Your Knowledge

Accountancy Plus apw Whitsunday

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How good is ChatGPT at tax?

Not being paranoid or anything but we were curious about the skills of the latest innovation to take the world by storm, ChatGPT, and its ability to work with the Australian tax system.

Let's start by saying that we were impressed. Not so much by ChatGPT's ability to work with the complexities of the tax system, but for its tone and approach. The outcome from our testing, including the example below, is that you might end up with some general comments that are reasonably accurate, but you're unlikely to get an answer that can be relied on. And with most technical commentary tied up in personal advice rather than on the web where ChatGPT can explore it, it is unlikely that we will get there any time soon.

Here are the results of our test question and our commentary (ChatGPT's response is in italics).

Question: How much capital gains tax does an Australian resident pay on an investment property with a worked example.

ChatGPT: *An Australian resident pays capital gains tax (CGT) on the profit made from selling an investment property. The CGT is calculated by subtracting the cost of the property (purchase price plus any costs associated with acquiring and owning the property) from the sale price.*

For example, let's say an Australian resident purchased an investment property for $500,000 and spent $50,000 on costs associated with acquiring and owning the property (such as legal fees, stamp duty, and repairs). The total cost of the property is $550,000.

The accountant: Let's stop there and take stock. There are some tricks and traps that need to be considered when working out an asset's cost base.

While repair costs in some cases can form part of a property's cost base, this is not always the case. The situation is often different where the asset being sold is an investment property that has been rented to tenants. When a landlord repairs damage that occurs while the property is rented to a tenant, this will often be deductible to the landlord at the time the repair costs are incurred. Because deductions are available for these repair costs, they should not also be included in the property's cost base.

There are also other adjustments that need to be considered. In the context of investment properties, it will often be necessary to make adjustments to the cost base to take into account capital works deductions. Landlords can often claim capital works deductions when an investment property is used to derive assessable rental income. The property's cost base should then be reduced by capital works deductions that have been or could be claimed by the landlord (although there is an exception to this if the property was acquired before 13 May 1997 and the cost of improvements was incurred by 30 June 1999).

The longer the period of ownership, the more likely that capital works deductions and repair costs can end up being quite significant and have a material impact on the capital gain calculation.

ChatGPT: *After several years, the resident decides to sell the property for $700,000. The profit made from the sale is $700,000 - $550,000 = $150,000. The CGT rate in Australia is currently at 45% and the resident will pay 45% of the $150,000 profit, which is $67,500.*

The accountant: Let's take a closer look at that calculation. There is no CGT rate of 45% that applies specifically to capital gains. Net capital gains form part of an individual taxpayer's assessable income. This figure is then used to calculate the individual's taxable income for the relevant income year. If there is a positive taxable income figure, then we apply the individual's marginal tax rates.

One way of explaining this is that a higher taxable income normally results in a higher tax bracket and a higher rate of tax. In other words, the tax rate that applies to an individual's net capital gains is impacted by the individual's other income or losses (if any).

Also, while the highest marginal tax rate for individuals is currently 45 per cents for each dollar of taxable income above $180,000, Australian residents are also normally subject to the Medicare levy of 2%. This should be considered and factored in.

ChatGPT: *It's worth noting that there are certain exemptions and reductions that can be applied to the CGT calculation, such as the main residence exemption and the small business CGT concessions.*

The accountant: If only tax was that simple! There are certain exemptions and reductions that can apply to capital gains. While the answer mentions the main residence exemption and the small business CGT concessions, these concessions do not normally apply to the sale of an investment property.

For the main residence exemption (or partial main residence exemption) to be available, one of the key conditions is that property would need to have been established and used as the individual's main residence. The exemption is unlikely to be available if the property has been used solely as an investment property to

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derive assessable rental income, although if the property was inherited then the position could be different.

Also, the small business CGT concessions would not normally apply to the sale of an investment property. This is because the concessions can only apply if the asset passes an active asset test, which requires the property to have been used in qualifying business activities for a minimum period of time.

Assets used in a business carried on by the owner or certain related parties can often be treated as active assets for the purpose of these concessions, but there is a specific exception for assets used mainly to derive rent from unrelated parties.

If the property has been solely used to derive rent (even if used in a rental business) from unrelated parties, the property is likely to fail the active asset test and the small business CGT concessions shouldn't be available.

Interestingly, the answer didn't refer to the general CGT discount or indexation, which are the most likely concessions that would apply to a situation like this.

If the seller is an Australian resident (and not a temporary resident) during the period they owned the property and has owned the property for more than 12 months, the 50% CGT general discount would often be available to reduce the capital gain.

If the property was acquired before 21 September 1999, indexation of the cost base could be available instead. It would be necessary to compare both options to see which provides the more favourable result.

ChatGPT: *It is advisable to consult with a tax professional to determine the specific tax implications of selling an investment property.*

The accountant: Yes, indeed it is. Thank you ChatGPT.

Full throttle in 2023

In a volatile market, keeping to a strategy, or let's face it creating one, can be tough.

The downside of not taking time out for your strategy is that there is a tendency to keep a short-term focus at an operational level to try and pick quick wins to generate financial returns. Sometimes in the process, this short-term focus undermines longer term value and returns.

Here are our 'must dos':

Know what your position is.

A business health check is an analysis of the current state of your business. It is an analytical review of its operation with view to providing a broad overview of operating performance and identifying potential issues. Understanding your position will reveal your risks and capacity to develop.

Know what to look for.

Once you know your position, the next question is what are the measures that are going to give you the best insight into business performance. In a volatile market, this information will give you what you need to make informed decisions at any one point in time.

Be prepared to make quick decisions.

If you know your position and have the data you need, be prepared to make quick decisions and take the first mover advantage. If you have the two elements above, you have your radar for identifying opportunities and mitigating risk. Most businesses are simply a replication of what they see. While the pandemic and market instability is difficult, we have also seen a wave of innovation as people adapt to find solutions.

Don't bank on a single opportunity.

If COVID has taught us anything it is that things change, and we need to adapt and change with the circumstances. While one single opportunity might make all the difference, an overreliance on one product, service, or methodology of delivering those products and services, exposes you to risk.

Understand your end game.

What are you aiming for? Family empire? Fast growth and sale? Sustainable growth and sale as a retirement plan? Public listing? Even if you plan on simply running and growing your business for decades to come, that is a decision. Your end game and your progress towards that end game impacts your structure, focus, and decision making.

Document your strategy.

Document your strategy - knowing it in your head is not enough. This does not have to be an onerous *War & Peace* approach. It is understanding what you are aiming for, and breaking that down into measurable objectives, then into measurable outcomes and timeframes (preferably actionable against rolling 90 day plans). This approach also makes management meetings a lot more meaningful.

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Is 'downsizing' worth it?

From 1 January 2023, those 55 and over can make a 'downsizer' contribution to superannuation.

Downsizer contributions are an excellent way to get money into superannuation quickly. And now that the age limit has reduced to 55 from 60, more people have an opportunity to use this strategy if it suits their needs.

What's a 'downsizer' contribution?

If you are aged 55 years or older, you can contribute $300,000 from the proceeds of the sale of your home to your superannuation fund.
Downsizer contributions are excluded from the existing age test, work test, and the transfer balance threshold (but are limited by your transfer balance cap).
For couples, both members of a couple can take advantage of the concession for the same home. That is, if you and your spouse meet the other criteria, both of you can contribute up to $300,000 ($600,000 per couple). This is the case even if one of you did not have an ownership interest in the property that was sold (assuming they meet the other criteria).
Sale proceeds contributed to superannuation under this measure count towards the Age Pension assets test.
Because a downsizer contribution can only be made once in a lifetime, it is important to ensure that this is the right option for you.
Let's look at the eligibility criteria:

- You are 55 years or older (from 1 January 2023) at the time of making the contribution.
- The home was owned by you or your spouse for 10 years or more prior to the sale – the ownership period is generally calculated from the date of settlement of purchase to the date of settlement of sale.
- The home is in Australia and is not a caravan, houseboat, or other mobile home.
- The proceeds (capital gain or loss) from the sale of the home are either exempt or partially exempt from capital gains tax (CGT) under the main residence exemption, or would be entitled to such an exemption if the home was a post-CGT asset rather than a pre-CGT asset (acquired before 20 September 1985). Check with us if you are uncertain.
- You provide your super fund with the Downsizer contribution into super form (NAT 75073) either **before or at the time of making the downsizer contribution**.
- The downsizer contribution is made within **90 days of receiving the proceeds of sale**, which is usually at the date of settlement.
- You have not previously made a downsizer contribution to super from the sale of another home or from the part sale of your home.

Do I have to buy another smaller home?

The name 'downsizer' is a bit of a misnomer. To access this measure, you do not have to buy another home once you have sold your existing home, and you are not required to buy a smaller home - you could buy a larger and more expensive one.
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The ATO's final position on risky trust distributions

The ATO has released its final position on how it will apply some integrity rules dealing with trust distributions - changing the goal posts for trusts distributing to adult children, corporate beneficiaries, and entities with losses. As a result, many family groups will pay higher taxes because of the ATO's more aggressive approach.

Section 100A

The tax legislation contains an integrity rule, section 100A, which is aimed at situations where income of a trust is appointed in favour of a beneficiary, but the economic benefit of the distribution is provided to another individual or entity. For section 100A to apply, there needs to be a 'reimbursement agreement' in place at or before the time the income is appointed to the beneficiary. Distributions to minor beneficiaries and other beneficiaries who are under a legal disability are not impacted by these rules.

If trust distributions are caught by section 100A, this generally results in the trustee being taxed on the income at penalty rates rather than the beneficiary being taxed at their own marginal tax rates.

While section 100A has been around since 1979, until recently there has been relatively little guidance on how the ATO approaches section 100A. This is no longer the case and the ATO's recent guidance indicates that a number of scenarios involving trust distributions could be at risk.

For section 100A to apply:

- The present entitlement (a person or an entity is or becomes entitled to income from the trust) must relate to a reimbursement agreement;
- The agreement must provide for a benefit to be provided to a person other than the beneficiary who is presently entitled to the trust income; and
- A purpose of one or more of the parties to the agreement must be that a person would be liable to pay less income tax for a year of income.

High risk areas

Until recently many people have relied on the exclusions to section 100A which prevent the rules applying when the distribution is to a beneficiary who is under a legal disability (e.g., a minor) or where the arrangement is part of an ordinary family or commercial dealing (the 'ordinary dealing' exception). It is the ordinary dealing exception that is currently in the spotlight.

For example, let's assume that a university student who is over 18 and has no other sources of income is made presently entitled to $100,000 of trust income. The student agrees to pay the funds (less tax they need to pay to the ATO) to their parents to reimburse them for costs that were incurred when the student was a minor. This situation is likely to be considered high risk if the student is on a lower marginal tax rate than the parents because the parents are receiving the real benefit of the income.

The ATO is also concerned with scenarios involving circular distributions. For example, this could occur when a trust distributes income to a company that is owned by the trust. The company then pays dividends back to the trust, which distributes some or all of the dividends back to the company. And so on. The ATO views these arrangements as high risk from a section 100A perspective.

Common scenarios identified as high risk by the ATO include:

- The beneficiary is a company or trust with losses and the beneficiary is not part of the same family group as the trust making the distribution.
- A company or trust which is entitled to distributions from the trust returns the funds to the trustee (i.e., circular arrangements).
- The beneficiary is issued units by the trustee of the trust (or a related trust) with the amount owed for the units being set-off against the entitlement and where the market value of the units is less than the subscription price or the trustee is able to do this without the consent of the beneficiary.
- Adult children are made presently entitled to income, but the funds are paid to a parent in relation to expenses incurred before the beneficiary turned 18.

Where to from here?

If you have a discretionary trust, it will be important to ensure that all trust distribution arrangements are reviewed in light of the ATO's guidance to determine the level of risk associated with the arrangements. It is also vital to ensure that appropriate documentation is in place to demonstrate how funds relating to trust distributions are being used or applied for the benefit of the beneficiaries.

The ATO's new approach applies to entitlements before and after the publication of the new guidance but for entitlements arising before 1 July 2022, the ATO will not generally pursue these if they are either low risk under the new guidance, or if they comply with the ATO's previous guidance on trust reimbursement agreements.

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SMSF reporting changes from 1 July 2023

If you have an SMSF with a total balance of less than $1 million, from 1 July 2023 you will need to report quarterly to the ATO instead of annually. Previously, SMSFs with a balance under $1m reported annually at the same time as lodging the SMSF annual return.