

## **SUMMER NEWSLETTER 2004**

Welcome to the first newsletter for 2004. This year should prove interesting to everyone who pays tax because it is an election year. As usual we try to bring to your attention a wide range of topics that might start you thinking about possible outcomes that will be beneficial. Please feel free to call or send us an email if you need additional information.

### **Earning \$20,000 A Year Tax Free**

A growing number of retirees are generating significant income from profitable hobbies such as photography, woodturning and restoring antiques. A question that often arises is, "Am I in business, or is my pursuit classified as a hobby by the Australian Taxation Office (ATO)?"

The answer, as you would expect, is not always clear-cut. The ATO publish a booklet titled "Am I in Business" and it offers some insight into the questions you need to consider. By attempting to define the characteristics of a business, they define a hobby by default. The following examples set the scene:

### **Example one**

Roger sells wooden toys from a retail outlet and is open during normal business hours. He advertises in the yellow pages and even has a dedicated website. He sells his toys in the local area and to anyone who responds to his advertising. The prices are set commercially and in an average market, he expects to make a profit. The ATO would normally classify Roger as being in business.

### **Example two**

Denise makes soft toys at home and devotes six hours a week to this activity. She sells to family, friends and people that hear about her work through the local Rotary Club. She has no intention to grow any bigger and is happy to recover her costs and perhaps make a small margin over a full year. The ATO is likely to classify Denise's activity as a hobby.

### **Why is this issue important?**

The income from a hobby is not taxable and the expenses incurred are not allowed as a tax deduction. In addition people pursuing a hobby cannot claim losses as an offset against investment income, and losses cannot be carried forward. In the past we have had experience with taxpayers who generated up to \$20,000 from a hobby, and the ATO ruled that the activity was not a business.

If you are genuinely in business, the ATO assesses your taxable income and allows tax deductions for expenses necessarily incurred in carrying on a business. Some losses can be offset against other assessable income, and some losses can be carried forward until there is a profit against which the losses can be offset.

### **Apportionment Of Rental Property Expenses**

A recent Tax Practitioner Seminar conducted by the Australian Taxation Office (ATO) highlighted a number of issues relating to taxpayers who have a rental property that is partly used for private use, and partly available for rent. The following four issues were highlighted:

- Taxpayers cannot claim a deduction for any expenditure incurred during periods when their rental property was used by them, their family or friends or relatives for private purposes.
- If the purpose for travelling to inspect a rental property is merely incidental to the main purpose for the travel, they cannot claim a deduction for the cost of the travel.
- If a loan has been taken out for say a car (used privately) and a rental property, then accurate records must be kept so as to justify the portion applicable to the rental property.
- If only part of the property is used to generate rental income, expenses should be apportioned on a floor area basis.

Clients who own rental property should understand these issues and ensure that they keep accurate records.

### **The Tax Office Admits A Mistake!**

Tax professionals have been alerted to a mistake that occurred when superannuation surcharge assessments were issued in November 2003. The printing error has been rectified and taxpayers were sent a new assessment. Clients who have questions about their surcharge assessments should ring to discuss their particular concerns.

### **Website Of Interest**

Clients who need to delve into the finer points of social security law and practice should find the following website illuminating: [www.facs.gov.au](http://www.facs.gov.au)

### **Did You Know?**

According to a research at an English university, it doesn't matter in what order the letters in a word are, the only important thing is that the first and last letter is at the right place. The rest can be a total mess and you can still read it without a problem. This is because we do not read every letter by itself but the word as a whole.

Pretty funny!

### **Government Co-Contribution For Low Income Earners**

Recent legislation provides for a government co-contribution for low - income earners who make a contribution of up to \$1,000 to a superannuation fund before the 30<sup>th</sup> of June. This effectively means doubling your money. A low - income earner must earn no more than \$27,500 for the full matching co-contribution. A reduced co-contribution applies to taxpayers who earn up to \$40,000.

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This new initiative could be useful when planning when to retire, especially if you have a partner and can plan to retire in different financial years. It may also be of benefit to people who are still working but have elected to work reduced hours. Further details are available at [www.ato.gov.au/super](http://www.ato.gov.au/super) and select "Fact Sheets".

### **Ever Been Menaced By A "Cold Caller" Offering Investment Schemes?**

The Australian Securities and Investment Commission (ASIC) have issued a warning that illegal international cold callers are renewing their attempts to swindle investors. The ASIC website lists 100 organisations that are known operators. Please always check with us if you are contemplating new investments. To give you an idea of how gullible some fellow Australians are, the 2002 ASIC report estimates that 6,000 Australians have been caught in these scams, and could have lost up to \$400,000,000.

### **Investment Seminars, Are They A Tax Deductible Expense?**

The Australian Taxation Office has written to Tax Agents reminding them that in many cases the expense incurred in attending an investment seminar or course needs to be apportioned between the deductible and non-deductible components. Topics that relate to a taxpayers current income earning activities are deductible, while topics that relate to future income producing activities are not deductible.

### **New Regulations Apply To Advisers**

By March this year all financial advisers will be regulated under the provisions of the Financial Services Reform Act (FSRA) that has introduced a new more stringent regulatory regime. We have transitioned to the new regime ahead of the required deadline. This means that we have a new licence to deal in securities.

The FSRA effectively introduces three documents that every client will need to become familiar with. These are;

- **Product Disclosure Statements** that are issued by the product providers. This document is in effect an enhanced form of prospectus and it includes better disclosure elements relating to fees and charges.
- **A Financial Services Guide** that must be provided to all clients setting out the range of services provided by your adviser and how fees and charges are calculated.
- **A Statement of Advice** must accompany all specific advice, outlining the basis of the advice, the fees and charges and the remuneration paid to the adviser.

To maintain our licence we must comply with strict audit requirements and meet statutory liquidity requirements. In addition we must belong to a complaints resolution body and meet the ethical and operational requirements of our professional association.

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In practical terms the new regime is going to force us to think carefully before accepting new clients. We do want new clients and we thank you for referring your friends and colleagues to us. FSRA also means that we will adopt a new approach to writing reports. This will involve separating the strategy advice from specific product recommendations. The new regime is good for the industry because it introduces better disclosure from all parties and it will increasingly lead to better client education.

### **Annual Reviews**

As part of our on-going service we have always attempted to see each client at least once a year. If we are unable to see clients face to face due to distance or other circumstances, we will telephone clients to discuss their portfolio. We keep file notes of these discussions for audit purposes.

Please feel free to request a review at any time.

**Quote:** *“The Future belongs to those who see it first”*  
(source unknown).

### **Land Tax – Watch Out!**

Land Tax is an insidious State Tax that many clients are unaware of. Some clients who are aware of the tax, incorrectly think that because they have not received a land tax assessment, they are not liable. Land tax varies from State to State.

In Victoria Land Tax is assessed on a calendar year basis. The assessment is based on the total unimproved value of all land owned in Victoria on the 31<sup>st</sup> of December. Tax is levied if the total unimproved value of land excluding exempt land exceeds \$150,000.

Land tax is levied on “owners” of land and the definition includes a person who owns the freehold title to the land, a person who leases land from the Crown, a person who occupies land subject to a life estate, or a person who is in possession of land. Joint owners of land are equally liable for land tax. For most people there is a principal residence exemption, but people who operate a business from home should seek advice on the exemption provisions.

The unimproved value of land is assessed using the relevant municipal site value, adjusted by an indexation factor.

### **Examples**

<b>Total unimproved value</b>	<b>Tax rate based on 2003 tax scale</b>
\$540,000	\$880
\$810,000	\$2,905
\$1,620,000	\$22,480

There is no land tax paid by an investor who buys shares in a listed property company or trust, or an investor who owns units in a managed property fund.

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## **Investment Risk**

The following table lists the risks associated with investing and in future the table will be included in all of our investment recommendations;

<b>Type of Risk</b>	<b>Explanation</b>
Business Risk	Poor business management that leads to low income returns and, or, loss of invested capital. Factors that may contribute to business risk are changes in the particular industry, government legislation, rising interest rates, exchange rate fluctuations and the business cycle.
Financial Risk	The risk of losing part or all of your capital through a failed investment, such as when a company becomes insolvent or financially unsound.
Market Risk	The risk of another stock market collapse like the 1987 worldwide crash.
Information Risk	The risk that information which impacts on the value of your investment is incomplete, misleading or incorrect, and has an adverse effect on your investment.
Economic Risk	The risk that factors such as inflation, interest rate changes and currency fluctuations will have on your investment.
Political Risk	The risk that changes relating to Government policies, legislation and spending etc will impact on the value of your investment.
Re-investment Risk	The risk that when your investment matures you will be unable to reinvest and get the same level of return for a further term.
Management Risk	The risk that the quality and skill of the investment managers may change and adversely impact on your investment.
Mismatch Risk	The risk that the investment selected is not suitable for your needs and circumstances.
Inflation Risk	The risk that the value of your invested funds do not keep pace with inflation. This means that the purchasing power of your money loses its value.
Interest Rate Risk	The risk that your funds may be locked into a set rate of return for a period of time during which interest rates rise significantly.
Market Timing Risk	The risk of trying to time when to be in or out of a particular investment market, and ultimately being found to be wrong.
Risk of Not Diversifying	The risk of investing in one investment or strategy and missing the opportunity to spread your capital across other investments. The one investment or strategy then performs poorly.
Liquidity Risk	The risk that you are unable to access your funds when you need them.
Credit Risk	The risk that the investment you have selected is unable to repay your invested capital. This generally relates to debentures and bonds.
Gearing Risk	The risk that if the value of your geared investment falls, not only will the value of the initial investment and borrowed funds fall, but the value of the borrowed funds will still be required to be repaid. In the short term the lender may require additional security, and make a margin call.

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## **Investment Markets In 2004.**

A lot has already been written about the outlook for investment markets in the next 12 months. Here is our summary of the commentary that made sense.

### **Share market.**

Local share market returns are likely to produce high single digit returns but as always there will be some stand out performers and some disappointments. Australian investors will continue to benefit from relatively high levels of franked dividend income. Given the growth in world economic activity particularly in China and Asia, Australian companies that serve these markets should do well. The large resource companies in particular should benefit for many years to come.

International share markets are likely to produce mixed results and the biggest risk to investors may well be currency fluctuations. According to long-term predictions we will need to wait for another year before we see strong returns in the United States of America. After the elections in the USA, the focus will be on economic growth.

### **Property markets**

Commenting on real estate is difficult because of the fact that no two pieces of real estate are the same. As a general comment, domestic real estate is likely to settle down and in some areas values will fall. The inner city apartment market that has attracted so many investors is probably in for a period of little or no growth for the rest of the decade.

Domestic real estate purchased as an investment must be valued in terms of the rental return. Investors have choices and if there are better returns with similar risk, then domestic real estate prices may fall. Currently rental returns have fallen and vacancy rates are rising, at least in the big capital cities.

Investing in commercial real estate, shopping centres, office blocks and hotels is a different proposition. This form of investment is driven by commercial demand, and prices reflect scarcity, location and quality. Investors can participate in this form of investment either by purchasing whole properties, participating in syndicates or unit trusts, or by investing in share market listed property companies and trusts. Generally the rental return from this type of property investment is well above the returns that investors make from domestic real estate. We expect that non-domestic real estate will provide excellent returns for many years. Listed property trusts appear to be fully valued at present and therefore price growth may be small in the next 12 months. However the income return should still be well above the rent received from domestic real estate.

### **Term Deposits, Debentures And Cash Management Funds**

Interest rates are more likely to rise during the year, both internationally and domestically. Local interest rates are already high by world standards, so rises are likely to be small. Practically this means that investors should avoid getting locked into low rates for any longer than one year.

### **Disclaimer**

This newsletter is for general information only. Tax, Social Security and Investment Laws change frequently and may affect different persons in different ways. You should not act solely on information in this newsletter.

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