Tarrants Accountants
(Market St Tax Pty Limited)
*Big enough to trust, small enough to care*

# TARRANTS TAX TALK

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# Who is a spouse under the tax laws, and why does it matter?

## About this newsletter

Welcome to the Tarrants client information newsletter, your monthly tax and super update keeping you on top of the issues, news and changes you need to know. Should you require further information on any of the topics covered, please contact us via the details below.

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While Australia doesn't have a joint filing option for married couples, there are some aspects of your individual tax assessment that depend on your spouse's income.

For example, your eligibility for the private health insurance rebate and your liability for the Medicare Levy Surcharge both take into account your spouse's income. Other tax attributes affected by your spouse's income include the senior and pensioner tax offset, the Medicare Levy reduction for families, the zone and overseas forces tax offsets, and the invalid and invalid carer offset.

*continued overleaf*

## Who is a spouse under the tax laws cont

Under Australian tax law, a spouse is a person (of any gender) with whom you were in a relationship that was registered under a prescribed State or Territory law, or not legally married, but who lived with you on a genuine domestic basis in a partnership as a couple.

So, spouses are either legally married or living in a de facto relationship under the same roof. Note the additional requirement for cohabitation for de facto couples, which is in itself evidence of the relationship.

Sounds simple enough, but here are some commonly asked questions about spouses:

### Q WHAT ABOUT OVERSEAS MARRIAGES?

*Many marriages for Australian residents took place in other jurisdictions. The Marriages Act has reciprocal provisions and most overseas marriages are recognised in Australia.*

### Q WHAT IF MY SPOUSE IS STILL A FOREIGN RESIDENT?

*Sometimes visa requirements prevent both spouses from entering Australia at the same time. Where this occurs and the parties are legally married, the foreign partner is regarded as a spouse. All their global income needs to be disclosed in the Australian tax return of the resident partner. Where the parties are in a de facto relationship and they are not cohabiting, the foreign partner will not be treated as a spouse under the tax rules.*

### Q WHAT IF I DON'T KNOW MY SPOUSE'S INCOME?

*You might need to lodge by 31 October, but your partner runs a business and uses his tax agent's extension to lodge by the following May. Or you and your partner may be going through a difficult separation and the communication process is far from ideal. Make your best estimate, based on what you know about their affairs. If you have acted in good faith you won't be penalised for getting it wrong, although the Tax Office might adjust your return down the track.*

### Q WHAT IF MY RELATIONSHIP LASTED FOR LESS THAN A YEAR?

*Most people don't start or finish relationships on 1st July. There is space on your tax return to indicate when you have started or finished a spousal relationship part way through the year of income. The Tax Office will pro-rate the various tax rebates or surcharges as necessary.*

### Q WHAT IF I AM SEPARATED BUT NOT DIVORCED?

*Couples who are legally married but who subsequently separate continue to be spouses until their divorce is finalised. On the other hand, couples who were in a de facto relationship but who subsequently separate cease to be regarded as spouses from the time they are no longer cohabiting.*

### Q DOES COHABITING NEED TO BE FULL-TIME FOR A COUPLE TO BE REGARDED AS BEING IN A DE FACTO RELATIONSHIP?

*Some couples prefer to maintain their own respective households while engaging in a co-dependent intimate relationship with another person. They might spend a number of nights together at either one of their homes but also spend time apart, which gives them independence and makes their relationship work.*

*These things are a question of fact and degree. If the couple spend most nights together at one place or the other and conduct themselves as a couple they might be regarded as being in a de facto relationship.*

*If they were legally married this would not be an issue, as they would be regarded as each other's spouse regardless of how much time they spend apart. Perhaps not the most romantic reason for popping the question, but marriage would sort out any tax uncertainty there might be.*

# Riding the market waves

**Don't let share market volatility get you off course with your superannuation investment strategy.**

## Market volatility

Market downturns can make anyone nervous, but sticking to your investment strategy is key.

If you move your investments to cash or a more conservative option after the market has fallen, you're effectively locking in your losses. Decisions driven by fear are rarely the right ones, and acting impulsively can be costly. It is also very difficult (if not impossible) to correctly time the market, so if you're planning to switch back to growth assets before the market recovers, this might see you miss out on the rebound.

A more optimistic view of a falling market is that your regular superannuation contributions are buying assets at a lower price. When the market eventually recovers, those assets purchased during the downturn can significantly increase in value.

## Don't panic and stay the course

Riding the ups and downs of financial markets is an inherent aspect of investing.

Although market volatility can be stressful, particularly for those nearing or in retirement, it's crucial to keep a long-term perspective and stick to your investment strategy (assuming it still meets your needs). Even those approaching retirement, or already retired, still have many years of investing ahead.

And if like most people your superannuation benefits are invested in a balanced or growth option, diversification plays a key role in shielding your balance from extreme market swings. That in turn allows you to have a diversified position and be confident that your superannuation can stay the course over time.

For those in a large APRA-regulated fund, most funds have pre-mixed diversified options for you to choose from. Otherwise if you have your own SMSF, you'll need to ensure your investment strategy factors in a range of requirements such as diversification, the risk and return in making investments, and so on. As trustee or director of your fund, you will need to manage this yourself or seek advice from a licensed financial adviser who can assist you in developing a compliant strategy that is tailored to your fund and members' circumstances.

But if market volatility continues to keep you up at night, it might be wise to check your investments and superannuation balance less often. By focusing on the long-term rather than daily fluctuations, you'll have a clearer perspective on your financial progress without unnecessary worry.

## The last word

As the investment saying goes, "it's not about timing the market, it's about time in the market". The key takeaway is to stay patient, adhere to the fundamental principles of diversification and asset allocation, and as always, don't hesitate to seek advice if you need it.

# Take care if you sell your home after leaving Australia!

If you have lived in Australia for many years and bought yourself a home here but decide to leave and go and live elsewhere, and you wish to sell your home, you should do so before you leave Australia.

Otherwise, if you sell your home after you have left Australia (and have become a foreign resident for tax purposes) you will not get ANY capital gains tax (CGT) exemption on your home (subject to some limited circumstances).

It's a severe rule which can punish you harshly. And furthermore, you will be denied the full benefit of the 50% CGT discount on any assessable capital gain – broadly, to the extent that you have been a foreign resident during any period that you owned the home.

Furthermore, any capital gain will be taxed in your hands at the higher non-resident tax rates.

What about the case if you have signed the contract of sale while you are still in Australia, but the settlement does not take place until after you have left Australia?

In this case, you are off the hook. This is because the time at which you are judged to have sold the home for CGT purposes is the time at which you have "entered into the contract" of sale – and not at the time of settlement (or any other time).

So, if you are still a resident of Australia at this time, then you will not be denied a CGT exemption on the sale of your home – nor the CGT discount, as relevant (such as where a partial CGT main residence exemption may otherwise apply).

This rule has important practical implications – and offers various solutions to get around any potential problem. For example, you could offer a sufficient discount on the asking price to make sure the agreement is entered into before you cease to be a resident.

And no doubt there are more extreme steps that can be undertaken if necessary.

For example, you could return to Australia and become a resident again for tax purposes on a bona-fide basis – and then sell the home. But if the home is, say, jointly owned between spouses, then both spouses would need to return to Australia.

On the other hand, in the case that you may have a capital loss on the home, selling it while you are a foreign resident is a good way to realise it so that you can use it for other purposes.

Finally, the rule denying you a CGT main residence exemption on your home if you sell it while you are a foreign resident does not apply if you have been a foreign resident for less than 6 years and you are required to sell it because of divorce or separation or family illness or death, etc.

Suffice to say, the issue of losing your CGT exemption on your home is no small matter.

So, if you are thinking of leaving Australia and you wish to sell your home (or any other property) make an appointment to come and speak to us about the matter so you can avoid any unnecessary and unwanted liabilities down the track.

# Separation and divorce
## CGT consequences .... and relief

With apparently at least one in three marriages ending in divorce – and with countless more defacto relationships breaking down – the capital gains tax (CGT) roll-over provisions for "marriage and relationship breakdowns" has assumed increasing relevance.

These rules provide for the "roll-over" of any capital gain on the transfer of assets between the separating parties so that there is not any immediate CGT liability in the circumstances.

However, they (like all CGT concessions) are subject to important conditions to be met and special rules that apply to certain categories of assets.

The first and foremost of these conditions is that the transfer of the asset must take place in accordance with one of the specific ways set out in the provisions – and these are essentially by way of a relevant court order or a defined financial or maintenance agreement.

And here's the first big planning opportunity: if one of the parties wants to realise a capital loss on an asset that they propose to transfer to the other spouse, then don't transfer it under any of the ways specified in the CGT rollover provisions – do it by way of a private agreement with the other party.

The second key rule is that the roll-over does not apply unless the asset is transferred to the other spouse. It cannot be transferred to the other spouse's discretionary trust or private company. It cannot even be transferred to the estate of the other spouse if that spouse dies during the separation proceedings.

The only possible exception to this rule is if the asset is transferred to a "child maintenance trust" – and even then strict conditions would apply.

In addition, not all assets can get roll-over under these rules. For example, trading stock is excluded and would be subject to the normal rules that apply to the disposal of trading stock outside the ordinary course of business.

Of course, if the rollover applies it does not mean CGT is avoided; it just means that it is deferred until the spouse to whom the asset is transferred later sells the asset or it is subject to a CGT event in their hands.

## Separation and divorce ... cont

However, in this case they would generally acquire the other party's "cost base" for the purposes of calculating any capital gain or loss. And they would also generally be entitled to the CGT 50% discount if it was held for the required time.

Nevertheless, there is an important and tricky rule that applies where the asset that is transferred is a dwelling (eg, a rental property) which is used for another purpose in the hands of the other spouse (eg, their home).

In this case, the spouse who acquires the asset will be liable for CGT for the gain that accrued while it was a rental property – even though it became their home from the time they acquired it from the other spouse until they later sold it.

Suffice to say, this type of scenario requires some careful negotiations between the parties before such a transaction is undertaken to make sure everything is "fair" for all the parties.

There are also special rules that apply when, say, an asset that is held by a family company or trust is transferred out of that company or trust to the other party as part of a settlement agreement.

Again, these rules can be complex and require good advice to ensure that all the issues are managed effectively.

So, all in all, if you are facing any spousal separation issues come and speak to us first about the ins-and-outs of the rules that apply on any transfer of assets.

And perhaps some of the impact of divorce or separation can be alleviated by making sure that the CGT rollover is used most effectively – because like death, divorce affords certain tax planning opportunities.

# Setting up an SMSF
## Who can join the fund?

A question that often gets asked is who can set up an SMSF together.

### The rules

The answer is practically anyone can set up a SMSF together. You can have up to six people in an SMSF, and they're often family members. The most common setup is you and your partner running the fund together, or just you if you're single. But it doesn't stop there. It is also common for business partners to set up an SMSF together, and in other cases, children may also join their parents' SMSF. As can be seen, other setups are possible.

### Business partners

As mentioned above, it is possible for business partners to set up an SMSF together. However there is a catch – that is, no fund member can be employed by another member unless they're related. To be clear, the rules allow two people who are directors of a company which owns the business to set up a fund together, however it is not possible if one person is not a director – in this case, it's only allowed if you are relatives.

### Your children

It is also possible for your children, regardless of their age, to join your fund. However, if your child is under 18, they can't be a trustee, so you as their parent would be the trustee on their behalf and handle that role for them. Once they're over 18, they must be a trustee unless they give someone else the power to act on their behalf by granting them an enduring power of attorney.

### The number one thing to keep in mind when sharing an SMSF

Shared responsibility! As a rule, all members are usually trustees, meaning you'll share the obligations of managing the SMSF and making decisions. This means you generally won't be able to act entirely on your own and will require everyone's agreement when it comes to making decisions impacting your fund.

### Change of mind and exit plan

If down the track you want to separate off into different funds, someone will have to exit the fund. This could involve selling assets or transferring them to a new fund, which might trigger capital gains tax or stamp duty issues.

When setting up your SMSF, it is important to also consider your exit plan as there will come a time when your benefit eventually needs to be paid out of the fund – this will usually happen when specific life events occur which may trigger an exit. As such, its best to plan well ahead and deal with this consideration upfront to avoid future disputes and tax implications later on.

# "Debt recycling"

## ...flavour of the month

It seems that "debt recycling" is the favour of the month among financial advisors (and some financial institutions too). And if you do a Google search for the term you find that it is being quite heavily marketed.

It is being marketed as an easy way to convert non-deductible home loan interest into deductible investment interest and to thereby pay off your home quicker – while at the same time generating good investment income and/or an investment portfolio. (It sounds almost too good to be true!)

And with house prices being the way they are and with new and existing homeowners with large mortgages, "debt recycling" seems to be becoming increasingly popular.

Essentially, "debt recycling" involves paying down the non-tax-deductible home loan debt on your home in full or to some extent (and by some means!) and then borrowing against it (or any other equity in the home) to buy investment assets, such as a rental property or shares.

The income from this investment is then generally used to pay off any existing home loan where the interest is non-deductible, while a deduction is claimed for outstanding interest on the investment loan.

And if you invest in shares that give rise to franked dividend income then the benefit is even better with the franking credits reducing some or all of the tax on that dividend income – and even on other income (depending on your financial circumstances).

There are of course various versions of "debt recycling" with their different design features. These include arrangements where you draw down on existing equity in a home to acquire funds for investment purposes or where you just convert an existing offset account into an investment income account.


But either way, one of the effects of debt recycling is to, in effect, "convert" non-deductible home loan interest to deductible investment interest – or, in other words, to restructure your affairs to also generate investment income for which an interest deduction can be claimed.

So, if you are attracted to the idea of "debt recycling" (or have already entered into such an arrangement) then come and speak to us about it to make sure you understand how it works and understand its advantages and disadvantages.

Or, at least, we can point you in the right direction.

And by way of example, one big disadvantage seems to be that if the investment market goes down dramatically, your lender may require you to repay the loan which, in a worst case scenario, may require you having to sell your home to meet the loan call – or at least take out a larger mortgage.

We can also, of course, explain to you the tax consequences of "debt recycling" and their specific tax features – including those which may or may not attract the Commissioner's attention.

So, again, if you are interested in the aspect of "debt recycling" then come and have a general chat to us about it first.