WFH and the Self-Employed

Art Phillips

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'Before the days of Skype and Zoom calls, a NASA engineer by the name of Jack Nilles laid the foundation for modern remote working when he coined the term 'telecommuting' in 1973. Long before modern remote working came into play at the turn of the millennium, a limited numbers of workers at IBM were working from home to test the effectiveness of telecommuting' (Butler 2022).

History of WFH

What began as a handful of offsite workers at IBM in 1973 had increased to 2,000 by ten years' later. IBMs 'call center' staff conducted work via landline telephones, and their employees were offered the option of doing this work from home.

From a long-view perspective, working from home has always been a thing, not just in the last several decades with the advent of telecommuting, but for thousands of years. Combining workspace and living space is a natural way for families and communities to efficiently pool resources, make the most of the space at hand, and work cooperatively together for the good of all (Reynolds 2022).

Reynold states - 'Fast-forward to work from home during medieval times, when the working classes often set up craft and trade-focused shops in their homes. They offered goods and services to support their families in living spaces that were architecturally designed to accommodate working from home. In fact, during medieval times, most working-class English people lived in work-homes. The single-story, one-room houses were a combination of kitchen and spinning, weaving, dressmaking workshop, bedroom and dairy, dining room, butchery, tannery, and byre'.

The Psychology of WFH

One needs to be quite dedicated and completely focused to be able to work from home effectively as to avoid the normal day to day home-life distractions which can cause unwanted interruptions to workflow. In addition, one needs to be careful that work time does not interfere with home life, as this can take a toll on family and personal relationships.

Working from home (WFH) causes changes to both work and life environments which can impact on family relationships. Family relationships have critical impacts on wellbeing and mental health. Strong family relationships provide crucial social support that could mitigate psychological problems including anxiety and loneliness. As a rapidly growing future work arrangement, WFH may have a widespread impact on family relationships and affect the wellbeing and mental health of many individuals (Wu, Song, Proctor, Chen 2022).

As Heather Ikin (2020) notes: 'Working from home has been associated with a range of detrimental outcomes, including decreased social interaction, difficulties psychologically detaching from work, tendency to overwork, stress, depression, and anxiety'. Working from home can also hinder team effectiveness and creativity, and result in fewer career opportunities (Sander, 2019). Song and Gao (2018) found that working at home is associated with a higher likelihood of experiencing work-related stress and negative impacts.

In a recent article - *Productivity and Workspace Design (August 2022*) – I suggested that there are many considerations to take on-board if one wishes to achieve the most productive outcomes of working from home, from deciding on the most effective workspace location within the home property, on through the design and fit-out of the workspace itself.

The Self-Employed

In this article I focus on the self-employed regime of business entrepreneurs where decisions need to be made whether to save on costs and convert a home office space or to work from a rented / leased office location outside the home - or alternatively to purchase a commercial property as an investment where a business can create a more ideal set-up to accomplish a complete separation from home-life and work-life.

In my main business – within the music industry - the majority of musicians, composers, music producers, and TV /film soundtrack orchestrators historically work from home for the most part of their working life. But it is not just music composers and musicians who opt to work from home, as there are many other industries that do the same - and this has little to do with COVID-19 pandemic hitting the planet - it has been happening for centuries.

WFH has positive and negative implications as I see it. It is very practical and saves in expenditure, but can we keep home-life and work-life 'in-check' and not infringe upon each other? We also need to be aware of the 'tax trap' if using the home office space as proportional business deductions against income.

The Tax Trap

If you rent your home or apartment you can utilize allowable expenses as business deductions proportionally to the physical space that your work area represents. For example, if your home office workspace utilizes say 15% of your floor space you can use 15% of your rental (lease) payments - 15% of electricity, 15% of water and gas, 15% of telephone, and the like......but if you own your own home or apartment there is a TRAP when utilizing home workspace expenses as business deductions as you will be subject to capital gains tax (CGT) when you go to sell the property.

There are two types of expenses you can consider using as a business tax deduction for your home-based business: running expenses and occupancy expenses, but you must have a designated area set-up specifically as a place of business inside your dwelling for this to be allowed. One must be very careful if you are attempting to do this when you own your residence, as you will be subject to capital gains tax when you sell that property.

As the Australian Taxation Office (ATO) publishes in *'small business, home-based business expenses':*

https://www.ato.gov.au/uploadedFiles/Content/MEI/Downloads/TaxTimeToolkit_SB_home-business.pdf

If you operate some or all of your business from your home, you may be able to claim tax deductions for home-based business expenses in the following categories -

- Occupancy expenses (such as mortgage interest or rent, council rates, land taxes, house insurance premiums);

- Running expenses (such as electricity, telephone, decline in value of plant and equipment, furniture and furnishing repairs, cleaning).

You would calculate occupancy expenses based on the proportion of the floor space of your home that is a place of business and the proportion of the year it was used for business. You can only claim deductions for the portion of your expenses that relate to running your business, and you must keep records for at least 5 years to show that your business incurred the expenses and how you calculated your claim.

If you sell your home, there will be capital gains tax (CGT) implications from the portion of your home used as a business deduction from the income generated in the business.

One can also utilize expenses of motor vehicle trips between your home and other locations, if the travel is for business purposes, but you will need to keep a logbook documenting your business trips for a consecutive period of 12 weeks using odometer readings and locations of travel. You then calculate the percentage of business-related use compared to private use where motor vehicle costs such as insurance, registration, petrol, and repairs is tax deductible proportioned to the business use ‘percentage’. You must also update your vehicle logbook every 5 years (Synectic 2021).

If you are an employee of a business and the business pays for or reimburses you for some of the costs of running your business from home, you cannot claim a deduction for the expenses in your individual income tax return. Your business may also be subject to fringe benefit tax (FBT) if it pays or reimburses you for these expenses.

It might seem appropriate to work from home and use the office space proportion dimensions as a business deduction but there are tax implications of using the home office expenses against income if you own your home (AT0 2022).

My advice is to always consult a qualified tax accountant about your tax situation.

Working Away from Home (WAFH) for the Self-Employed

After more than 20 years of working from a home office and home-based recording studio, I decided to move to a **‘work away from home’** commercial property environment. **‘WAFH’** – a newly coined term for the ‘self-employed’ who decide to move out of their home office space and conduct their business in a commercial set-up away from home.

After leaving the home-workplace environment, I rented an office space for 2 years where I modified the leased property to use as a recording facility, acoustically soundproofed as best possible for the budget available with an office set on the same premises to work the admin and back-office tasks. This effort cost somewhere around AUD$ 60,000 to modify the space – but then lo and behold, when the owner decided to sell the property, I was left in the lurch as it then became ‘dead cash’. Dead cash as these modification works were mostly structural with the creation and soundproofing of new walls, a raised floor and ceiling isolation due to recording studio requirements, where all these items were unable to be removed and relocated to use in another facility.

The Dead Cash Syndrome

I had learnt my lesson and decided it would now be best to purchase a commercial property where I would be able to build a state-of-the-art recording studio and office set-up, being completely soundproofed. If I owned the property I could build an isolated and floating recording studio shell sitting inside a pod, consisting of two sets of walls, outer walls and

inner walls each constructed of plywood on each side of the wall frames, built-up with 32 mm of gyprock over the plywood on each side of the walls, where the internal wall frames would be stuffed with a special wool insulation (not the normal insulation used in homes), and where the outer wall frame would be filled with sand. Between these walls would be 32mm of dead air space for additional isolation, with a floor built over rubber padding blocks sitting on a solid concrete base. The ceiling would be sprung hung where it would detach from the above floor via springs the more you pump the room with sound vibrations / volume.

Inside the studio would be acoustically treated with various wood panels on the wall and ceiling filled with the most unusual contents (rags, insulation, foam, silk and woolen textiles and the like), with the panels covered in chosen design fabric and set in unorthodox placements to achieve the perfect balance of frequencies inside the room when writing and mixing. When positioned correctly, using special acoustic analysis devices when choosing the placements of the panels, allows a perfect balance of acoustic sound frequencies with zero reflections nor any false impressions of hi, mid or low frequencies.

A well-designed bass trap (low frequency fixer) would also be constructed in the back of the room to allow an 'even balance' of low sub frequencies from front to back, from side to side and in the any place in the room. Every sub-frequency would then be evenly heard with no lumps, bumps nor frequency cancellations no matter where one is sitting.

I would also build a separate office facility in the property, with a boardroom for 10 and a foyer where this workspace would last a lifetime.

But where and how would I find the cash to buy a commercial property and to implement such an environment?

I am very fortunate to have a great tax advisor / accountant and was therefore able to accomplish this task some 22 years ago using the strategy outlined below.

I was able to pull enough funds together initially to purchase the property in a 'trust' that I created, where over time my self-managed superannuation fund (SMSF) would own all the units in that trust, allowing me to use this business structure to benefit smartly, and well into the future.

The Unit Trust and a Self-Managed Superannuation Fund (SMSF)

The strategy – a self-managed superannuation fund acquires commercial property indirectly via a related non-geared 'unit trust' and operates at 'arms-length'.

A unit trust is set up and the SMSF invests cash into the unit trust in return for a percentage of ownership of the units in the trust. Other units can be purchased by you, the individual, as long as you operate at 'arms-length'. For example, you want to purchase an $800,000 commercial property. A unit trust is set up and your SMSF buys 50% of the units ($400K) (for example) and you personally purchase the other 50% ($400K). The property is owned by the 'unit trust'. Both you and the SMSF indirectly hold the property via your percentages of ownership of the units in the Trust.

Your business will pay rent (the lease) to the 'unit trust' and the unit trust will distribute the net rent (post expenses) proportionally as per the ownership percentage to you and your SMSF.

It is important to note that in this structure that the property cannot be geared. Additionally, rent must be at market rate and all expenses need to be paid by the unit trust. Market lease valuations must be sought - and in writing - every couple of years. You must also have a

valid commercial lease in place between the trust (who is the property owner, via trustees of the trust) and the lessor.

Over time the superfund can purchase additional units in the trust, when in time the superfund would own all the units in the trust - which then in turn owns the commercial property at 100% - a perfect superfund income stream.

Superannuation income is taxed at 15% while you are still working and at a rate as low as 0% when you have satisfied special conditions in your retirement age. The concessional tax rates apply to both the rental income as well as any capital gains resulting from the sale of the property.

As Liam Shorte says in his article: How a SMSF can Purchase a Property with a Related Party: 'One way you can purchase a property with your SMSF and a related party as co-owners is to establish a unit trust to purchase the property. For this to work you must ensure that the strategy complies with the SIS Act 1993, and in particular Regulation 13.22C of the Superannuation Industry (Supervision) Regulations 1994 at all times'.

Shorte continues - here is a simple practical example of how this strategy works -

Nancy & Colin have an SMSF that has $250,000 that they would like to invest in a commercial property. In their personal names, they also have the ability to borrow $350,000 against their home that they would like to invest in property;

A unit trust is established and their SMSF purchases $200,000 of units leaving $50,000 liquidity in the fund and they purchase $350,000 of the units personally which funds the unit trust with $550,000 in cash, with the SMSF owning 36% and Nancy & Colin owning 64%;

The unit trust then uses this money to purchase an Industrial Unit/ commercial property, pay for any purchase costs such as transfer duty and legal fees and maintains some extra funds in a bank account for some liquidity;

The unit trust enters into the lease with Widgets Pty Ltd as tenants, receives the rent and pays the expenses such as rates, insurance and repairs. The net income is then distributed to the unit holders based on their ownership. In the scenario above the superfund would receive 36% of the net rent and Nancy & Colin would receive 64%. Each owner would include their share of the income in their tax returns.

This is called a 13.22C Ungeared Trust and works well for simple scenarios where you wish to buy a property and your SMSF can contribute towards the cost -

- The SMSF can in later years later acquire more units from the related party which allows it to increase its ownership of the property. The idea would be to have the property eventually owned 100% by the superfund and the money paid to Nancy & Colin for the units is used to pay down their personal loan. This is not possible when a Self-Managed Super Fund and related party co-own a property as tenants in common unless it is business real-property;
- The related party and/or the SMSF can subscribe to new units in disproportionate amounts if more capital is needed for improvements or renovations;
- The related party (Nancy & Colin in the above example) can borrow to acquire their units in the unit trust (generally by offering another asset such as their home as security) and then claim the interest on the loan as a personal tax deduction because the trust is income-producing. This effectively allows them

to gear their share of the ownership much like they would if they owned it as a tenant in common with the SMSF.

Disadvantages -

- The unit trust must comply with the provisions of 13.22c at all times. Any breach of any of the provisions will mean that the trust is subject to the in-house asset rules which limit the value of this investment in the fund to 5% of its assets. This almost always means that the SMSF must dispose of its investment in the trust even if the breach is rectified;
- There are additional costs to establish this structure due to the set-up of a unit trust (and corporate trustee if desired);
- There are additional costs to run this structure because the unit trust is a separate entity and must lodge a tax return.

SUMMARY OF 13.22c RULES:

To meet the requirements of SIS regulation 13.22C, the trust must -

- Be a 'unit trust';
- Have no debt and not allow any security to be taken over its assets;
- Have no lease arrangement with a related party other than one relating to business real property;
- Not acquire an asset (other than business real property) from a related party;
- Not lend money to any entity other than an authorised deposit taking institution (e.g., a bank);
- Not conduct a business. Therefore, depending on the size and scale of the development, the trustee should consider engaging a third party to develop the land for a fee.; and
- Not own an interest in another entity – which means it cannot own shares or invest in another trust.

Broadly, this means the trust can only own residential or business real property and cash on deposit.

Other consequences you may have to consider -

- Some of the transactions outlined above could have capital gains tax (CGT) implications;
- May be subject to duty as the trust may be or in the future become be a 'land rich entity' under the various state Duty Acts.

However, with careful planning, these outcomes can be managed in some circumstances. For example -

- If the Units are disposed of by the SMSF during pension phase they would generally be CGT-free;
- Some of the different States Duty Acts offer concessions in some form or another where there are transactions between an SMSF and its members; and
- The related party may be able to utilise the small business CGT concessions when disposing of units in the trust.

As George Karavias writes, 'if you're currently renting your business premises by using your superannuation to purchase, it means you are paying off your own assets as opposed to paying off someone else's investment'.

Holding your business premises within an SMSF can provide asset protection against any future claims or liabilities that could result from operating your business. That means if your business goes belly up, your property is safe.

As the property is held in your SMSF, you can guarantee and secure your business' tenancy for the longer term.

Once again, and as stated earlier, it is advised to consult and get advice from a qualified tax advisor at all times.

Conclusion

A thorough assessment must be undertaken of your business and personal situation in order to make the most appropriate decisions when setting up a workplace environment especially when one is self-employed. Importantly, one must be vigilant about tax driven strategies to ensure the structure you are undertaking is the most effective for your situation and that it follows the ATO tax guidelines (tax and superannuation rules) to ensure what you are doing is completely legal.

I had undertaken this strategy (as Nancy & Colin did in the above example) some 22 years ago. The benefits have been enormous over time as my company business pays lease payments to the 'unit trust' monthly at market rates under a commercial lease, then the unit trust distributes the rent to the unit holders proportionally.

At this stage in my life the superfund owns all the units in the trust, where my company pays lease payments to the trust, the trust then distributes the returns to the superfund (who now own all the units in the trust) – a good way to accumulate wealth. The company business claims a tax deduction on the lease payments for the business and there is an income stream going into the superfund from the investment. As I am also now in my retirement phase I am able to distribute a pension back to myself from the superfund.

What goes into the lease as a deduction for business comes back out to myself, as an individual, by way of a pension.

This takes careful planning by a qualified tax advisor and considerable time in order to achieve these lifelong benefits. In the beginning it is tough, as you need to find the cash to invest in the purchase of the commercial property and to make on-site modifications to suit requirements (more cash, more loans), set up a SMSF which is expensive, quite complicated and has ongoing yearly costs associated to run correctly. Your company business (the lessee) must be able to pay the ever-changing market value lease payment rates for the rental of the property and never default. If any of this goes haywire, you will be up for fines and heavy penalties as you are running your own SMSF in this strategy.

Please be sure get advice from a qualified and experienced tax advisor / accountant if you are contemplating any of these strategies.

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Art Phillips is an Adjunct Professor at UBSS, Director of the Centre for Entrepreneurship and a Fellow of the Centre for Scholarship and Research.