

# WEALTHMATTERS

YOUR PERSONAL GUIDE TO WEALTH CREATION

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## Tips before guaranteeing a partner's loan

Partners must carefully assess the risks and benefits of guaranteeing their spouse's loan before they rush into an agreement.

A person can become the guarantor of their partner's loan when a credit provider is reluctant to lend to them on their own. Once they sign their name as a guarantor, they can be held accountable for the entire repayments of the loan when their partner is incapable of doing so. They will not have any rights to own the property, or the items bought with the loan.

Before taking financial responsibility for the loan, there are certain factors a partner needs to take into consideration, such as the

payback period of a loan. Some loans do not have a distinct time.

The loan contract should state exactly how much the partner is guaranteeing, the amount of the loan and the repayments, the interest rates, fees and charges and whether it is secured.

If they are guaranteeing a business loan, they will need a copy of the business plan and past financial statements to familiarise themselves with its operations.

They will need to consider how the borrower intends to repay the loan and the circumstances that could prevent them. It will help to have a plan of their repayment options in the likelihood their partner cannot pay the loan.

Partners should be aware of the exact amount

they are guaranteeing. A fixed amount of money or the total amount owing can make a huge difference to the decision. They may have to sell assets, such as a house or car, to fund the loan.

When a partner is sure they want to continue with the guarantee, it is worth enquiring about reducing the amount they are guaranteeing.

There is a possibility the guarantee could damage the relationship between the borrower and guarantor when something goes wrong. The partner needs to factor in whether it is worth that risk or better to decline now. A partner should never pressure or force their spouse into signing an agreement if they are not interested in guaranteeing their loan. If this is the case, consult with a financial counsellor for help.

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# SMSF property gearing risks

While many self-managed super fund (SMSF) members are turning to gearing in superannuation as an investment strategy, this investment approach may not always be appropriate for every member.

## Property depreciation

Quantity surveyors produce a detailed depreciation schedule to help investors boost their cash return each financial year.

Depreciation is one of the most under claimed deductions that property investors fail to take advantage of.

A specialist quantity surveyor will prepare a depreciation schedule that outlines all of the deductions the owner of a property can claim for both structural items and plant and equipment assets. An owner and their accountant will then use this schedule to implement the correct deductions when they go to lodge their income tax return.

It is crucial that property owners choose a depreciation schedule from a quantity surveyor who offers a site inspection. If they do not inspect the property, it is possible that many of the plant and equipment assets within the property will be neglected in the final report.

A quantity surveyor uses both the prime cost and diminishing value methods of depreciation to calculate depreciation deductions. An investor should confer with their accountant about what method is most appropriate for their circumstances.

Before embarking on a gearing strategy, it is important for SMSF members to undertake a sensible analysis of the true risks involved or they could find themselves in serious trouble with the ATO.

### Limited recourse

Members have to follow strict borrowing conditions called a 'limited recourse borrowing arrangement' (LRBA) when gearing their super into property. Under this arrangement, only a single asset can be purchased, such as shares in a single company, a residential property or a commercial property.

Members considering a geared property investment have to ensure that the investment aligns with their SMSF investment strategy and risk profile. If an SMSF member does not abide by these arrangements and purchases an inappropriate asset or the arrangement has been structured incorrectly, they may be required to sell the asset and risk a considerable loss to their fund.

### Costs

SMSF property loans are quite often more expensive than other property loans, so it is important to give this aspect thought before making any investment decisions. An asset under a limited recourse borrowing agreement will incur extra charges for members. They will need to pay for a separate trust and drafting of separate legal instruments. There is a possibility that financial institutions will also charge

a fee for examining the fund's trust deed. In addition, the LRBA asset may acquire a higher interest rate.

### Tax losses and capital gains

When the after-tax cost of the property exceeds the income made from the property, any tax losses from the property cannot be offset against the taxable income outside the fund. Likewise, the value and equity of a LRBA property cannot be used as security for other loans or purchasing more properties outside of the fund.

### Liquidity

Since loan repayments are deducted from the fund, members must ensure that the fund's investment income and other contributions cover the repayments. Having adequate liquidity in the fund is paramount, especially during any long periods without tenants.



## Action plan for low rates

Borrowing at a time of low-interest rates to invest can yield high returns in the long run, and help pay off debts.

Although borrowing to grow a portfolio of shares or a managed fund is risky, if investors have a secure income stream and extra funds, the results can be very favourable. Diversifying the investment may be a way of lowering potential risk.

### Negative gearing

Taking a loan out can help reduce an individual's payable tax. To receive these tax benefits the investment must be negatively geared - where the borrowing costs (interest and fees) are greater than the profit received (rent or dividends).

Although this is considered a high-risk strategy;

an individual can deduct the overall losses from their total taxable income, therefore reducing tax.

### Positive gearing

When the income received from an investment is greater than the expenses, the individual must pay tax on the total net income.

Extra income can be put back into the property. The amount of positive funds flowing back can be increased by taking advantage of the capital allowances. This is taking advantage of the building's depreciation.

### Review loans

Take a three-point approach to reviewing and renegotiating long and short term debt and finances: consolidate all debt, look into refinancing and challenge the lender to get a better rate.



# Maximising the value of your business

For business owners looking to sell their business as part of their overall retirement strategy, there are some practical measures they can apply to maximise its value.

By focusing on the value drivers in the categories: sales and marketing, operational, financial, legal and on point of sale, owners can optimise the value of their business in order to obtain the best sale.

## Sales and marketing

Owners will help boost revenue for their business and lower their dependency on their primary clients by expanding their client base. By marketing their products or services to different sectors they will reduce its liability to a downturn in that region. If they adjust their costs and services to industry standards, then buyers will have a better chance of retaining their clients.

Owners that drop their prices make it difficult for buyers to expand their business, and offer more desirable packages to continue delivering quality service. It is also important for the business to have staff that can complete the sales function, so that buyers are not at risk of losing sales when the owner leaves.

## Operational

Owners must ensure the business can

operate without them before they sell. It will be more appealing to a buyer to have the freedom to work when they want, rather than having to spend their time resolving daily issues. Installing an efficient management structure will assist with making the take over smooth. It is also crucial for the owner to confirm the business has the right accreditations and company policies. It proves to buyers the business complies with regulations and that the business can run without the owner.

## Financial

Producing an outlook of the following year's revenue and profit will convince buyers of the potential for growth. An owner should have a management accounting system in place to be able to prove the credibility of the outlook, which presents the revenue, costs and profits from each client every month in a clear and concise manner. Showing the revenue received from each client will further confirm to clients that the business does not rely on its top clients.

Buyers will be more inclined to purchase a business with no overdue settlements. Hence, owners should make sure that all of their clients are up to date with their payments.

## Legal

It is essential for owners to inspect their contract documentation to reduce the possibility of conflict or potential claims.



This requires going over client, supplier and employee contracts, including terms and conditions, and making sure they are correct.

## On point of sale

An owner may have to sign a non-compete agreement to reassure buyers that they will not continue to contact their clients for business after the sale. It is worth noting that an earn-out deal, rather than a downright payment, will help convince buyers of the continued strength and profitability of the business. Look at the business in the eyes of potential buyers and identify what needs to be modified to make it easier for them to make a return on the investment.

# The CGT concerns of joint tenant assets

It is important for owners of a joint tenant asset to be aware of the Capital Gains Tax (CGT) issues that may arise when the asset is sold.



When two or more people acquire a property asset together, it can be either as tenants in common or as joint tenants.

Individuals who own an asset as tenants in common are allowed to have differing interests in the asset, for example where one partner has 30 per cent interest, and the other has 70 per cent interest.

An owner will incur a capital gain or capital loss from a CGT event in line with their amount of interest in the asset. If they decide to sell their asset, the result of the gain or loss will be split between them based on their legal interest.

There are also joint tenants that are treated as having equal shares in an asset. For example, when a couple agrees to sell their asset, each partner will obtain an equal share of the gain or loss.

A partner of a deceased spouse will secure their share of the ownership interest on the

date of their death. When this occurs, there is a special rule that allows any capital gain or loss to be deferred unless it was acquired before 20 September 1985.

For CGT purposes, when a partner from a joint tenancy dies, their interest in the property passes to the surviving joint tenants in equal shares.

The exception to this rule is when an asset is passed from the deceased to a tax-advantaged entity or to a non-resident at the time of death. When this occurs, a CGT event is considered to have happened to the asset just before the person passed away.

A spouse will trigger a CGT event when they transfer legal ownership of an asset to their partner, such as giving 50 per cent of their share to their spouse. The partner will gain a profit equal to the market value of the asset, and they may be subject to CGT.



## Avoiding rental claim errors

The ATO continuously find common mistakes made in claiming rental property borrowing expenses.

It is important for rental property owners to ensure these mistakes are avoided in the future to reduce the possibility of being selected for an audit or review.

Property investors can claim certain deductions in their tax return when taking out a new loan to purchase an investment property. These costs include:

- Stamp duty charged on the registration of a mortgage
- Title search fees charged by the lender
- Loan establishment fees
- Lenders mortgage insurance (taken out by the lender and billed to the borrower)
- Mortgage broker fees
- Fees for a valuation required for loan approval, and
- Costs for preparing and filing mortgage documents

There are several common mistakes investors make when claiming borrowing expenses:

### Claiming stamp duty deduction

Stamp duty charged by the state government on the transfer of the property title is not considered a borrowing cost. However, it may be included in determining the cost base of the property for capital gains tax (CGT) purposes.

### Claiming borrowing expenses in full

Borrowing expenses that exceed \$100 must be spread over five years or the term of the loan, whichever is less. If the total deductible borrowing expenses are \$100 or less, they may be fully deductible in the income year they are incurred.

It is only when an investor repays the loan in

less than five years, they are able to claim a deduction for the balance of the borrowing expenses in the year of repayment.

### Claiming deductions for private purposes

Some taxpayers have taken out a loan to purchase or renovate a rental property and have used part of the proceeds for a private purpose, such as purchasing a vehicle. In these circumstances, borrowing expenses can only be claimed against the part of the loan that relates to the rental property, and not the portion used for other private purposes.

### Additional property claim errors

Other common mistakes routinely made by property owners that need to be prevented include:

- Claiming initial repairs and capital improvements as immediate deductions rather than a claim for capital works deductions.
- Claiming deductions for any expenses related to friends and family using the property for free during the year.
- Claiming the cost of travel to inspect the property when the main purpose of the trip is to have a holiday.
- Claiming deductions for a property that is not available for rent.



## Crackdown on SMSF dividend stripping

Private companies who are avoiding their tax responsibilities by channelling company profits to a self-managed super fund (SMSF) face ATO scrutiny.

The Australian Taxation Office (ATO) issued a Taxpayer Alert (TA 2015/1) on 1 May 2015 to self-managed super fund (SMSF) members involved in transferring private company profits to an SMSF.

This alert addresses situations where members were accumulating profits from paying franked dividends to a new SMSF, instead of to its original shareholders. The ATO is concerned that these transactions are contrived to avoid further income tax on the dividend income.

The ATO has likened this arrangement to the dividend stripping process, where investors

sell a company's shares to a third party before the payment of dividends and then repurchase them afterwards at the lower ex-dividend price.

The transactions can create compliance issues, such as triggering non-arm's length income for the SMSF, acquiring assets from related parties and capital gains tax consequences for transfers below market value.

The ATO is encouraging SMSF members involved in such arrangements to voluntarily disclose the information and seek advice from an advisor who is not involved in the transaction.

The ATO may undertake compliance activity to reinforce the taxation and superannuation provisions and help affected SMSF members develop practical options to deal with the consequences of their arrangement. There is a definite chance the ATO will cancel the shares and deny the SMSF the franking credit tax

offset. For further public guidance on the issue, the ATO will supply a product that explains their view on how taxation and superannuation laws apply to such arrangements.

