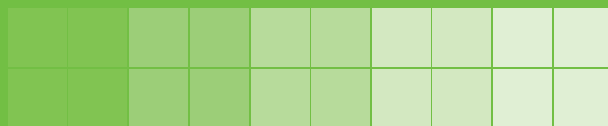
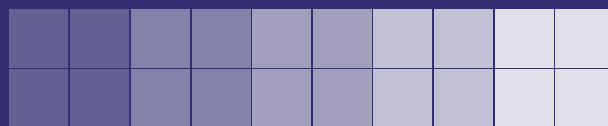


# A SIMPLIFIED SUMMARY OF THE AUSTRALIAN TAXATION SYSTEM



The Australian Tax System	1
Assessable Income	2
Exempt Income	3
Tax Deductions	4
Tax Offsets	5
Residency	6
Accounting For Tax	7
Superannuation	8
Depreciation And Capital Allowances	9
Business Structures	10
Small Business Entities	11
Accounting Methods And Income Tax	12
Tax Planning Issues	13
Tax Reform	14
Pay As You Go (PAYG)	15
Capital Gains Tax	16
Consolidation	17
Goods And Services Tax (GST)	18
Primary Production	19
Fringe Benefits Tax	20
Tax Audits And Taxpayers Rights	21
State Government Taxes	22
Effective Lives	23

# ANNUAL TAXATION SUMMARY 2012



**GET SMART WITH TAX SMART...**

# TABLE OF CONTENTS

1. THE AUSTRALIAN TAX SYSTEM .....	2
2. ASSESSABLE INCOME .....	7
3. EXEMPT INCOME .....	12
4. TAX DEDUCTIONS .....	15
5. TAX OFFSETS .....	21
6. RESIDENCY .....	29
7. ACCOUNTING FOR TAX .....	33
8. SUPERANNUATION .....	38
9. DEPRECIATION AND CAPITAL ALLOWANCES .....	49
10. BUSINESS STRUCTURES .....	55
11. SMALL BUSINESS ENTITIES .....	65
12. ACCOUNTING METHODS AND INCOME TAX .....	68
13. TAX PLANNING ISSUES .....	70
14. TAX REFORM .....	74
15. PAY AS YOU GO (PAYG) .....	78
16. CAPITAL GAINS TAX .....	84
17. CONSOLIDATION .....	92
18. GOODS AND SERVICES TAX (GST) .....	96
19. PRIMARY PRODUCTION .....	107
20. FRINGE BENEFITS TAX .....	114
21. TAX AUDITS AND TAXPAYERS RIGHTS .....	124
22. STATE GOVERNMENT TAXES .....	132
23. EFFECTIVE LIVES .....	135
INDEX .....	154

# Chapter 1

## THE AUSTRALIAN TAX SYSTEM



## Chapter 1

# THE AUSTRALIAN TAX SYSTEM

### HISTORY

Throughout Australia's post-Federation period, income tax collections have been affected by the major World Wars and have certainly played a role in the thorny issue of Commonwealth/State relations.

Prior to Federation in 1901, income tax was first imposed by the States starting with South Australia in 1884, closely followed by Victoria and NSW in 1895.

The Federal Government introduced an income tax in 1916 largely to fund Australia's involvement in the First World War, but it was still the States that collected income taxes, both for themselves and on behalf of the Federal Government. In 1932, at the time of the Great Depression, the Lyons Federal Government briefly took over collection of income tax from the Lang Labor NSW Government. This constitutional crisis was soon resolved however, and the states retained responsibility for tax collection when a new consolidated act (the *Income Tax Assessment Act 1936*) was passed in 1936.

However, in 1942, at the height of World War II, the Commonwealth took over all income tax collection. This position remains unchanged to the present day. The States received annual grants from the Commonwealth to fund their revenue needs until 1 July 2000, when the Goods and Services Tax (GST) was introduced with proceeds going directly to the States, replacing the grants system.

Over the years there were many changes and insertions into ITAA 1936, rendering the act incomprehensible even to many professionals.

In the mid 1990's the Government decided to "simplify" matters by re-writing the complete act. This process commenced in 1997 with the introduction of the *Income Tax Assessment Act 1997* (ITAA 1997).

Eventually ITAA 1997 will supersede the prior 1936 Act. In 1998 the Howard Government began a comprehensive programme of tax reform and suspended further activity on updating the 1997 Act. This will further delay

# Chapter 1

## THE AUSTRALIAN TAX SYSTEM

completion of the 1997 Act. Until ITAA 1936 is completely re-written, tax professionals need to be familiar with both Acts. Following the 2020 Summit, the Rudd Government introduced a “roots and branches” review of the taxation system. The Henry Report which resulted was released by the Labor Government on 2nd May, 2010.

Over the years numerous taxpayers have argued, some at High Court level, that collection of taxes is unconstitutional. These attempts have proved fruitless with Courts finding that the Commonwealth Government has full power to impose taxes provided it does not discriminate between the States and does not impose taxes on property belonging to a State.

### THE AUSTRALIAN TAXATION OFFICE – A BRIEF HISTORY

On 12th November, 2010 the ATO announced 100 years of service to the Australian community. Below are some key dates:

- 1910** – Federal Land Tax Branch established with 105 staff – 15,000 returns assessed in first year.
- 1915** – Income Tax Assessment Act introduced.
- 1917** – Female employment introduced due to men away at war.
- 1924** – State Tax Office branches amalgamated.
- 1930** – The sales tax introduced.
- 1933** – Flour tax introduced for one year, at a time when flour production exceeded sale price.
- 1944** – The Pay-As-You-Earn (PAYE) tax system introduced.
- 1952** – Federal Land Tax abolished.
- 1966** – The decimal currency introduced in Australia.
- 1975** – The first tax computer system-the Central Taxpayer System – commenced operation.
- 1978** – A surge in tax avoidance schemes (known as bottom-of-the-harbour) resulted from soaring inflation and threatened the integrity of the tax system.
- 1986** – Self-assessment introduced.

**1987** – Electronic Lodgement System (ELFS) for tax agents trialled.

**1988** – The first ‘Tax Help’ volunteer program was introduced to help people in need prepare their tax returns.

**1997** – The Taxpayers ‘Charter’ introduced, setting out taxpayers’ rights and standards of service.

**1999** – e-tax launched resulting in 27,000 lodgements.

**2000** – Introduction of ‘The New Tax System’ – the ATO delivered the largest range of tax reforms in its history including the introduction of the GST and Pay As You Go system as part of broader business tax reform.

**2007** – Implementation of ‘Better Super’ – the biggest reform to superannuation ever.

**2009** – A one-off tax bonus payment worth \$7.7 billion was distributed to 8.7 million people. It was the largest payment ever made through the tax system and one of the most significant in Australia’s history.

**2010** – Over 2.3 million taxpayers lodged online using e-tax, which has evolved to include pre-filling, online help and automatic calculations.

### LODGEMENT AND PAYMENT OF TAX

The Australian tax year starts on 1 July and ends on 30 June each year.

Income taxes are determined from taxable income disclosed in income tax returns which are required to be prepared and lodged each year by individuals, trusts, partnerships, companies and other entities.

Each year required lodgement dates are gazetted; however, if a taxpayer is using a tax agent, extra time is normally granted in accordance with the tax agents’ lodgement programme. Tax returns are lodged and assessed on an annual basis.

Individual taxpayers usually pay their taxes throughout the year under the Pay As You Go (PAYG) System which involves deductions from salaries and wages or quarterly instalment tax payments.

Most individual business taxpayers are required to meet

# Chapter 1

## THE AUSTRALIAN TAX SYSTEM

their tax obligations quarterly.

Income tax rates were reduced when the Goods and Services Tax (GST) was introduced on 1 July 2000, and some taxes such as sales tax were abolished. However, some State taxes such as payroll tax still exist despite the Federal Government's intention that they be abolished. The GST has turned into a cash windfall for the States.

Further obligations some taxpayers have are Business Activity Statements (BAS) and Instalment Activity Statements (IAS).

Partnerships and Trusts do not normally pay tax. The income flows down to individual partners or beneficiaries who are assessed on the amounts distributed to them.

In order to prevent double taxation of dividends, companies can frank their dividends (to reflect company tax paid) and these franking credits are refundable to taxpayers if the amount of tax paid is less than the amount of the franking credit.

Franked dividends paid to discretionary trusts flow through to nominated beneficiaries who are able to claim the franking credits.

Taxable income is calculated by adding all assessable income, then deducting all allowable deductions from the total. To determine the actual tax payable from the table below, multiply the taxable income by the marginal tax rate and deduct any tax offsets and credits.

### 2010/11 AND 2011/12 INCOME TAX RATES FOR RESIDENT INDIVIDUALS

Taxable Income	Tax Payable
0 – \$6000	Nil
\$6001 – \$37,000	Nil + 15% of excess over \$6,000
\$37,001 – \$80,000	\$4,650 + 30% of excess over \$37,000
\$80,001 – \$180,000	\$17,550 + 37% of excess over \$80,000
\$180,001 +	\$54,550 + 45% of excess over \$180,000

### FLOOD LEVY

Taxable Income	Flood levy on this income
\$0 – \$50,000	Nil
\$50,001 – \$100,000	Half a cent for each \$1 over \$50,000
\$100,001+	\$250 plus 1c for each \$1 over \$100,000

### Notes:

- Applies to income for the 2011-12 financial year only.
- In the case of couples, both members will be assessed individually for flood levy purposes based on their own taxable income.
- Employment termination payments (ETPs) and certain superannuation benefits paid to your clients under age 60, that are taxable income, will also be included.
- The levy will not apply to income which is exempt from income tax; for example, superannuation benefits paid to a person over the age of 60 years that are non-assessable and non-exempt income and not subject to tax.
- This levy applies to the taxable component of super withdrawals within the low rate cap - \$165,000 for 2011-12 which is subject to a tax rate of nil.

## MEDICARE LEVY

In addition to income tax, a Medicare levy of 1.5 per cent is charged on a resident taxpayer's taxable income.

Note that some taxpayers are exempt from the Medicare levy because of their foreign status, or the type of health care which is provided to them.

Low-income earners are exempt, so that in 2010/11, if taxable income is \$18,839 or less, no Medicare levy is payable.

A higher threshold of \$31,789 is available if you were married or would have been entitled to certain sole parent or carer rebates that existed prior to 30 June 2000. The threshold amount also increases by \$2,919 for each dependent child or student. A shading in arrangement also applies. The thresholds for the year ending 30 June 2012 will be announced in next May's Federal Budget.

## MEDICARE LEVY SURCHARGE

The Medicare Levy Surcharge is levied on payers of Australian tax who do not have private hospital cover and who earn above a certain income. The surcharge aims to encourage individuals to take out private hospital cover, and where possible, to use the private system to reduce the demand on the public Medicare system.

The surcharge covers you and your dependents. Providing you contribute to their maintenance (including child support payments), your dependents are your spouse, any

# Chapter 1

## THE AUSTRALIAN TAX SYSTEM

of your children who are under 16 years of age, or any of your student children who are under 25 years of age.

The surcharge is calculated at the rate of 1% of taxable income. It is in addition to the Medicare Levy of 1.5%, which is paid by most Australian taxpayers.

You have to pay the surcharge if you are:

- A single person with an annual taxable income greater than \$80,000 in the 2011-12 financial year (previously \$77,000 in 2010-11); or
- A family or couple with a combined taxable income greater than \$160,000 in the 2011-12 financial year (previously \$154,000 in 2010-11). The family income threshold increases by \$1,500 for each dependent child after the first;
- And do not have an approved hospital cover with a registered health fund.

You must also pay the surcharge if you are a prescribed person with a taxable income over the threshold, and have any dependents who are not prescribed persons and who are not covered by an approved health cover policy as described above.

### TAXATION RULINGS

A system of public and private rulings was introduced on 1 July 1992. A public ruling or determination essentially sets out the ATOs interpretation of the legislation applied to certain situations. Public Rulings may be relied upon as they are binding on the ATO. If a taxpayer takes a matter to court, it is possible for an unfavourable ruling to be overruled.

If a taxpayer requires guidance before making a claim or entering a transaction, a private ruling may be applied for. Once issued, private rulings are binding on the ATO for that particular taxpayer only. Individuals are able to apply for binding oral rulings for simple tax matters. The application must be made orally and generally by the person concerned.

### FAMILY ASSISTANCE

Three forms of family assistance are available to taxpayers. These are:

- Family Tax Benefit Part A
- Family Tax Benefit Part B
- Child Care Benefit

The Family Assistance Office administers these benefits and most claimants receive these benefits as direct fortnightly payments or as reduced child care fees. Alternatively, eligible persons can apply for reduced PAYG amounts to be withheld from wages or they may claim the benefit when lodging their tax return.

To be eligible, an income test must be passed which takes into account family income determined as the sum of the following:

- Taxable Income
- Reportable Fringe Benefits – less FBT paid by the employer
- Centrelink or Veterans' Affairs Pensions and Benefits
- Income from overseas not taxable in Australia
- The value of net rental property losses.

The annual amount of any child support/child maintenance paid by the taxpayer or their partner is deducted from this total.

In the 2008 Federal Budget, the Government announced the following changes to the FTB scheme:

- From 1 July 2008, an income test was introduced so that FTB Part B will only be available to families where the annual adjusted taxable income of the principle earner does not exceed \$150,000; and
- From 1 July 2009, the FTB will only be delivered through Centrelink and Medicare, thereby removing claims through the tax system.

In the 2012 Budget it was announced the upper threshold limits would not be indexed from 1 July 2011, for a period of three years. This means less families will be eligible for the benefit.

The 2011-12 Federal Budget provides an increase of Family Tax Benefit (FTB) Part A for 16-19 year olds.

From 1 January 2012, the new maximum of FTB Part A for 16-17 year olds in secondary school will be increased from the current \$52.64 per fortnight to \$214.06 per fortnight, i.e. by around \$160 per fortnight – an increase of around \$4,200 per year. For 18-19 year olds in school, the rate will be \$3,741 per year. This will align with the 13-15 year old rate and ensure assistance for families does not drop when children turn 16. The increases to FTB Part A will only be available for families where their teenager is in full-time secondary study, or the vocational equivalent.

# Chapter 1

## THE AUSTRALIAN TAX SYSTEM

From 1 January 2012, the Government will lower the maximum age of eligibility for FTB Part A from 24 to 21. This will bring FTB Part A into line with the reduction in the Youth Allowance age of independence to 22 from 1 January 2012.

From 1 July 2011, families will be able to advance a maximum of 7.5% of their total rate of FTB Part A payment, up to \$1,000. For example, a family with 2 children under 12 will be able to receive an advance payment of up to \$644.

### NON-RESIDENT INDIVIDUALS

Non-residents are usually only required to pay Australian tax on income derived in Australia. They are not taxed on fully franked dividends and a withholding tax system applies to these.

As non-residents are not eligible for the tax-free threshold, it is necessary for them to lodge an Australian tax return.

#### 2010/11 AND 2011/12 INCOME TAX RATES FOR NON-RESIDENT INDIVIDUALS

Tax thresholds – Income range \$	Tax Payable
\$0 – \$37,000	29%
\$37,001 – \$80,000	\$10,730 + 30% of excess over \$37,000
\$80,001 – \$180,000	\$23,630 + 37% of excess over \$80,000
\$180,001 +	\$60,630 + 45% of excess over \$180,000

#### 2009/10 INCOME TAX RATES FOR NON-RESIDENT INDIVIDUALS

Tax thresholds – Income range \$	Tax Payable
\$0 – \$35,000	29%
\$35,001 – \$80,000	\$10,150 + 30% of excess over \$35,000
\$80,001 – \$180,000	\$23,650 + 38% of excess over \$80,000
\$180,001 +	\$61,650 + 45% of excess over \$180,000

### OTHER TRUSTS

In situations where the trustee chooses not to allocate income to a beneficiary, the income is accumulated. In such instances the tax is assessed at the highest marginal tax rate (45%) plus Medicare.

### AUSTRALIAN BUSINESS NUMBER

The Australian Business Number (ABN) is a single identifier for all business dealings with the ATO and for dealings with other government departments and agencies.

An ABN is required if:

- You carry on a business
- You establish a self managed superannuation fund
- You request endorsement of an income exempt charity or as a deductible gift recipient.

If a supplier does not have an ABN and if you are making a total payment of more than \$75 (excluding GST) you will have to withhold 46.5 per cent of that payment and remit that amount to the ATO. If the supplier has an ABN, make sure that they quote it on their invoice to you.

If you are a Family Trust, you must show both the ACN (Australian Company Number) of the Corporate Trustee and the ABN of the Trust on your tax invoices. If you are a company, you must display your ABN on all tax invoices. The ABN can be used instead of the ACN on other public documents, provided the ACN represents part of your ABN.

### TAX FILE NUMBERS

Whether individual or entity, all taxpayers must have a Tax File Number (TFN). As the ATO uses the TFN to identify you, it must be used on all documents lodged with the ATO including taxation returns.

## Chapter 2 ASSESSABLE INCOME



## Chapter 2 ASSESSABLE INCOME

Tax is levied on the taxable income of the taxpayer derived during the income year. Assessable income minus allowable deductions equals taxable income.

Assessable income as defined in ITAA 1997 consists of ordinary income and statutory income.

If specially excluded or made exempt, certain types of ordinary and statutory income will not be subject to tax.

### DEFINITIONS

**Ordinary Income** is defined to mean income according to ordinary concepts. However, no specific guidance on what is meant by "income according to ordinary concepts" is contained in the legislation.

It is the courts that have identified a number of factors

to provide guidance as to whether an amount has the character of income according to normal concepts.

These include: recurrence and regularity, provision of a service or work, also the carrying on of a business or profit-making undertaking or scheme.

**Statutory Income** applies if the amount is not ordinary income and is included by a specific provision of the Tax Act.

Examples include royalties, some capital gains, lump sum retirement payments, dividend imputation credits and allowances.

**Exempt Income** is any ordinary or statutory income which the Tax Act specifically exempts from taxation.

## Chapter 2

# ASSESSABLE INCOME

### CAPITAL -V- REVENUE

The distinction between capital and revenue is a principle established in the Tax Act and extensively dealt with by numerous court findings. It applies to both receipts and payments.

Prior to 1985, income receipts were assessable to tax and payments were deductible if they were connected with the earnings of income; however, capital receipts were not. If no such connection existed, usually such payments were only then based on capital account and were non-deductible.

The capital gains tax regime ensured that from 20 September 1985, that many formerly non-assessable capital receipts would be subject to some form of tax.

Generally, taxpayers prefer receipts to be on capital account and payments to be on revenue (income) account. This is because:

- Prior to calculation of tax, capital gains may be subject to various discounts and exemptions
- Outgoings are deductible if they relate to the earning of income
- Outgoings related to capital assets are usually not deductible, but may be added to the cost base of the asset. There is also provision for some building capital allowances
- Capital losses can be carried forward to be offset against future capital gains and cannot be claimed against income on revenue account.

### BUSINESS INCOME

Assessable income includes all proceeds from transactions carried out in the ordinary course of business. Where a business enters isolated transactions outside normal activities, if there is a profit making undertaking or scheme, then these receipts are also assessable.

### DIRECT COMPENSATION FOR SERVICES

All remuneration for personal services, whether in the capacity of an employee or in connection with employment or personal services is assessable income. Exceptions to this include living away from home allowances and fringe benefits.

Voluntary payments or gifts received, resulting from services provided, are also assessable income.

### NON-CASH BUSINESS BENEFITS

These are widely defined as benefits received as property or services. Services include any right, privilege or benefit, and may be provided either partly or wholly, or directly or indirectly in a business relationship. If the annual total received is less than \$300 then such payments are exempt from tax, but should the annual benefit exceed \$300 then the total amount will be assessable.

### EMPLOYMENT TERMINATION PAYMENTS (ETPS)

From 1 July 2007, the tax treatment of employment termination payments has been rewritten into the Tax Act. Between 1 July 1983 and 30 June 2007, these payments were referred to as "eligible termination payments". From 1 July 2007, it is no longer possible to roll-over an ETP to superannuation.

The tax treatment of an ETP will depend on whether it is a life benefit ETP or death benefit ETP.

From 1 July 2007, a life benefit ETP is only taxed on two components: the tax-free component and the taxable component. The tax-free component comprises the 'pre-July 1983 segment', the 'concessional segment', the 'undeducted contributions segment', the 'post-June 1994 invalidity segment' and the 'CGT-exempt segment'.

## Chapter 2 ASSESSABLE INCOME

Age of Recipient	Life Benefit ETP	
	Tax-free Component	Taxable Component
Preservation age or over on the last day of the income year in which the payment is made.	Tax-free	15%: \$0 - \$165,000* 45%: \$165,001+
Under preservation age on the last day of the income year in which the payment is made.	Tax-free	30%: \$0 - \$165,000 45%: \$165,001+

\*Note the ETP cap amount is \$165,000 in 2011/12 (\$160,000 in 2010/11).

Transitional arrangements apply where a person was entitled, as at 9 May 2006, to a payment on termination of employment under a written contract, legal instrument or workplace agreement, provided the payment is made before 1 July 2012.

The tax treatment, which applies to these transitional payments, is:

Age of Recipient	Life Benefit ETP	
	Tax-free Component	Taxable Component
Preservation age or over on the last day of the income year in which the payment is made.	Tax-free	15%: \$0 - \$165,000* 30%: \$165,001 - \$1,000,000 45%: \$1,000,000+
Under preservation age on the last day of the income year in which the payment is made.	Tax-free	30%: \$0 - \$1,000,000 45%: \$1,000,001+

\*The ETP cap amount of \$165,000 is indexed annually, but only in \$5,000 increments.

**The tax treatment of a death benefit ETP (i.e. the payment is made from the deceased's employer, rather than via a superannuation fund) will depend on whether the payment is made to a dependant or non-dependant.**

**Preservation age is the age at which retirees can generally access their benefits on retirement.**

Recipient	Death Benefit ETP	
	Tax-free Component	Taxable Component
Dependant	Tax-free	0%: \$0 - \$165,000* 45%: \$165,001+
Non-dependant	Tax-free	30%: \$0 - \$165,000 45%: \$165,001+

\*The ETP cap amount of \$165,000 is indexed annually, but only in \$5,000 increments. It is not counted towards the life benefit of ETP cap.

**The new indexed amount is generally available each February.**

## Chapter 2 ASSESSABLE INCOME

### SUPERANNUATION LUMP SUMS

From 1 July 2007, superannuation lump sums paid from a taxed source to those aged 60 and over are tax-free (i.e. non-assessable non-exempt income).

Tax is still payable on superannuation lump sums paid to someone aged less than 60. The superannuation lump sum is split into the tax-free component and taxable component. The tax-free component comprises the 'crystallised segment' and the 'contributions segment'. The taxable component is determined by subtracting the tax-free component from the total value of the superannuation interest. The taxable component may consist of an element taxed in the fund or an element untaxed in the fund (e.g. paid from an untaxed fund).

Age of Recipient	Superannuation Lump Sum		
	Tax-free Component	Taxable Component 2011-12	
		Element taxed in fund	Element untaxed in fund
60+	Tax-free	Tax-free	15%: \$0 - \$1,205,000 45%: \$1,205,000
55 - 59	Tax-free	0%: \$0 - \$165,000 <sup>2</sup> 15%: \$165,001+	15%: \$0 - \$165,000 <sup>2</sup> 30%: \$165,001 - \$1,205,000 45%: \$1,205,000
0 - 54	Tax-free	20% of entire taxable component	30%: \$0 - \$1,205,000 45%: \$1,205,000

1. Medicare levy of 1.5% is also payable.
2. The low rate cap amount of \$165,000 is indexed annually.
3. The untaxed plan cap amount of \$1,205,000 is indexed annually.

End benefits tax may still apply for certain untaxed superannuation funds (e.g. some public sector schemes) in respect of an element untaxed in a fund (i.e. no contributions or earnings tax has been paid on this element).

### FREQUENT FLYER AND CLUB BENEFITS

The ATO accepts as a result of Payne's case that flight rewards received by employees from an employer paid expenditure are not assessable income.

Any customer loyalty programme benefits earned as a result of private expenditure are not assessable.

The ATO has indicated that it will closely scrutinise situations where the number of points accumulated in a year exceed 250,000 and arise from a business relationship or business expenditure, whereby the arrangement has no commercial purpose other than to allow the recipient to receive reward points.

In such cases the ATO will treat such rewards as assessable income or as a fringe benefit.

### BARTER EXCHANGES AND TRANSACTIONS

The ATO's view is that barter transactions are assessable and deductible to the same extent as other cash or credit transactions. For tax purposes the ATO considers one trade dollar (T\$1) to be equal to one Australian dollar, unless it can be shown that the T\$1 is being traded consistently at a different value. Barter Exchanges and transactions are coming under increased ATO scrutiny as it is considered that income is not being properly accounted for.

### COMPENSATION PAYMENTS

Such payments take many forms and depending on their nature can be treated as assessable income, as a capital gain, as an adjustment to the cost base of an asset, or tax exempt.

## Chapter 2

# ASSESSABLE INCOME

- Periodical amounts of workers compensation are taxable
- Lump sum amounts received for personal injury or wrong doing are not taxable as these are private or capital recipients
- Recent changes for personal injury cases allow for structured settlements or orders which allow for such cases that formerly would have been settled for a lump sum to be delivered as tax-free periodic payments to an injured person.

This complex issue is dealt with at length in Taxation Ruling TR 95/35.

### REDUNDANCY AND EARLY RETIREMENT PAYMENTS

Tax planning opportunities exist as employees can receive limited bona fide redundancy and approved early retirement payments tax-free. Such payments are not classified as Eligible Termination Payments.

Bona fide redundancy and approved early retirement payments in 2011/12 of up to \$8,435 plus \$4,218 for each completed year of service with the employer are tax-free. Such receipts cannot be rolled over or paid in lieu of superannuation benefits and do not form part of a pensions RBL.

The ATO's view on what are genuine redundancy payments is contained in Taxation Ruling TR2009/2.

### LEASE INCENTIVES

Usually a cash incentive paid to a business taxpayer to enter into a lease of premises will be assessable income.

Some non-cash incentives are tax-free as outlined in Tax Ruling IT 2631.

- Rent free period
- Interest free loan – provided it is a genuine business loan
- Free holiday (this is not deductible to landlord)
- Free fit out (if owned by landlord).

In cases where the free fit out is owned by the tenant the cash incentive will be assessable, but a deduction will normally be allowed for depreciation.

### SALE OF FORMERLY LEASED EQUIPMENT

Where you or an associate make a profit on the sale of a motor vehicle informally leased, an amount will have to be included in assessable income. There are three choices available in determining the income (Tax Act Subdivision 20B).

If other formerly leased equipment is sold, the isolated transactions provisions may apply to make such a transaction assessable. If not the profit would be taxed as a capital gain.

### BALANCING ADJUSTMENTS

Where plant and equipment subject to depreciation is disposed of for an amount exceeding its written down value, the surplus is known as a "balancing adjustment" and is assessable income.

## Chapter 3 EXEMPT INCOME



### Chapter 3

## EXEMPT INCOME

The Tax Act deals with a wide category of exempt income on which income tax is not payable.

However, such exemptions still should be declared in income tax returns. Although income tax is not payable on exempt income itself, its inclusion in tax returns does alter the rate of tax payable on other income.

Note, that any tax losses carried forward are first applied against exempt income.

### ITEMS OF EXEMPT INCOME

#### Exempt income includes:

- Bona fide redundancy payments (subject to limits)
- Certain pensions and allowances
- Child care payments
- Commonwealth education payments to assist in the cost of rent, commencing employment, travelling, special equipment etc.
- Demerger dividends
- Employment security scheme payments
- Exceptional circumstances relief payments
- Foreign dividends received by an Australian company (where > 10% ownership)
- Foreign earnings of companies operating active businesses through branches
- Frequent Flyer benefits for employees
- Fringe benefits
- International scholarships
- Mutual income
- Open employment incentive bonus
- Pay and allowances for part-time members of the Defence Force Reserves
- Pay and allowances to ADF personnel whilst on operational service
- Periodic maintenance payments received by a spouse, former spouse or child
- Private health insurance payments
- Rent subsidy payments
- Scholarships, bursaries etc, derived by a student receiving full-time education at the school, college or

## Chapter 3 EXEMPT INCOME

- university
- Secondary education and isolated children's education assistance
- Some allowances paid and the value of rations and quarters for members of the Defence Force
- Some Veteran's entitlement pensions and similar benefits
- Wartime persecution pensions.

### EXEMPT VETERANS' ENTITLEMENTS

**Exempt payments made under the Veterans' Entitlements Act include:**

- Attendant allowances
- Bereavement payments
- Carer service pensions in certain circumstances
- Clothing allowances
- Decoration allowances
- Funeral benefits
- Income support supplements in certain circumstances
- Invalidity service pension where under pension age
- Loss of earnings allowance
- Partner service pension when under pension age
- Pension bonus
- Pension for defence or war caused death or incapacity
- Pharmaceutical allowance
- Recreation transport allowance
- Rental assistance etc, paid with Aged Service Pension
- Special assistance
- Telephone allowance
- Temporary incapacity allowance
- Travelling expenses for health treatment
- Vehicle assistance scheme payments
- Victoria Cross allowance.

### EXEMPT SOCIAL SECURITY PAYMENTS

**Exempt payments under Social Security legislation include:**

- Advance pharmaceutical supplements
- Carer allowances, carer payments in certain circumstances
- Disability wage supplements when under pension age
- Disaster relief payments
- Double orphan pension
- Employment entry payment
- Family assistance

- Fares allowance
- Maternity payment
- Mobility allowance
- Parenting payments (under certain circumstances)
- Pensioner bonus
- Pensioner education supplements
- Remote area allowance, etc. paid with AUSTUDY
- Rental assistance and allowances paid with aged pensions
- Rental assistance etc, paid with bereavement allowances
- Rental assistance etc, paid with mature age allowances and mature age partner allowances
- Rental assistance etc, paid with Newstart allowances
- Rental assistance etc, paid with special needs
- Rental assistance etc, paid with partner allowances
- Rental assistance etc, paid with sickness allowances and special benefits
- Rental assistance etc, paid with widow allowance and widow B pension
- Rental assistance etc, paid with youth allowances
- Senior's concession allowance
- Senior's utilities allowance
- Telephone allowance
- Wife pension when under pension age.

### HOBBIES

Occasional receipts that involve nothing more than vigorous pursuit of a hobby should not be assessable. It can be a fine line and if you are consistently making profits the ATO will take the view that you are conducting a business.

Other factors the ATO will consider include:

- Size and scale of operations
- Activity levels
- Details of business records kept.

### WINDFALL GAINS

Gambling, betting or lottery wins are considered windfall gains and are not assessable unless it is considered that you are in the business of gambling. Examples of professional gamblers include bookmakers, casino proprietors and professional punters.

A professional punter gambling in a systematic way and making profits may be considered to be operating a

## Chapter 3

# EXEMPT INCOME

business and hence, would be assessable on such income. Sadly such people may consistently make losses and professional punters who have tried to offset gambling losses against other income have had little success in the courts!

Conversely those who only occasionally gamble must keep adequate records of any significant win to prove that the payout is from a gambling source and not from other undeclared income.

In the event of an audit, the onus of proof is on the taxpayer and the ATO will deem unexplained increases in cash or assets to be assessable income unless you can prove otherwise.

### AUSTRALIANS WORKING OVERSEAS

Up to 30 June 2009, given the global nature of the labour market, many Australians were aware that overseas employment income may be exempt from tax if certain conditions regarding "continuous employment" were met. Here we are dealing with a situation where the taxpayer is still a resident of Australia. However, this overseas income still has to be disclosed in the tax return possibly resulting in Australian sourced salary and investment income being placed in higher marginal tax brackets.

From 1 July 2009, this exemption is only available to income earned from:

- As an aid or charitable worker employed by a recognised non-government organisation; or
- As a government aid worker; or
- As a specified government employee (for example, defence and police force personnel deployed overseas).

Further, income earned by an individual employed on an overseas project approved by the Minister for Trade as being in the national interest will remain exempt, as provided for by existing rules.

To avoid Australians paying double-taxation, a tax offset will be available for any foreign tax paid on their foreign employment income.

### MUTUAL INCOME

The principle of mutuality means that a taxpayer's

income can only consist of amounts derived from outside the individual or entity. This means that membership subscriptions and profits on sales to club members are not income.

Apportionment rules apply for clubs that are used by both members and non-members and appropriate records must be kept.

A High Court decision demolished this long-held principle by holding the mutuality principle did not apply where the members were prevented from obtaining the value of the net assets when the organisation was wound up.

Legislation has now been passed to restore the principle of mutuality to non-profit organisations.

### GIFTS

Genuine gifts are not income. This most commonly occurs between family members. Note that if there is a link between the recipients's work-related activities and the gifts received, this will not be the case.

Tips received by waiters, for example, are assessable because they directly relate to the work they are doing.

Gifts made by an employer to an employee are exempt to the employee, but may be subject to FBT.

## Chapter 4 TAX DEDUCTIONS



## Chapter 4 TAX DEDUCTIONS

### BUSINESS AND EMPLOYMENT DEDUCTIONS

Income tax is calculated based on a taxpayer's taxable income. The fundamental equation is: assessable income less allowable deductions equals taxable income.

In claiming income tax deductions there are "general" and "specific" deductions.

The general provision for claiming allowable deductions is section 8(1) of the Tax Act, which states that any loss or outgoing is a tax deduction to the extent that:

- It is incurred in gaining or producing assessable income; or
- It is necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

It should be noted, however, under the second limb of

section 8(1) that you cannot claim a deduction if the outgoing is of a capital, private or domestic nature.

There are also provisions in the Tax Act that prevent you from claiming certain deductions, for example fines and most entertainment expenses.

### SUBSTANTIATION

The key principal underlying substantiation is that to deduct work expenses, a taxpayer needs to have written evidence of the expense. (Division 900 of ITAA 1997.) Note that substantiation applies only to individual taxpayers and partnerships that include at least one individual. Normally the written evidence must be kept for a minimum of five years from the date of lodgement of the return in which the claims are made.

Once you have established that the relevant expenses were incurred in earning assessable income or in carrying on a business, the substantiation rules must be considered

## Chapter 4

# TAX DEDUCTIONS

before the expense is claimed.

There are exceptions where substantiation is not required:

- The total claimed for all employment related expenses is less than \$300.
- Laundry expenses up to a maximum of \$150.
- Travel claims less than the amounts stipulated in TD 2011/17, provided that a bona fide allowance has been paid to you as an employee.
- Car expenses under the cents per kilometre method.
- Overtime meal allowances up to \$26.45 per day (TD 2011/17).

Under the substantiation requirements, you must have documentation that contains the following:

- The name of the supplier
- The amount of the expense
- The nature of the 'goods' or services
- The date the expense was incurred
- The date the document was made out.

Small expenses of \$10 or less that total less than \$200 per annum do not require substantiation if you record the details in a book or a diary.

### MOTOR VEHICLE EXPENSES

Whilst business travel expenses or employee work-related expenses are deductible, travel expenses incurred travelling between home and work are not generally deductible.

However, if you have a detour for work-related expenses on the journey to see a client, a tax deduction may be claimed.

Taxpayers who have to carry heavy or bulky equipment to their place of work may also claim a deduction.

#### **Examples:**

- A self employed tradesman will be able to claim a deduction if he uses his home as his base and when he travels to sites is obliged to take his own tools of trade and equipment.
- Musicians who carry bulky equipment e.g. amplifiers to their place of performance may be able to claim a tax deduction.

- Trips to town by primary producers will be deductible if it can be shown that the principal purpose of the journey was business in nature. Examples could include purchasing equipment and supplies or visiting the bank.

When claiming motor vehicle expenses there are four choices open to the taxpayer. You may alter your choice from year to year and make a fresh choice when replacing a vehicle. If you are choosing the actual cost method it may be necessary to keep a replacement logbook.

If you own more than one vehicle a claim may be made for each vehicle if it can be demonstrated each vehicle has a business use.

### GENTS PER KILOMETRE METHOD

This method is available for motor vehicle usage up to 5,000 kilometres of business use.

In cases where the vehicle has been used for more than 5,000 kilometres in a tax year, this method is still available as long as the claim is reduced to 5,000 kilometres.

The rates per kilometre change each year and are released by the ATO. The rates differ according to car engine sizes and are:

#### **ENGINE CAPACITY**

Non-Rotary Engine	Rotary Engine	Rate
Up to 1600cc	Up to 800cc	63(c/km)
1601-2600cc	801-1300cc	74(c/km)
Over 2600cc	Over 1300cc	75(c/km)

This method does not have to be substantiated by logbook; however, on occasion the ATO may enquire (particularly in the case of employees) how the motor vehicle has been used for business purposes, and may seek verification from the employer.

Couples engaged in small business may jointly own and use a car for business purposes. In such cases where the vehicle is used separately by each person, it is possible for both to claim a deduction up to the 5,000 kilometre limit using the set rate per kilometre method.

This method is popular for small business persons and employees who own older vehicles and as such cannot access high depreciation claims.

# Chapter 4

## TAX DEDUCTIONS

### ACTUAL COST METHOD

Using this method the total operating cost of the vehicle is determined with an apportionment made between private and business use. A logbook that is kept in the "prescribed format" determines the apportionment. Logbooks may be purchased at stationers and normally state that they comply with ATO requirements. A logbook must be kept for at least 12 consecutive weeks and remains valid for five years as long as there are no substantial changes in patterns of usage. An existing logbook may also be used for a replacement vehicle if patterns of usage remain consistent.

Motor vehicle expenses include all costs and outgoings incurred in operating and maintaining the vehicle. These include, but are not limited to, fuel, tyres, servicing, repairs, maintenance, registration, financing costs (interest), depreciation and/or lease payments. All relevant records to substantiate the amounts claimed must be kept. A depreciation cost limit (maximum amount) applies and for 2010/11 and 2011/12 is \$57,466. Cars that cost more than this can only be depreciated from a value of \$57,466.

Be certain to keep change-over details when purchasing new vehicles. The relevant details are make, model and registration number and odometer records of both cars and the date of change-over.

Always be able to demonstrate that your business percentage is based on a reasonable estimate. Although logbooks will be the primary source, changes in patterns of usage or the number of cars you use are also relevant.

### ONE-THIRD OF ACTUAL EXPENSE METHOD

You may only elect to use this method if your vehicle has travelled more than 5,000 business kilometres in the year. In such instances one-third of expenses incurred in the year are assumed to be business related and tax deductible.

Whilst you do not need to keep a logbook, the substantiation requirements regarding documentation of expenses apply. It must also be demonstrated that the car has travelled more than 5000 kilometres on business. Where a vehicle is not owned for a full year, claims can be made on a pro-rata basis.

### TWELVE PERCENT OF COST METHOD

This method is available as long as the relevant vehicle has travelled more than 5,000 business kilometres in the year and allows a tax deduction equal to 12 per cent of the capital cost of the vehicle, up to the depreciation cost limit of \$57,466.

To make this claim you are required to establish business use exceeding 5,000 kilometres with evidence of the cost of the vehicle. Other than this there is no requirement to keep a logbook or document expenses.

For part year ownership, a pro-rata claim is available if you establish that greater than 5,000 business kilometres would have been travelled in a full year.

### EXCEPTIONS TO MOTOR VEHICLE SUBSTANTIATION RULES

The above rules do not apply to:

- Panel vans, utilities or other vehicles designed to carry weights exceeding one tonne
- Taxis
- Motorcycles and similar vehicles
- A car only used for lease or hire in a business of leasing or hiring
- Panel vans, utility trucks or other vehicles designed to carry less than one tonne, (not being vehicles mainly designed for passengers) where no private use is indicated. This usually means that the only private use is travel between home and work. If a second vehicle is owned, it is suggested this contention of incidental private use can reasonably be made.

Although substantiation may not apply, reasonable documentation should still be kept to justify all claims.

### TRAVELLING EXPENSES

Substantiation is required for all domestic and overseas travel expenses. Written evidence must be retained regardless of the length of absence from home. The only exception is expenses incurred by employees that are not in excess of reasonable travel allowances received from employers.

## Chapter 4 TAX DEDUCTIONS

Travel records, being a travel diary or similar document must be kept if you are away from home for more than five nights. The diary must set out:

- The nature of the activity,
- The day and approximate time it began,
- How long it lasted, and
- The location where the activity took place.

The travel records required are for business activities only and it will be necessary to establish that the principal purpose of the trip was for business purposes.

### PREPAYMENT OF EXPENSES

Carefully note the tax treatment of prepayments depends on the status of the taxpayer and the amount and nature of the expense. The tax treatment also depends on whether the taxpayer has elected to access the small business entity (SBE) (if eligible).

In general, prepaid expenditure must be apportioned over the period in which the relevant service is provided.

The following expenses are excluded:

- Amounts less than \$1000 (net of GST)
- Amounts paid pursuant to Court Order or government legislation
- Salaries and wages
- Payments by taxpayers using the SBE as long as the period of service does not exceed 12 months.

Individuals and SBE taxpayers are still able to participate in "tax effective" investments such as forestry plantations by making a prepayment of management fees.

Individuals with negatively geared investments can still make prepayments of interest.

### TRAVEL CLAIMS WITHIN AUSTRALIA

The substantiation requirements do not apply to 'travel expenses' incurred by an employee who receives a travel allowance for travel within Australia and the claim for costs of accommodation, food, drink and other incidentals do not exceed reasonable amounts as determined by the ATO.

These are the 2011/12 daily rates for accommodation, meals and incidentals as outlined in TD 2011/17.

Place	Salary below \$100,840	Salary \$100,841-\$179,350	Salary above \$179,350
Adelaide	\$270.10	\$322.80	\$367.15
Brisbane	\$314.10	\$370.80	\$394.15
Canberra	\$278.10	\$345.80	\$388.15
Darwin	\$302.10	\$366.80	\$436.15
Hobart	\$238.10	\$304.80	\$353.15
Melbourne	\$286.10	\$353.80	\$423.15
Perth	\$289.10	\$363.80	\$433.15
Sydney	\$296.10	\$362.80	\$423.15

### LONG DISTANCE TRUCK DRIVERS

If in receipt of a travel allowance, employee truck drivers who are required to sleep overnight away from home can claim food and drink expenses up to stipulated daily rates without substantiation.

Expenses must be substantiated if no allowances are paid or if amounts paid are in excess of stipulated amounts.

Acceptable daily rates for 2011/12 are:

Salary of \$100,840 and below	\$87.00 per day
Salary of \$100,841 and above	\$94.95 per day

### NON-COMPULSORY UNIFORMS

Deductions are not allowed for non-compulsory uniforms unless the design of the uniform is entered on the Register for Approved Occupational Clothing at the time the expense is incurred.

### CONVENTIONAL CLOTHING

This is generally disallowed, but there are some interesting exceptions:

- A professional actor who buys stage clothing specific to a production.
- A police officer doing surveillance or undercover work who incurs costs to buy clothing he would not normally wear.

# Chapter 4

## TAX DEDUCTIONS

- A television game show host who purchases evening and formal wear to complement the prizes and sets.

### OCCUPATIONAL CLOTHING AND PROTECTIVE GEAR

Clothing expenditure is generally private expenditure and not deductible. However, there are circumstances where expenditure on certain types of occupational clothing gives rise to a deduction listed below:

#### Occupation Specific

Generally, a deduction will be allowed for occupational specific clothing, which clearly identifies a person as a member of a specific profession, vocation, trade, occupation, or calling. Examples may include a barrister's robes; a chef's checked pants and a nurse's uniform. A business suit is not occupation specific and therefore not tax deductible.

#### Protective Clothing and Footwear

Such costs are deductible where the clothing is specially designed to protect the taxpayer from personal work injury, disease or death.

#### Compulsory Uniform

For expenditure to be deductible, the wearing of the uniform must be an express policy of the employer, consistently enforced and applicable to all employees at the same class.

#### Glasses, Sunhats and Sunscreen

Since the Morris case (2002), expenditure on sunglasses, sunscreen, and sunhats is deductible for taxpayers who are required as part of their duties to work outside and be exposed to sunlight while performing their duties.

Examples of such taxpayers include those involved in farming, outdoor sports, the construction industry, courier services and other outdoor services.

### HOME OFFICE EXPENSES

A taxpayer can make expenditure claims for home office expenses if it can be shown that part of the home is used

for income earning purposes and has the character of a place of business, or is used in connection with income earning activities, but is not a place of business.

Where additional running costs are incurred because of income producing activities, an individual taxpayer may make a claim for home office expenses based on:

- Actual expenses
- Diary records for a typical four week period in each year. This will establish a pattern for the entire year.

In broad terms the following types of expenses are normally incurred:

- Telephone and internet expenses
- Heating and lighting expenses
- Equipment depreciation
- Occupancy expenses where the home is a place of business. These include rent, interest, etc.

Occupancy expenses are deductible only if a particular or part of the dwelling is set aside and is clearly identifiable as a place of business and used exclusively for business purposes. Having a computer alcove at home will not meet this test.

**Note:** If you elect to claim occupancy expenses there are Capital Gains Tax implications. Having accepted that your home is a place of business the main residence exemption will be affected.

### INTEREST

The fundamental test in determining the deductibility of interest is the "use test", being the use to which the finances have been put. Security is irrelevant and under section 8(1) of the Tax Act you can only claim a deduction for interest expenses if the funds have been used in gaining or producing assessable income or in carrying on a business for that purpose.

#### Examples:

1. A business owner has a business overdraft limit, which is secured on business assets. The owner decides to use funds of \$15,000 to finance an overseas holiday. The interest cost on this \$15,000 of the overdraft is not deductible because the borrowings have not been used for business purposes.

## Chapter 4

# TAX DEDUCTIONS

2. A business borrows \$30,000 to purchase a new computer system. The loan is secured on the owner's home. Interest on the loan is deductible because the monies have been borrowed for business purposes and the interest expense has been incurred in carrying on the business.

As long as existing loan arrangements remain unchanged, interest on borrowings that remain after ceasing business are deductible. Interest in connection with borrowings necessarily incurred prior to commencement of business may also be deductible if there is a sufficient connection with the expense and future income derived. Interpretive decision ID 2006/269 indicates that interest incurred on borrowings by a sole trader to pay income tax is deductible under section 8(1), ITAA 97. This has long been the case for companies (IT 2682).

If you replace or reconstruct entire premises or plant, this is not a repair. Essentially a repair involves the restoration of an object to the condition it formerly had, without changing its character. Tax Ruling TR97/23 provides guidance on this issue.

### TELEPHONE

If you are required to contact clients or your employer on a regular basis, or if you are required to be on call, home telephone rental expenses may be partly deductible.

Claims can be made in either of the following ways:

- A diary or log is kept for 28 days, establishing a pattern of usage for the whole year; or
- Actual expenses based on a completely itemised account.

It is suggested that the itemised account method is too onerous and the 28 day diary method is recommended.

### REPAIRS

Deciding whether a claim should be made should be relatively simple; however, items of expenditure may be capital in nature and this issue has been tested in the Courts on numerous occasions. The dictionary definition of repairs is "the restoration of some material thing by the removal of some decayed or worn out parts".

Before making a claim, carefully consider whether the expense is:

- A capital expense in respect of recently acquired property
- An improvement
- The replacement of a subsidiary part or of an entirety.

## Chapter 5 TAX OFFSETS



## Chapter 5 TAX OFFSETS

### TAX OFFSETS DIFFERENT TO DEDUCTIONS

Tax offsets – which are different to tax deductions – allow some individual and business taxpayers to reduce the amount of tax they pay when they lodge their tax return. Pensioners, small business, low-income earners and parents are among those who may be entitled to this concession.

Tax offsets are slightly different to a tax deduction, which is taken off a person's income before the tax is calculated. With tax offsets, the Tax Office works out how much tax a person should pay then reduces that amount by the tax offsets available.

Generally, there are three types of tax offsets – those that:

- Provide tax relief for personal circumstances – for example, offsets for senior Australians and people living in remote areas;

- Give you a credit for an amount of tax that has effectively already been paid – such as credits for franked dividends and foreign tax; and
- Provide an incentive – for example, the tax offset for mature age workers and the private health insurance rebate.

In most cases, tax offsets can only reduce the amount of tax you pay to zero. In other words, you generally don't get a refund if the offsets are greater than the tax that is payable.

The only tax offsets which do provide a refund are the private health insurance rebate, franking tax offset and baby bonus.

Tax offsets, in general, do not reduce your Medicare levy. However, if you have excess refundable tax offsets available – such as those mentioned above – these can reduce your tax, including the Medicare levy.

# Chapter 5 TAX OFFSETS

## PERSONAL TAX OFFSETS

CATEGORY	MAXIMUM OFFSET 2010/11	MAXIMUM REBATE 2009/10
Dependent Spouse/de-facto with dependent child/student	(Replaced by Family Tax Benefit Part B)	
Dependent Spouse/de-facto no-dependent child/student	\$2,286	\$2,243
Child-housekeeper – with dependent child/student	\$2,232	\$2,190
Child-housekeeper – no dependent child/student	\$1,863	\$1,828
Invalid relative	\$839	\$823
Parents of taxpayer or spouse	\$1,676	\$1,645
Housekeeper – with dependent child/student	\$2,232	\$2,190
Housekeeper – no dependent child/student	\$1,863	\$1,828
Low-income Earner	\$1,500	\$1,350
Low-income Aged Person	Same as pensioner rebate	
Pensioner	Variable – see below	
Social Security and Education Beneficiaries	Variable – see below	
Medical Expenses	20% of excess of net costs above \$2,000	
Private Health Insurance	30% of premiums paid	
Zone Rebate – Ordinary Zone A	\$338 plus 50% of dependent rebates	
Zone Rebate – Special Zone A	\$1,173 plus 50% dependent rebates	
Zone Rebate – Ordinary Zone B	\$57 plus 20% of dependent rebates	
Zone Rebate – Special Zone B	\$1,173 plus 50% of dependent rebates	
Defence Forces	Same as for Ordinary Zone A	
Income Arrears	Difference between tax payable and tax which would have been payable had the income been received progressively.	

### DEPENDENT SPOUSE TAX OFFSET

You are eligible to claim the dependent spouse tax offset if you have a dependent spouse and meet **all** of the following conditions:

- Your spouse was a resident of Australia for tax purposes. Your spouse will be treated as a resident if you have always lived in Australia or you came to live in Australia permanently – unless they have set up a permanent home outside Australia.
- You were a resident of Australia at any time in 2010/11 for tax purposes;
- You contributed to the maintenance of your spouse;
- The Adjusted Taxable Income (ATI) of your spouse was **not** over \$9,426 in 2010/11. Shading out occurs where

spouses (ATI) is between \$286 and \$9,426.

- The relevant (SNI) figure for 2011 is \$9,426.

During your time together, if you or your spouse were eligible for family tax benefit (FTB) Part B, you are only able to claim the spouse tax offset under certain conditions.

- If you or your spouse were eligible for FTB Part B for only part of the year you may be able to claim a tax offset for the rest of the year.
- If you or your spouse were eligible for FTB Part B at a rate which was based on a child whose care you or your spouse shared with someone else, such as a former partner – you may be able to claim a tax offset for the periods when the child was in the care of the other person.

## Chapter 5 TAX OFFSETS

This offset is reduced by \$1 for every \$4 by which the spouse's ATI exceeds \$286.

### HOUSEKEEPER REBATE

To be eligible, the housekeeper must be wholly engaged in keeping house for the taxpayer and in caring for a child under 21, an invalid relative or a disabled spouse. If you or your spouses are eligible for FTB this rebate cannot be claimed.

### LOW-INCOME TAX OFFSET (LITO)

This offset of \$1,500 is available to low-income earners. The offset cuts out entirely when taxable income reaches \$67,500.

Minors can claim the low-income rebate and therefore the \$416 tax-free threshold for unearned income for the year ending 30 June 2011, this figure is \$3,333.

In a significant change from 1 July, 2011 Minors will be unable to claim the LITO on unearned income. Income from part-time jobs etc won't be affected, however keep in mind interest and/or dividend income.

### INCOME MEANS TESTING FOR OFFSETS

There is an income threshold of \$150,000 to determine whether a taxpayer is eligible for the following offsets:

- Dependent spouse;
- Housekeeper;
- Child housekeeper;
- Invalid relative; and
- Parent/parent in-law.

### BENEFICIARY TAX OFFSET

If you received one or more of the payments listed below, you may be entitled to a beneficiary tax offset. Beneficiary offsets are calculated to reduce tax which would be otherwise payable on beneficiary allowances.

The following list shows the payments and allowances that qualify for the beneficiary tax offset:

- Parenting payment (partnered);
- Newstart allowance;
- Youth allowance ;
- Mature age allowance;
- Partner allowance;
- Sickness allowance;
- Special benefit;
- Widow allowance;
- Austudy payment;
- Exceptional circumstances relief payment or farm help income support;
- Education payment of any of the following, and you were aged 16 years or older:
  - ABSTUDY living allowance;
  - Payment under the veterans' children education scheme;
  - Payment under the assistance for isolated children scheme;
  - Payment under the Military Rehabilitation and Compensation Act education and training scheme 2004 – shown as 'MRCA education allowance' on your PAYG payment summary – individual non-business.
- Training for employment programme allowance; new enterprise incentive scheme allowance; textile, clothing and footwear special allowance; green corps training allowance; or other taxable Commonwealth education or training payments.
- Income support component from a community development employment project (CDEP) – shown as 'CDEP salary or wages' on your PAYG payment summary – individual non-business.
- CDEP scheme participant supplement.

### THE TAX ZONE OFFSET

You may be able to claim a tax offset if you lived or worked in a remote or isolated area of Australia, not including an offshore oil or gas rig.

Remote areas are classed as either Zone A or Zone B. There are also special areas within these zones. The Zone rebate was introduced as a concession to taxpayers having to contend with high costs and the isolation of living and working in remote areas of Australia. Tables set out in Taxation Ruling TR94/28 define these areas. If resident in

## Chapter 5

# TAX OFFSETS

a Zone area for more than half of one income year, you may claim the appropriate rebate.

The Ordinary Zone A rebate may be claimed by Australian Servicemen who are posted overseas in certain circumstances.

### MATURE AGE WORKER TAX OFFSET

This tax offset aims to encourage and reward mature age workers who stay in the workforce.

To be eligible for the mature age worker tax offset you must:

- Be an Australian resident for tax purposes;
- Be aged 55 years or more at the end of the income year; and
- Have received net income from working (within certain limits).

The mature age worker tax offset can only reduce your tax liability to nil. Any unused portions cannot be refunded or transferred to another taxpayer. This offset should not be confused with the senior Australians tax offset or the pensioner tax offset. Some people may be eligible for more than one of these.

The maximum tax offset of \$500 is based on 5 per cent of earnings. In 2010/11 this offset phases out at 5 cents per dollar. When earnings exceed \$53,000, this means entitlements will cease when earnings of \$63,000 are reached.

### SMALL BUSINESS ENTITY: THE 25 PER CENT ENTREPRENEURS' TAX OFFSET

The entrepreneurs' tax offset (ETO) allows a tax offset (reduction) of up to 25 per cent of the income tax attributable to the business income of a Small Business Entity (SBE) with an annual group turnover of less than \$75,000.

The ETO is available to:

- An individual or a company that is an SBE taxpayer; and
- A partner in an SBE partnership.
- A Trustee or beneficiary of an SBE trust (depending on who is liable for tax on the trust income).

### Income Test

From 2010/11 you will need to meet an income test if you are an individual receiving small business income that is eligible for the ETO as a sole trader, partner in a small business partnership or beneficiary of a small business trust. The income test can further reduce your tax offset.

You meet the income test if your income for ETO purposes does not exceed:

- \$70,000 (the single threshold) if you are single with no qualifying dependant, or
- \$120,000 (the family threshold) if you had a
  - Qualifying dependant on any day during the income year, or
  - Spouse on the last day of the income year

If your income for ETO purposes does not exceed the threshold amount your ETO will not be reduced.

If your income for ETO purposes is above the threshold, your ETO calculated before applying the income test, will be reduced by 20 cents for every \$1 over the threshold amount. This reduction is in addition to the phase-out that begins where your aggregated turnover exceeds \$50,000.

If your income for ETO purposes is above the threshold use the following formula to work out your reduction amount:

(Income for ETO purposes for that income year) – (the relevant threshold)

You will not be entitled to any tax offset if the reduction amount is greater than your ETO calculated before applying the income test.

Note that the new small business instant write off for the first \$5,000 of any motor vehicle will effectively replace the ETO which will be abolished effective 1 July, 2011.

### NET MEDICAL EXPENSES TAX OFFSET

The medical expenses tax offset may be available if you have out-of-pocket medical expenses over a specified limit in an income year.

## Chapter 5 TAX OFFSETS

For the 2010/11 income year, the tax offset is 20 per cent - 20 cents in the dollar of your net medical expenses over the \$2,000 threshold amount. There is no upper limit to the amount you can claim.

Medical expenses include payments to a legally qualified medical practitioner including doctors, dentists, psychologists (referral required), pharmacists, nurses and hospital expenses.

Payments to naturopaths and chiropractors generally won't qualify.

Take care with pharmacy expenses – only items purchased under prescription will be eligible.

Note, the offset applies to net expenses after Medicare refunds or reimbursements from your private health fund.

Due to the \$2,000 threshold it is important that only one family member claim the offset in order to maximise benefits.

### 2010/11 TABLE SATO

CATEGORY	INCOME THRESHOLD	CUT-OUT INCOME THRESHOLD	MAXIMUM TAX OFFSET AVAILABLE
Single	\$30,685	\$48,525	\$2,230
Couple (each)	\$26,680	\$39,496	\$1,602
Couple – living apart due to illness (each)	\$29,600	\$45,920	\$2,040

## PENSIONER TAX OFFSET

The pensioner tax rebate is available for persons below the age (or service) pension age who receive an Australian government pension, or pensions or allowances paid under pension conditions.

The rebate is intended to ensure that no tax is payable by a person whose assessable income consists of the full pension and in some cases, small amounts of non-pension income.

PENSIONER TAX OFFSET THRESHOLDS FOR PEOPLE BELOW AGE PENSION AGE 2010-11			
FAMILY STATUS (PENSIONER)	MAXIMUM TAX OFFSET PER PERSON	(1) SHADE OUT THRESHOLD (TAXABLE INCOME)	(2) CUT-OUT TAXABLE INCOME THRESHOLD
Single	\$2,732	\$24,214	\$46,070
Couple separated due to illness (each)	\$2,577	\$23,180	\$43,796
Married or de facto couple (each)	\$1,905	\$18,700	\$33,940

(1): The shade out threshold is the maximum (assessable) income at which the full tax offset applies. The tax offset reduces by 12.5 cents for each dollar of taxable income in excess of the shade out threshold.  
 (2): For income levels at or above the cut-out threshold the offset is nil.

## THE SENIOR AUSTRALIANS TAX OFFSET

The senior Australians tax offset is a tax offset available to anyone who meets certain eligibility conditions. The tax offset allows you to earn more income before you pay tax and the Medicate levy. In some cases it will result in seniors no longer having to lodge a tax return.

To be eligible for SATO you must:

- Have reached the pension age by year end,
- Be an Australian resident, and
- Have a taxable income below the relevant thresholds.

The rebate phases out at 12.5 cents in the dollar of taxable income over the threshold.

Note, if you are eligible for both SATO and the Pensioner tax offset, choose SATO as the tax offsets are greater.

## Chapter 5

# TAX OFFSETS

### REFUNDING FRANKING CREDITS – INDIVIDUALS

Dividends paid to shareholders by Australian resident companies are taxed under a system known as 'imputation'. It is called an imputation system because the tax the company pays is imputed, or attributed, to the shareholders. The tax paid by the company is allocated to shareholders by way of franking credits attached to the dividends they receive.

You include an amount equal to the franking credit attached to your dividend in your assessable income. You are also entitled to a franking tax offset equal to the amounts included in your income.

The franking tax offset will cover, or partly cover, the tax payable on the dividends. If the tax offset is more than the tax payable on the dividends, the excess tax offset will be applied to cover, or partly cover, any tax payable on other taxable income received.

If any excess tax offset amount is left over after that, the Tax Office will refund that amount to you.

### PRIVATE HEALTH INSURANCE REBATE

All Australians who pay premiums to a registered health fund for appropriate private health insurance are able to claim a rebate.

The private health insurance rebate is worked out as a percentage of the premium paid to a registered health fund for appropriate private health insurance cover. The rebate is not affected by your level of income.

Generally this is 30 per cent of the premium cost of a private health insurance policy for hospital and ancillary cover.

Higher offsets apply for senior Australians:

- 35% for policies covering at least one person aged 65 to 69 years
- 40% for policies covering at least one person aged 70 years and older.

As announced in the 2009 Budget, from 1 July 2010, there was to be a sliding reduction in the 30 per cent private health insurance tax offset for taxpayers with a taxable income of more than \$75,000 (\$150,000 for couples),

with no offset for taxpayers earning more than \$120,000 (\$240,000 for couples). However, this legislation was defeated in the senate and its uncertain as to whether the Government will re-introduce the legislation.

### SUPERANNUATION CO-CONTRIBUTIONS

This is an initiative to assist eligible individuals to save for their retirement.

Those eligible (see Chapter 1) now receive a matching \$1,000 from the Government if they make a \$1,000 contribution to a complying superannuation fund.

### BABY BONUS

The Baby Bonus is paid to customers following the birth (including stillborn babies) or adoption of a child. It recognises extra costs incurred at the time of a new birth or adoption.

To be eligible for Baby Bonus you must:

- Be the primary carer of a dependent child or the partner of the primary carer
- Have the care of the child within 26 weeks of the child's birth and be likely to continue for at least 26 weeks
- In the case of adoption, have the child come into your primary care as part of the adoption process before the child is sixteen years of age.
- Not have received or be receiving Parental Leave Pay for the child
- Have adjusted taxable income of less than or equal to \$75,000 (per couple) for the period in the six months following the child's entry into your primary care, and
- Meet Australian residency requirements for family assistance purposes.

Parents are required to formally register the birth of their child as a condition of receiving the Baby Bonus. This requirement does not apply to parents whose child is stillborn, adopted or born outside Australia.

Baby Bonus is paid per eligible child in 13 fortnightly instalments. From 1 July, 2011, customers eligible to receive Baby Bonus will get a higher instalment of \$879.77 and 12 fortnightly instalments of approximately \$379.77. The higher first instalment of Baby Bonus will assist with

## Chapter 5 TAX OFFSETS

the upfront costs of having a new child.

You cannot receive Parental Leave Pay and a Baby Bonus payment for the same child. If you are eligible for both Parental Leave Pay and the Baby Bonus, you can access the Paid Parental Leave Comparison Estimator on the FAO website to help you make an informed decision about which payment to claim.

If you have twins, you could receive a Baby Bonus payment for each child. If you have twins and are eligible for Parental Leave Pay, you could receive Parental Leave Pay for one child and Baby Bonus for the other.

### STANDARD SET OF AGE CRITERIA FOR DEPENDENT CHILD RELATION CONCESSIONS

The dependent child age criteria used to determine a taxpayer's entitlement to the housekeeper, child-housekeeper, medical expenses and zone tax offsets, as well as the Medicare levy and Medicare levy surcharge, have been standardised effective 1 July 2003.

Formerly, the dependent child age criteria varied across these entitlements. The introduction of a single set of age criteria, namely a child aged less than 21 years or a full-time student aged less than 25 years, provides consistency across each of the relevant areas of income tax.

For example, a family living in a remote area with a dependent child aged 18 could claim up to an additional \$188 as part of their zone tax offset. A low-income family with a dependent child aged 18 would also be able to earn more before they start paying the Medicare levy. In 2010/11, a family can earn an additional \$2,865 for each dependent child before they start paying the Medicare levy.

### EDUCATION TAX REFUND

From 1 July 2008, the Education Tax Refund (ETR) helps eligible families and independent students to meet the cost of primary and secondary school education.

You can claim the ETR for education expenses you incur while your child attends primary or secondary school.

Families and approved care organisations can claim 50

per cent of their eligible educational expenses if:

- They received family tax benefit (FTB) Part A for the child, **or**
- A payment was made for the child that stopped them from receiving FTB Part A for that child.

Independent students may also be eligible to claim the ETR.

The maximum you can claim is 50 per cent of eligible expenses up to:

- \$794 for each eligible child in primary school – that is, a refund of up to \$397
- \$1,588 for each eligible child in secondary school – that is, a refund of up to \$794.

You are eligible to claim an Education Tax Refund (ETR) for the period 1 July 2009 to 30 June 2010 if:

- You had eligible education expenses for a child, and
- The child was in primary or secondary school, and
- You received family tax benefit (FTB) Part A for the child, **or**
- A payment was made for the child that stopped you from receiving FTB Part A for that child, **or**
- Your child stopped full-time school during the year and received sufficient income to stop you receiving FTB Part A.

If you are an independent student attending secondary school or a secondary course of education provided at an educational institution such as a TAFE, you may also be eligible.

#### Items Which Qualify As Eligible Education Expenses

Eligible education expenses are items that support a child's or independent student's primary or secondary school education. They include the purchase, lease, hire or hire-purchase costs, repairs and running costs of:

- Laptops, home computers and associated costs
- Computer-related equipment such as printers, USB flash drives, as well as disability aids to assist in the use of computer equipment for students with special needs
- Home internet connections, including the costs of establishing and maintaining them
- Computer software for educational use

## Chapter 5

# TAX OFFSETS

- Word processing, spreadsheet, database and presentation software, internet filters and antivirus software
- School textbooks and other paper-based school learning material, including prescribed textbooks, associated learning materials, study guides and stationary, and
- Prescribed trade tools – for example, tools required to complete a school-based apprenticeship.
- School uniforms (after 1.07.2011)

Remember, eligible expenses should be listed separately and receipts kept for the purposes of calculating your claim. Receipts may be necessary to prove the information you provided on your claim.

### **Expenses That Are Not Eligible**

Education expenses that are not eligible include:

- School fees
- School uniform expenses (prior to 1.07.2011)
- Student attendance at school-based extra curricular activities, such as excursions and camps
- Tutoring costs
- Sporting equipment
- Musical instruments
- School subject levies – for example, payment for consumables for particular subjects such as woodwork, art or home science
- Building levies
- Library book fees
- School photos
- Donations
- Tuck shop expenses
- Waiting list fees
- Transport
- Membership fees, and
- Computer games and consoles.

## Chapter 6 RESIDENCY



## Chapter 6 RESIDENCY

The two principal criteria for determining an entity's liability to Australian tax are residency and source of income.

A resident of Australia has to pay tax on their world wide income whether it is earned in or out of Australia.

A non-resident on the other hand is limited to Australian tax on income derived only from Australian sources. They are not entitled to any tax-free threshold and are taxed at a higher rate.

Those taxpayers resident for only part of the year pay tax at resident rates, but are only entitled to the tax-free threshold for the months they reside in Australia.

### INDIVIDUAL RESIDENCY

The dictionary definition of reside is to have one's settled abode, to dwell permanently or for a considerable time or to live in or at a particular place.

Whether a person resides in Australia under this definition is a question of fact in view of the individual's unique circumstances.

It is suggested that the following factors are useful in determining whether the individual's behaviour over a considerable period of time has the degree of continuity, routine or habit that is consistent with Australian residence:

- The intention or purpose of the person's presence in Australia
- The extent of the person's family or business / employment ties with Australia
- The location and maintenance of the person's assets
- Social and living arrangements.

### THREE STATUTORY TESTS

#### 1. The Domicile / Permanent Place of Abode Test

Under this test a person whose domicile is in Australia

## Chapter 6 RESIDENCY

is deemed to be a resident, unless the Commissioner is satisfied that the person's place of abode is outside Australia.

"Permanent" is not used in term of everlasting, but contrasts with temporary or transitory. Key factors the ATO will consider include intention, actual length of stay overseas and where the taxpayer maintains a home. Taxation Ruling IT2650 deals with this detail.

### 2. The 183 Day Test

Under this test constructive residence will be attributed to a person who is in Australia either continuously or intermittently for more than half of the year, unless it can be established that the person's usual place of abode is outside Australia and there is no intention of taking up residency here.

### 3. Commonwealth Superannuation Test

This applies to public servants and means that if an individual is contributing to a super fund of Commonwealth Government officers they will be an Australian resident.

## RESIDENCE OF COMPANY

A company is resident in Australia if:

- It is incorporated in Australia; or
- If not incorporated in Australia it carries on business here and has either its central management or control in Australia, or its voting power controlled by shareholders who are residents of Australia.

## SOURCE OF INCOME

The operation of rules that deal with the taxation of foreign source income for residents and the fact that non-residents are usually only assessable on Australian sourced income make the identification of the source of any item of income fundamentally important.

As business transactions become more complex, the following comments are general in nature:

- Income from personal exertion is derived in a country where the services are performed, regardless of how and where you were paid.

- The location of a contract may be relevant where creative knowledge or specialist skills are used to an extent that the place of use is irrelevant.
- The source of business or trading profits is generally the place where services are performed or trading takes place.
- In cases where income has multiple sources, it will be necessary to determine the dominant factor or factors. On occasion it may be necessary to apportion income among the various sources.
- The source of interest is in the country where the obligation to pay the interest arose e.g. for bank interest it is where the bank account is held.
- Dividend income is sourced in the country in which the company made its profits.
- A pension or annuity is sourced in the country in which the pension fund or annuity fund is located.

## DOUBLE TAX AGREEMENTS

The clear intent of double tax agreements (DTA) is that taxpayers are not taxed twice on income earned in countries outside their own. DTAs usually have a standard format, but it is vital that you refer to a specific agreement should any queries arise.

Income that is usually taxed according to the source of the income includes:

- Business income derived through a permanent establishment
- Directors' income and similar company offices
- Entertainers and performing artists
- Income from real property including mining royalties
- Salary or wages where the employee is present in the other country for more than 183 days
- Income derived from personal services or derived from a fixed base used by the person concerned.

The following income is generally taxed on a country of residence basis:

- Income from independent activities or professional

## Chapter 6 RESIDENCY

services (excluding public entertainers)

- Income earned by an employee present in other countries for less than 183 days in the tax year. This applies where the employer is a resident of the same country where the employee is resident and the income earned is not an allowable deduction for the employer in that country
- Remuneration for services rendered to government officials and bodies
- Remuneration for academics or teachers present in other countries for two years or less
- Profits from shipping or aircraft
- Income derived by a resident from sources outside both countries
- Payments made to students for their maintenance
- Profits of an enterprise carried on in one country unless a permanent establishment exists in the other country.

### BECOMING A RESIDENT

People immigrating to Australia find their assessability to income and capital gains widens when they become residents for tax purposes. Australian residents are assessed on domestic and world wide income. New Australians will find that income from foreign investments including interest, dividends, pensions and capital gains or disposal of foreign assets will become subject to Australian tax.

Under the CGT regime, those commencing residency are deemed to have acquired their assets at market value on the given date. It is prudent to obtain valuations in such cases in order to accurately determine any future capital gains or losses.

### CEASING TO BE A RESIDENT

The main issue here is CGT. On becoming a non-resident you are deemed to have disposed all assets at market value, except those assets with a necessary connection with Australia.

This provision applies as non-residents are only subject to CGT on Australian assets. In such cases it is possible

for a taxpayer to elect to defer any CGT arising from the change in residency until ultimate disposal of the asset. A tax planning issue arises here and careful decisions will need to be made when changing residency.

### EMPLOYMENT INCOME EARNED OVERSEAS

Until 30 June 2009, income from wages or salary derived overseas by an Australian resident was generally exempt from Australian tax under section 23AG if the period of Foreign Service is 91 days or more.

However, such foreign earnings were not exempt if the foreign earnings are tax exempt in that foreign country. Foreign earnings exempt under section 23AG will be included in tax returns and taken into account in calculating the tax payable on other income derived by the taxpayers.

See Chapter 3 for the 2009 budget changes.

On 1 April, 2010 the Assistant Treasurer issued a media release making it clear:

- Australians working overseas are able to claim a Foreign Income Tax Offset for the foreign income tax paid on those amounts now included in their assessable income.
- These taxpayers are not required to lodge a foreign tax return to demonstrate and claim amounts of foreign tax paid.
- All they are required to do is keep their normal pay slips, assuming they identify amounts withheld, and under the self-assessment regime these pay slips will only need to be provided if the Tax Office undertakes an audit.
- The general application of FBT to overseas based Australian employees is appropriate as it ensures there is consistent treatment of employee remuneration regardless of whether it is received as cash or as a non-cash benefit.
- Current judicial and Tax Office interpretative decisions have found having regard to the facts and circumstances of particular cases under review, that flights to and from home and domestic remote mining worksites are generally considered "otherwise deductible" (see chapter 20) for employers when

## Chapter 6 RESIDENCY

determining FBT liabilities. This extends to similar arrangements overseas.

### TRANSFER PRICING

These provisions deal with arrangements under which there are profits through the mechanism of inter company or intra company transfer pricing.

In recent years significant resources have been put into transfer pricing enforcement by the ATO. The aim is to stop profits being arbitrarily shifted between tax jurisdictions in order to minimise tax. It is recommended that taxpayers adopt a pricing methodology prescribed by the ATO. Adequate documentation should be kept to verify a prescribed methodology has been followed – TR 98/4.

In situations where international related party transactions exceed \$1 million, the ATO requires a Schedule 25A to be completed with the taxpayer's tax return.

### THIN CAPITALISATION

The current thin capitalisation rules have been in operation for six years and apply to both foreign entities investing in Australia and to Australian entities carrying on a business or investment activities overseas.

Effectively these rules set limits on the amount of debt that can be used to finance the Australian operations of an entity and to set a minimum level for the amount of equity capital that is required to finance Australian operations.

The objective is to prevent multinational taxpayers highly gearing their Australian enterprises with a view to paying less tax in Australia.

There are two important exemptions from the Thin Capitalisation rules:

- Taxpayer's who are claiming annual interest deductions of \$250,000 or less or;
- An outward investing entity where 90% or more of its assets are Australian based assets.

The ATO has announced that thin capitalisation is an area of its compliance program for 2011/12.

# Chapter 7

## ACCOUNTING FOR TAX



# Chapter 7

## ACCOUNTING FOR TAX

### INCOME RECEIVED IN ADVANCE

Monies that are received for goods or services to be rendered over a period of time are not required to be brought to account until they have been earned. Examples of this would be where monies are paid in advance for the provision of fixed term service contracts such as computer services, the provision of magazine subscriptions, the provision of tennis lessons, etc. This principle also applies to deposits for goods or services to be manufactured and delivered at a later date – including lay-by sales. It is therefore essential in these instances that the accounting records of a business identify the advance payments as liabilities and not income.

### PREPAID EXPENSES

Section 8(1) of ITAA 1997 allows a deduction for a loss or outgoing incurred in the relevant income or business activities provided that it is not of a capital, private or

domestic nature. Accordingly, a payment incurred for goods or services to be provided in the future appears to be deductible under this section.

However there are specific prepayment provisions (sections 82KZL to 82KZO of the ITAA36) that potentially apply to these types of expenditures. In effect, the ability to claim outright deductions for prepaid expenses of \$1000 or more for items such as services, interest and lease payments etc, is only available to businesses that are in the SBE. Alternatively, the prepaid amount is to be written off over the period to which it relates. At this stage the prepayment provisions do not apply to prepayments made under timber plantation managed investment schemes.

### INCOME FROM LONG-TERM CONSTRUCTION CONTRACTS

In respect of long-term construction contracts that may

# Chapter 7

## ACCOUNTING FOR TAX

apply to certain industries, the ATO has issued Tax Ruling IT 2450 in which it explains the two allowable methods available for the accounting of profits. Some of the industries to which this applies include:

- Building industry
- Major refurbishment projects
- Civil engineering
- Ship building.

It is imperative that the method chosen is applied consistently, both during the years for which the particular contract runs and also to all similar contracts that are entered into by the taxpayer.

### The Two Allowable Methods Are:

- Billings Method/Basic Method

This requires all progress and final payments received in a year (including amounts billed or entitled to be billed in the year) to be included in assessable income. An income tax deduction is allowed for losses and outgoings as they are incurred; and

- Estimated Profits Method

The taxpayer is permitted to spread the ultimate profit or loss over the term taken to complete the contract, provided that the basis is reasonable and is in accordance with accepted accountancy principles.

The ultimate profit or loss is required to reflect the anticipated profit on the project. This profit or loss may be adjusted from year to year in order to reflect any changes that may have been caused by price increases in material, labour and other costs, industrial disputes and delays caused by other factors for example, weather.

The completed contract method, where profits or losses are deferred until the completion of the contract, is not accepted by the ATO.

## TRADING STOCK

Trading stock is defined as including any item that is produced, manufactured or acquired, and which is held for the purpose of manufacture, sale or exchange in the ordinary course of a taxpayer's business. This definition also specifically includes livestock used in primary production activities (section 70-10 ITAA 1997).

In addition, land that is owned by a developer or land trader may be considered to be trading stock depending upon the intention for that property.

Note that work in progress forms part of trading stock for a manufacturer, but are not considered as trading stock under a long-term construction project.

Materials obtained by service providers (tradesmen) for supply to customers as part of the provision of their services are considered to be trading stock unless they are considered to be of a minor or incidental aspect of the services (refer Taxation Ruling TR98/8).

Consumables stored, however, are not trading stock and generally are deductible upon purchase (Taxation Ruling IT 333). Note that the computer spare parts of a computer supplier are generally deemed to be trading stock (Taxation Ruling TR93/20).

Materials such as containers, packing materials, labels etc, that are sold with the goods are considered to be trading stock for manufacturers and not consumables, whereas returnable packaging items are not considered to be trading stock.

Trading stock on hand at the beginning and at the end of a financial year together with the costs of purchasing trading stock during the financial year are taken into account in the calculation of taxable income (section 70-35 ITAA 1997).

As previously stated an adjustment needs to be made for any stock taken for private purposes.

A physical stocktake should be undertaken at least once a year even if a perpetual inventory system is in operation. An exception to this is in respect of taxpayers in the SBE.

Trading stock is considered to be on hand if you have the power to dispose of it (Taxation Ruling IT2670). This can still be the case where you may not necessarily have physical possession of it, such as where the stock may be held on consignment by another party or it is in transit.

It is possible to convert an item from a capital asset to trading stock, or from trading stock to a capital or personal asset. There are specific provisions in ITAA 1997 that deal with these circumstances. In effect section 70-30 will deem that there has been a disposal of the item as a capital asset and a subsequent purchase of it as trading stock at either cost or market value.

# Chapter 7

## ACCOUNTING FOR TAX

The appropriate treatment of discounts, rebates and other trade incentives offered by sellers to buyers is outlined in TR 2009/5.

### VALUE OF TRADING STOCK

Section 70-45 provides the alternatives available to be used in the valuation of each item of trading stock on hand. These alternatives are:

- Cost;
- Marketing selling value; or
- Replacement value.

The valuation of trading stock at cost relates to the full absorption cost of each item. This includes costs such as freight, insurances, customs and excise duties, and delivery charges.

For any work in progress and manufactured goods the valuation also includes a component for the cost of labour and materials and an appropriate proportion of variable and fixed overheads. No GST is included unless it has not been claimed as an input tax credit. The cost of infrastructure land and expenses forming part of the cost of land is considered trading stock for a land developer.

The following methods are acceptable to the ATO for the valuation of closing stock on hand where the cost basis is used:

- **First In First Out (FIFO)** – The cost of trading stock on hand is deemed to be the cost of the items most recently acquired.
- **Average Cost** – The cost of a particular item is based on the weighted average cost of all those items, whether purchased during the year or on hand at the beginning of the year. This method is an alternative where you cannot ascertain the actual cost of stock.
- **Standard Cost** – A predetermined standard cost per unit is used. This is acceptable where standards are reviewed regularly to equate with current prices.
- **Retail Inventory** – Goods are priced at their retail selling price at the time of stocktake, but then are subsequently reduced by the amount of the mark-up to produce the cost of the goods on hand. This is only acceptable where old stock has not been previously marked down.

You may choose either cost, market selling value or replacement value for each item of trading stock. In addition, the method used for the valuation of closing stock can be varied from year to year.

The only requirement of the ATO is that the closing value for stock must be used as the opening value of stock in the following income year. No formal election is needed as the method used to value the trading stock must be shown on the taxpayer's income tax return. Documentary evidence should be retained to support the valuation method used for closing stock.

Where the market selling value or replacement value are chosen for valuing stock, a higher assessable income will result as closing stock will be higher in value. This should be considered in instances where a business has low profitability in a particular year. Alternatively, it may be prudent to revise the closing stock valuation methods where there are to be changes in the tax rates in the ensuing year.

In the event of obsolescence or other special circumstances, a trading stock valuation using either of the above methods may result in an unreasonable value (section 70-50, ITAA97). The taxpayer is allowed to provide his own valuation in these circumstances. Where a taxpayer wishes to avail himself of this option he must apply the general guidelines as provided for in Taxation Ruling TR93/23.

Full absorption costing must be used when opting for the cost method for valuation of closing trading stock. That is, the manufacturer needs to include the indirect costs of operating the manufacturing facility (including light and power, administrative expenses, wages, etc.) as part of the cost of goods.

Full absorption costing requires the following costs to be absorbed into the value of trading stock on hand at year end:

- The purchase price;
- All costs incurred to the extent they are directly related to the purchase of the trading stock;
- Operating distribution centres;
- Operating warehouses or storage areas not forming part of the selling location;
- Freight from the supplier's premises to the retailer's or wholesaler's selling outlet, warehouse or distribution centre; and

# Chapter 7

## ACCOUNTING FOR TAX

- Freight from the retailer's warehouse or distribution centre to the retail outlet.

The Tax Office has issued Practice Statement PSLA 2003/13 relating to taxpayers or consolidated groups with operating turnovers in excess of \$10 million. The Practice Statement provides guidance as to the types of costs to be included in the valuation of closing trading stock. These costs include, but are not limited to, the following:

- Purchase costs;
- Costs of operating distribution centres;
- Costs of operating on or off-site warehouses or storage areas, including wages, electricity, cleaning, security etc;
- Inwards freight to the warehouse or distribution centres;
- Freight from the warehouse or distribution centre to the retail outlet.

For Small Business Entity taxpayers simplified trading stock rules apply. Generally where the difference between the value of trading stock at the beginning and the end of a year does not exceed \$5000, the taxpayer does not have to value each item or account for any change in the value of trading stock on hand. However, it is necessary that the estimate for the difference is based on reasonable assumptions or circumstances by the taxpayer.

### LAY-BY SALES

Income from lay-by sales is derived and therefore assessable when the buyer pays the final instalment for the goods, and the goods are delivered to the buyer. All amounts that are received while the goods are being held by the seller are not considered to have been earned by the seller and are therefore not considered assessable income for income tax purposes. However, where a non-refundable deposit is paid that amount is assessable (refer Taxation Ruling TR 95/7).

Note that goods that are in the possession of the seller at the end of the year of income are required to be taken up as trading stock on hand for tax purposes, even though they may not be available for resale at that point in time.

Where an early termination of the lay-by sale occurs, any refund to the buyer is not tax deductible as those amounts would not have initially been included as income of the seller - having been shown as a liability in the accounts of

the seller. Any amount forfeited to the seller is considered to be taxable income.

### PROFESSIONAL WORK IN PROGRESS

For many years a serious problem existed for professionals selling or retiring and disposing of work in progress (WIP). In effect, an amount of WIP received by a partner upon retirement was assessable income to the partner, but was viewed as a capital payment by the partnership and therefore not tax deductible to the partnership. When the work in progress was subsequently invoiced by the partnership it became assessable income to the partnership. In effect the WIP amount was subject to double taxation.

This issue has since been resolved by the retiring partner receiving a WIP advance from the partnership and continuing to be entitled to his share of the WIP as it is received. The collection of the WIP is used in paying the advance.

The law has been amended to prevent this double taxation of professional WIP. The amendments allow a deduction for payments made to a retiring partner for WIP. If the work will be completed within 12 months the deduction is available at time of payment for the WIP. If the work will not be completed within 12 months the deduction will be available in the following year. The retiring partner must pay tax on the amount received for the WIP. The amendments are retrospective and will apply from 23 September 1998 (the date of withdrawal of Taxation Ruling IT 2551).

### COMMERCIAL DEBT FORGIVENESS

Division 245 of the ITAA 1997 contains the commercial debt forgiveness provisions. Commercial debts are defined as being debts upon which the interest payable is deductible under section 8-1 or, if no interest is payable, it would have been deductible if it had been charged. It is imperative that the amount forgiven is actually a debt and not an unenforceable disputed claim. Forgiveness entails the release, waiver or extinguishment of a debt and includes debts that are unable to be pursued due to the statute of limitations.

Where a creditor forgives all or part of a debt owing to it, the debtor would in effect have received a gain. However, as there is no asset involved there can be no triggering of