ManserTierney&Johnston
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The ins and outs of "entertainment" business deductions

As a tax concept, "entertainment" can be relevant not only to fringe benefits tax (FBT), but also to income tax and even goods and services tax (GST).

For a business, whether a business expense is "entertainment" will generally also determine whether the cost is deductible. If the expenditure can be shown to be directly connected with the carrying on of a business, it should be deductible.

The example of someone taking a client out to lunch can certainly be shown to be in connection with a business. However, there is still a lurking danger within the relevant sections of the tax law that says that if such an expense also represents "entertainment", by the Australian Taxation Office (ATO) view, then that cost can be taken out of the deductibility equation. In this article, we explore these ins and outs in some detail.

About this newsletter

Welcome to Manser Tierney & Johnston's client information newsletter, your monthly tax and super update keeping you up to date on current issues, news and changes you need to know. Should you require further information on any of the topics covered, please do not hesitate to contact us.

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The ins and outs of "entertainment" business deductions *cont*

The definition of "entertainment"

The term "entertainment" is defined in income tax law, and both FBT and GST leverages off the income tax definition. The relevant legislation simply defines entertainment as meaning "entertainment by way of food, drink, or recreation". The ATO adds slightly to this by also including transport and accommodation costs relevant to the consumption of said food and drink. But as a guide to the application of tax, this definition is really not very helpful.

Realising that the definition came up short for giving taxpayers the required guidance on such deductions, the ATO issued a ruling in 1997 to give taxpayers a better, and more applicable, understanding of the concept of entertainment. This ruling suggests that when considering whether the consumption of food and drink is entertainment – and therefore whether it is non-deductible or deductible, depending on the analysis of the expenditure – the ATO will look at it in the context of four questions.

They are four very simple questions — why, what, where and when. And the viability of a claim does not live or die on the strength of any one of the answers to those questions, but on a balance of the answers. If an expense is deemed to be entertainment, it is of course non-deductible for income tax purposes and no GST credit is ascribed to it. If it is not entertainment and therefore a business cost, it is deductible.

Looking at the "why" question first, we must ask: is the consumption of the food and drink tied to a social reason, or is there a business reason? We can use the example above of taking a client out to lunch, which is underpinned by a solid business reason. However, the next answer needs to back this up.

The answer to "what" should bear out the reason assumed for lunching with a client, meaning that a lavish four-course meal is out of the question. The logic is that if the parties are meeting for business reasons, the food and drink will be no more than functional. So if we're looking at sandwiches or muffins, with coffee or orange juice, the "what" bears out the "why", and the deductibility of the expense looks safer. Note, however, that if alcohol is involved, the "what" answer will have much less credibility.

Generally, the "why" and the "what" must be satisfied in order to make a successful claim for deductibility, but the next question – "where" – can undermine the direction of the logic. If the food and drink is consumed on the business's premises, naturally there is more weight to the argument that the expense is a business cost. Being at a restaurant or café does not necessarily count against the viability of the claim, but the answer to the next question – "when" – helps if the food and drink expense is incurred during business hours.

Wriggle room for entertainment claims

There are some specific expenses that are generally accepted as deductible. Refreshments made available at a presentation to staff on business premises (such as sandwiches, biscuits and tea or coffee) are generally accepted as a business cost, and deductible. The ATO views this sort of food and drink as sustenance, or employee amenities. And again, alcohol has no place in tax deduction considerations in these situations.

Another scenario where food and drink would never be considered entertainment by ATO standards is where expenditure is incurred by an employee who is travelling away from home. In this situation also, there is less of a requirement that the items consumed be merely functional.

Within the tax law that denies the deductibility of the costs of food and drink that are entertainment is a proviso that can be called "promotion and advertising". So if a business hosts a product launch, for example, and serves up a spread of various food and drinks for the guests, including alcohol, the costs of this entertainment will be deductible. The food and drink are relevant and incidental to the promotional event of the business.

Another proviso within the entertainment deduction prohibition rules is where food and drink are consumed incidental to attendance at a seminar of at least four hours' duration. Clearly, the time frame is important to allow for an unchallengeable deduction claim. Note also that the word "seminar" covers events such as workshops, training sessions, conferences, lectures and so on.

Assessing the strength of deduction claims

When determining whether an expense is "entertainment", and therefore deductible or non-deductible, the taxpayer's position is more assured by having a "reasonably arguable position", as the ATO puts it, which can be arrived at by examining the answers to the questions spelled out above.

Naturally, many taxpayers are wary of not crossing a line when it comes to making tax deduction claims, as are many tax practitioners. The ATO has power to dole out various penalties and fines, which can be a disincentive in situations where the outcome is not certain. However, it is equally the case that taxpayers might be missing out on some very legitimate tax deductions by merely not exploring their books and taking too conservative a view that their expenditure is off the table.

Contact our office for help if you suspect that there could be "entertainment" deductions your business is missing out on. Over the course of a year, these otherwise unidentified pockets of expenditure could add up to a tidy sum. ■

Ten tips for rental property owners to avoid common tax mistakes

Below is a list of tips from the Australian Taxation Office (ATO) that should help rental property owners avoid what it has found are the 10 most common tax errors made by rental property investors. The ATO says that avoiding these tax mistakes will save many taxpayers both time and money.

1 CLAIMING THE RIGHT PORTION OF EXPENSES

The ATO is adamant that you can't claim deductions for rental property expenses when family or friends stay free of charge, or for periods when you use the property for your own purposes. Also, if the property is rented out to family or friends below market rate, you can only claim a deduction for that period up to the amount of rent received.

2 INITIAL REPAIRS AND CAPITAL IMPROVEMENTS

You are not able to claim initial repairs or improvements as an immediate deduction in the same income year that such expenses were incurred. The ATO takes the view that:

- Repairs must relate directly to "wear and tear" or other damage that happened as a result of renting out the property. Initial repair costs for damage that existed when you bought the property (such as replacing broken light fittings or fixing damaged floorboards) are not immediately deductible, but these costs come into play later when working out profit upon sale of the property (that is, your capital gain or loss: see tip 9).
- Ongoing repairs that relate directly to wear and tear or other damage that resulted from renting out the property (such as fixing the hot water system or part of a damaged roof) are classed as a repair and can be claimed in full in the same income year.
- Replacing an entire part of the property, such as replacing a bathroom, is classified as an improvement and is not immediately deductible. These "building costs" can be claimed at 2.5% each year for 40 years after completion.
- If you completely replace a damaged item that is detachable from the house and it costs more than $300 (for example, replacing the entire hot water system), the cost will need to be depreciated over a number of years.

3 CONSTRUCTION COSTS

It is possible to claim certain building costs, including extensions, alterations and structural improvements, as capital works deductions. Generally, you can claim a capital works deduction at 2.5% of the construction cost each year for 40 years from the date of completion.

If the previous owner claimed a capital works deduction, they should give the current owner the relevant information to calculate costs, so it always pays to ask for this. If they didn't use the property to produce assessable income, an estimate can be obtained from a professional. However, the ATO requires that this professional is qualified, uses a reasonable basis for their valuation and excludes the cost of the land when working out construction costs.

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Ten tips for rental property owners to avoid common tax mistakes *cont*

4 CLAIMING BORROWING EXPENSES

Borrowing expenses include loan establishment fees, title search fees and costs of preparing and filing mortgage documents. If the borrowing expenses are more than $100, the deduction is spread over five years. If they are $100 or less, you can claim the full amount in the same income year as the expense was incurred.

5 PURCHASE COSTS

You can't claim any deductions for the costs of buying your property. This includes conveyancing fees and stamp duty (for properties outside of the ACT). If you later sell your property, these costs are used when working out your capital gain (or loss): see tip 9.

6 MAKE SURE THE PROPERTY IS GENUINELY AVAILABLE FOR RENT

The property must be genuinely available for rent in order to claim a tax deduction. This means you must be able to show a clear intention to rent the property. The rent should be set in line with similar properties in the area, and the property should be advertised so that someone is likely to rent it. The ATO also says it is advisable to avoid what may be seen as unreasonable rental conditions.

7 CLAIMING INTEREST ON YOUR LOAN

You can claim interest as a deduction if you take out a loan for your rental property. However, if you use some of the loan money for personal use, such as buying a boat or going on a holiday, you are not permitted to claim the interest on that part of the loan. You can only claim the part of the interest that relates to the rental property.

8 CO-OWNING A PROPERTY

If you own a rental property with someone else, you must declare rental income and claim expenses according to your legal ownership of the property. If you are joint tenants, your legal interest will be equally divided, but if you are tenants in common you and the other owners may have different ownership interest percentages.

9 CAPITAL GAINS WHEN SELLING

When you sell your rental property, you will make either a capital gain or a capital loss (that is, the difference between what it cost to buy and improve the property, and what you receive when you sell it). If you make a capital gain, you will need to include this in your assessable income for that financial year. If you make a capital loss, you can carry the loss forward and deduct it from capital gains in later years.

10 KEEPING THE RIGHT RECORDS

Having evidence of your income and expenses is important to be able to claim everything you are entitled to. Capital gains tax may apply when you sell, so you should keep records over the period you own the property and for five years from the date you sell it. ■

Stay alert for scams & fraud

The Australian Taxation Office (ATO) is committed to educating taxpayers on how to protect themselves against tax scams and identity theft. It says that up to the end of last financial year, $2.7 million was handed over to fraudsters, with about 2,500 individuals providing some sort of personal information to scammers, including tax file numbers.

Over the 2017 calendar year, the ATO's *Be aware of what you share* video was viewed more than 800,000 times. (You can still find the video via a web search.) The ATO also maintains multiple web pages with information for businesses and individuals about scams, covering topics such as identity security and protecting your information. The most popular page is "Verify or report a scam" (which, again, a web search will find for you).

The ATO's social media channels also warn followers about current scams in the community, and advise people how to protect themselves and what to do if they suspect they've been affected.

But even with all these warnings and links to information, taxpayers are still being hit by scammers. The latest advice from the ATO reveals that fraudsters are constantly coming up with new tricks to try to hoodwink Australian taxpayers, making some scams harder to spot than others.

For example, some scammers source genuine ATO phone numbers from its website and project these numbers in their caller ID in an attempt to legitimise their call – a form of impersonation known as "spoofing". While the ATO does make thousands of calls per week to the community, its outbound calls do not project numbers on caller ID. If one appears, this is the first red flag to alert you that the call could be a scam.

You should also be wary of emails and SMS messages that claim to be from the ATO, even if they seem legitimate. If you're ever unsure about whether a call, text message or email is genuine, you can call the ATO on 1800 008 540. If the communication you have received is legitimate, the ATO will be able to connect you with the right department.

Additionally, major retailers and financial institutions continue to integrate customer warning notices into their businesses to try to combat some of the most common scam payment methods, including iTunes gift vouchers and direct transfer into fake "ATO" bank accounts.

TOP TIPS TO AVOID TAX TRAPS

- Be aware of what you share: You should only share your personal information with people you trust and organisations with a legitimate need for it.
- Stay secure: Keep your mobile devices and computers secure by changing your passwords regularly, keep your anti-virus, malware and spyware protection software up-to-date and don't click on suspicious links.
- Don't reply: Don't reply to any SMS or email with your personal or financial information.
- Recognise a scam: If someone asks you for your bank account or personal details, or demands money, refunds or free gifts, be cautious. Also avoid requests in emails or SMSs requesting you to click on a link to log on to government or banking digital services.
- Report scams: If you think you or someone you know might have been contacted by a scammer, or have fallen victim to a tax-related scam, contact the ATO on 1800 008 540. ■

Understanding novated leases, FBT and claims for work-related car expenses

A novated lease is a popular way for employers to reward and incentivise their staff. Through a salary sacrifice arrangement that includes a novated lease, employees are provided with a vehicle and can also reduce their personal tax liability. However, employees should understand how fringe benefits tax (FBT) might apply to their arrangement and what they can do to minimise an FBT liability.

How does a novated lease work?

Under a novated lease arrangement, the employer takes over all or part of the employee's rights and obligations under the lease of a vehicle provided to that employee by a finance company. This transfer of rights and obligations is agreed to in an arrangement between the employer, the finance company and the employee. (The lease obligation typically reverts to the employee should employment cease.)

In return, the employee agrees to the lease payments being deducted from their pre-tax salary. This arrangement therefore allows the employee to reduce their taxable income and pay less tax.

How does FBT potentially apply?

As well as paying for the car lease repayments, an employer will sometimes pay for the car's running costs, such as fuel, maintenance, registration and car insurance. This means that a car fringe benefit arises to the employer.

Under most arrangements reached between employers and employees, FBT is ultimately borne by the employee through adjustments made in the resulting salary package. However, this FBT liability can be reduced by the employee making after-tax contributions towards the vehicle's running costs. Therefore, a question commonly asked is whether such vehicle running costs incurred by an employee and paid from after-tax income are deductible in their personal tax return.

This is a common scenario for many taxpayers, and the answer to the deductibility question is best explained using the following scenario.

EXAMPLE

Susan is a senior executive at XYZ Pty Ltd (XYZ). She is occasionally required to travel to regional areas to perform her duties. Susan received a vehicle under a full novated lease as part of her total remuneration package.

Like many businesses, XYZ's policy is that any FBT liability from the provision of a car fringe benefit is to be borne by the employee through an adjustment to the salary package. In order to reduce the FBT liability, an employee contributions method is adopted by Susan's employer, such that the taxable value of the benefit is reduced by way of after-tax employee contributions.

Under this method, Susan pays for some of her car expenses, such as fuel and servicing, from her after-tax income (which reduces the FBT) while the rest of the

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Forced to unwind your LRBA?

Best to have a contingency plan

Limited recourse borrowing arrangements (LRBAs) were once all the rage in SMSF land. However, with the tightening of banking rules this frenzy has begun to abate somewhat over the last few years.

LRBAs are great in a growing market as they allow an SMSF to grow the value of assets it holds in the expectation of greater retirement income.

For all LRBAs, there does come a time when the trustees must unwind the LRBA – hopefully when the loan has been paid off and the asset can be transferred to the SMSF proper.

However, there are times when the choice to unwind an LRBA may not be fully in the hands of the trustees, but rather forced upon them by events outside of their control.

What events are we talking about? There are four main occurrences that may force the unwinding of an LRBA, and they are:

- forced sale by the lender
- divorce
- death/disability, and
- the member entering pension phase.

Forced sale by lender

The whole point of an LRBA is to generate capital growth and investment earnings for the SMSF, but as with all investments this is not guaranteed. We have seen property prices in the major cities rise spectacularly but that is now starting to taper off, with falling prices in some regions and market collapse in others. The share market has also fluctuated significantly over the last few years. What happens when you bet on black but it lands on red?

The great thing for an SMSF with an LRBA is that, should the value of the asset be less than the value of the debt and a sale is forced, the lender does not have recourse to other assets of the fund. However, the problem is that any money made from the sale must be put towards repaying the debt. Also, given that most banks only lend on the basis of a 60% loan-to-value ratio these days, the fund will lose any amounts initially contributed. Worse for the trustees is that while the lender may not have access to other assets in the fund, if they were prudent they would get the trustees to sign agreements to give access to other assets of the trustees outside of superannuation.

The reality is that if we see a bursting of a property bubble with significant falls in the value of property — as happened in the US and other countries during the GFC — this could cause the calling in of loans set up as LRBAs. The trustees may have no option other than to liquidate the asset in a falling market. Be prepared for the possibility.

Divorce

Unfortunately, one in three marriages will end in divorce (down from one in two). The hardest part of any divorce, other than custody issues involving children, is the division of property. This becomes even messier when the divorcing couple has an SMSF that holds an LRBA.

In this circumstance, one or more of the members of the SMSF are likely to leave. There needs to be sufficient assets to transfer the value of the leaving members' benefits to alternative funds. In SMSFs with an LRBA, the LRBA asset tends to be the major asset, and there

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Forced to unwind your LRBA? Best to have a contingency plan *cont from page 7*

are unlikely to be sufficient alternative assets to pay out the leaving members. This will force the fund to prematurely unwind the LRBA and sell the asset. If the asset is a business asset used by one of the members, this becomes even more of an issue in terms of how the trustees arrange for the sale and who to sell to.

Getting agreement on what to do, while also going through a divorce, will be tricky and add to the complexity, time and expense of the divorce. Given the one-in-three divorce odds, the best thing to do is to get agreement between the trustees as to how to deal with fund assets on divorce while things are good. This may seem like a strange thing to do, but having a prior agreement in place could save a lot of costs and hassles down the line.

Death/disability

Another situation that can lead to the forced sale of an asset subject to an LRBA is the death or disability of a member of the SMSF. In such a situation, either a death benefit must be paid out or a disability pension may be paid. Because these are paid out of the assets of the fund, an SMSF with a main asset that is a property subject to an LRBA may have liquidity problems that may force the sale of the property to pay the benefits.

To avoid this problem, one answer may be to have death and disability insurance outside superannuation that covers the amount of the outstanding loan. Therefore, upon the death or disability of a member, the amount of the loan can be repaid out of the insurance benefits, allowing the loan to be paid off and the asset freed from incumbrancers.

In reality, however, even where insurance is sufficient to pay off the loan, the ongoing costs of a death benefits pension or disability pension may be more than the income that can be generated from the assets. This would, therefore, require the sale of assets, including potentially the asset that previously underpinned the LRBA.

Pension phase by a member

The final main reason an LRBA could be forced to unwind early is the retirement of a member and the starting of a pension. If the LRBA asset is delivering positive income streams that can help to fund the pension, a sale may not be required. However, if there is not enough income to pay for the pension, this may require a sale. Again, the best way to deal with this is to have a written agreement between the trustees as to what will happen to the LRBA in the event of the retirement of one member and the need to liquidate assets.

Conclusion

In most cases, SMSF trustees will make their own decision as to when and how to unwind their LRBA. However, there are potential circumstances that may arise that take this decision out of the hands of the trustees. The best defence against such scenarios is to plan for their possibility (while hoping they don't occur) by having agreements in place with the trustees as to what is to occur should one of these events happen. It also highlights the importance of having insurance outside of superannuation. ■

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costs are borne by XYZ from Susan's pre-tax income. Because Susan pays some of these costs from her own pocket, she now wonders whether she is entitled to claim a deduction for some of the car expenses.

Unfortunately for Susan, the short answer is no.

Broadly, "car expenses" incurred by an employee in respect of a car provided by an employer, especially one provided for that employee's "exclusive and private use", are specifically denied as a deduction within the tax legislation. Note also that this applies to relatives of an employee, such as a spouse, parent or child. Notwithstanding the above, Susan will still benefit from the arrangement. Not only does she get the car, but her after-tax contributions towards the car's running costs reduce the amount of FBT that she would have been required to salary sacrifice as a component of her total remuneration.

The above rule would also be relevant where a company or fleet car is provided by an employer to an employee (or their relative) for their exclusive and private use. In such instances, running costs incurred by the employee, such as fuel, would not be deductible. ■