transfer balance cap was originally introduced in 2017 as a way to limit the amount of capital that can be transferred into a tax-exempt retirement phase. This was implemented in response to criticism that the superannuation system was being used by the wealthy for estate planning purposes rather than for retirement, and that the soaring cost of tax concessions for fund members threatened the sustainability of the entire super system.

The transfer balance cap was originally set at $1.6 million, and indexation has applied to that cap from 1 July 2021 in line with the CPI in $100,000 increments. As a result, the current transfer balance cap for the 2023–2024 income year is $1.9 million. Based on the release of CPI index numbers from the ABS, this figure of $1.9 million will also apply for the 2024-25 income year, as the CPI figure for December 2023 was not large enough to trigger a $100,000 increase.

The transfer balance cap is a lifetime limit on the amount an individual can transfer into one or more retirement phase accounts. Individuals will have a personal transfer balance cap equal to the general transfer balance cap when a retirement phase income stream is commenced for the first time. For example, if an individual commences a retirement stream in the 2024–2025 income year, their personal transfer balance cap will be $1.9 million.

For individuals who started their retirement phase income stream in an earlier year with a lower general transfer balance cap, if the full amount of the personal transfer balance cap was never used, proportional indexing may apply. This means the individual's personal transfer balance cap will be indexed based on the highest ever balance in the transfer balance account.

Where an individual exceeds their personal transfer balance cap, the excess is required to be commuted and excess transfer balance tax needs to be paid.

Australia’s love affair with SMSFs continues

Establishing a self managed superannuation fund (SMSF) offers a variety of benefits, so it is perhaps no surprise that in the latest data released by the ATO, the number of SMSFs in Australia continues to grow as more people seek to take advantage of the control and flexibility offered.

In the five years to 30 June 2023, the ATO estimates that there were on average 24,000 establishments and only 13,800 wind-ups of SMSFs, leading to an overall growth rate of 9%. As at 30 June 2023, there were 610,000 SMSFs holding roughly $876 billion in assets, which accounts for around 25% of all super assets.

It’s important to be aware of the challenges and considerations that can significantly impact this type of fund’s suitability for individual retirement planning. One of the primary concerns is the complexity and responsibilities involved in managing an SMSF: trustees must navigate a maze of financial, legal and tax regulations to ensure compliance with the ATO. This complexity is compounded by the potentially high costs associated with setting up and running an SMSF, including auditing, tax advice, legal advice and investment fees, which can erode investment returns, especially in funds with smaller balances.

The autonomy in investment decision-making, while a key advantage, also introduces significant investment risks – trustees’ lack of experience or knowledge can lead to poor investment choices. SMSFs also need to meet the sole purpose test, which means the fund’s investments are required to be for the sole purpose of providing retirement benefits to the fund’s members.

There is also a time commitment required to research investments, monitor fund performance and stay updated on regulatory changes. Taxpayers thinking about starting an SMSF should consult qualified advisers for further advice.