The expression "author" is a technical term from copyright law. Thus, a computer programmer is classified as an author for the purposes of the income averaging scheme (TD 93/65) — but see *Finlayson* below.

"Performing artist" is defined by reference to the activities which a performer undertakes as part of his/her profession. The first category of activities encompasses music, a play, dance, an entertainment, an address, a display, a promotional activity, an exhibition and similar activities. The second category comprises those activities within the performing arts field which are not always carried on in the presence of an audience. This includes the performance or appearance of a person in or on a film, tape, disc or television or radio broadcast.

"Production associate" refers to those persons who have an artistic input, as distinct from a technical input, into any of the activities mentioned in the definition of performing artist. The persons who qualify as production associates are specified in the definition of "artistic support" to be: an art director, a choreographer, a costume designer, a director, a director of photography, a film editor, a lighting designer, a musical director, a producer, a production designer, a set designer and any person who makes an artistic contribution similar to that made by any of these persons.

"Sportsperson" is any person who competes in a sporting competition in any of the ways identified in the definition of sporting competition. A "sporting competition" is a sporting activity to the extent that:

- human beings compete by riding animals, or by exercising other skills in relation to animals (eg jockeys, rodeo riders)
- human beings compete by driving, piloting or crewing motor vehicles, boats, aircraft or other modes of transport
- human beings compete with, or overcome, natural obstacles or natural forces (eg mountain climbers), or
- human beings are the sole competitors (eg footballers, golfers, athletes).

Competitors must use physical prowess, physical strength or physical stamina. Persons specifically exempt from this requirement are a navigator in a car rally, a coxswain in rowing and any competitor whose role is of a similar nature (s 405-25(8)), but not a golf caddy (*Davidson*; ID 2004/196).

Income derived from the following activities is expressly excluded from assessable professional income (ITAA97 s 405-30):

- coaching or training sportspersons
- umpiring or refereeing a sporting competition
- administering a sporting competition
- being a member of a pit crew in motor sport
- being a theatrical or sports entrepreneur
- owning or training animals.

Income from such activities will not be included in any above-average special professional income to which the averaging scheme applies.

Authors and inventors who enter into a scheme to provide services to others cannot count as assessable professional income any income derived under the scheme unless: (a) the scheme was entered into solely for the taxpayer to complete specified artistic works or inventions; and (b) the taxpayer does not provide such services to the other person or an associate under successive schemes that result in substantial continuity of the provision of such services (s 405-30). Hence persons such as journalists, draughtspersons

and graphic artists who produce works as an ordinary part of their employment are not eligible for income averaging simply as a result of their ordinary employment tasks. Similarly, in *Finlayson* a computer programmer was not able to take advantage of the income averaging provisions as the ongoing requirement to improve or upgrade specific products for the one employer amounted to the provision of services under successive schemes.

[FITR ¶385-220, ¶385-230]

¶2-144 Calculation of tax under income averaging scheme

The steps involved in calculating the tax payable under the income averaging scheme are as follows.

Step 1: Divide the taxpayer's total assessable income into assessable professional income and other assessable income.

"Assessable professional income" is income derived from activities related to the taxpayer's status as a special professional (ITAA97 s 405-20). It specifically includes prizes received in connection with a taxpayer's activities as a special professional and income from endorsing products, advertising, interviews and commentating. Specifically excluded are ETPs, unused annual leave or unused long service leave payments and any net capital gain (ITAA97 s 405-30).

Step 2: Divide the taxpayer's total taxable income into taxable professional income and other taxable income.

"Taxable professional income" is the taxpayer's assessable professional income minus any deductions attributable to that income (ITAA97 s 405-45).

There are two classes of deductions: (a) those which reasonably relate to the taxpayer's assessable professional income (this class includes deductions which relate exclusively to that income, such as the cost of a sportsperson's sporting equipment, and deductions which relate in part to that income, such as the use of a car); and (b) those which have no relation to the taxpayer's assessable professional income, but which are apportionable between assessable professional income and other assessable income in the same proportion as the taxpayer's otherwise ascertainable taxable professional income bears to the aggregate of the taxable income and the apportionable deductions (eg gifts to charity).

The taxable professional income will be treated as nil where the deductions exceed the assessable professional income (TD 94/6).

Step 3: Work out the taxpayer's average taxable professional income.

Ordinarily, "average taxable professional income" in an income year will be one-quarter of the sum of the taxable professional incomes for the preceding four years (ITAA97 s 405-50). However, there is a special rule for calculating average taxable professional income to assist taxpayers in the early stages of their careers. This rule applies where the preceding four-year period includes "professional year 1", ie the first income year in which the taxpayer was a resident for all or part of the year and had a taxable professional income of more than $2,500. In such a case, average taxable professional income is calculated as:

- in professional year 1 — nil
- in the second income year ("professional year 2") — one-third of the taxable professional income for professional year 1
- in the third income year ("professional year 3") — one-quarter of the sum of the amounts of taxable professional income for professional years 1 and 2
- in the fourth income year ("professional year 4") — one-quarter of the sum of the amounts of taxable professional income for professional years 1, 2 and 3.

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A taxpayer has only one "professional year 1". For a returning former resident this may be an earlier year than the year the taxpayer returns to Australia (*Case Z6*; TD 93/33). Where the taxpayer was a foreign resident in the income year preceding professional year 1, the average taxable professional income is:

- in professional year 1 — the taxable professional income for that year (this means that there is no above-average special professional income and therefore no averaging effect in that year)
- in professional year 2 — the taxable professional income for professional year 1
- in professional year 3 — half the sum of the amounts of taxable professional income for professional years 1 and 2
- in professional year 4 — one-third of the sum of the amounts of taxable professional income for professional years 1, 2 and 3.

Step 4: Divide the taxpayer's total taxable income into above-average special professional income and normal taxable income.

"Above-average special professional income" is taxable professional income minus average taxable professional income (ITAA97 s 405-15). "Normal taxable income" is average taxable professional income plus taxable income that is not taxable professional income.

Step 5: Calculate the tax payable on the normal taxable income using ordinary individual rates (¶42-000).

Step 6: Calculate the tax payable on the normal taxable income plus one-fifth of the sum of the above-average special professional income using ordinary individual rates.

Step 7: Take the difference between the amount calculated in step 6 and the amount calculated in step 5 and multiply the difference by five. This gives the amount of tax payable on the above-average special professional income.

Step 8: Add the tax payable on the above-average special professional income (step 7) to the tax payable on the normal taxable income (step 5) to give the total tax payable.

▶ Example

Yvonne, a jockey, is a special professional whose professional year 1 is 2015/16. She was also a resident in the previous year. She had taxable professional income of $15,000 in 2015/16 and $20,000 in 2016/17. She has a total assessable income of $60,000 in 2017/18 (professional year 3) comprising $20,000 from employment as a waitress and $40,000 from riding. Assume her only expenses are $3,000 for riding equipment. On the basis of the rates scale at ¶42-000, the tax payable on her income (disregarding Medicare levy) is calculated as follows:

1.	Assessable professional income	$40,000
	Other assessable income	$20,000
2.	Taxable professional income ($40,000 – $3,000)	$37,000
	Other taxable income	$20,000
3.	Average taxable professional income ([$15,000 + $20,000] ÷ 4)	$8,750
4.	Normal taxable income ($20,000 + $8,750)	$28,750
	Above-average special professional income ($37,000 – $8,750)	$28,250
5.	Tax on normal taxable income of $28,750	$2,004.50
6.	Tax on normal taxable income plus 1/5 of above-average special professional income (ie tax on $34,400 ($28,750 + 1/5 of $28,250))	$3,078
7.	Tax on above-average special professional income ([$3,078 – $2,004.50] × 5)	$5,367.50

8.	Total tax payable ($2,004.50 + $5,367.50)	$7,372

The total tax ordinarily payable would have been $10,072 (ie tax on $57,000). The tax saving from the averaging scheme is $10,072 – $7,372 = $2,700.

[FITR ¶385-310 – ¶385-400]

Income of Minors

¶2-160 Special tax payable by minors

Special rules apply in calculating the tax payable on income of a minor (ITAA36 Pt III Div 6AA: s 102AA to 102AGA). These rules were introduced to discourage income-splitting by diverting income to children, but they are not confined to situations where income-splitting is involved.

Under these rules, "unearned income" of minors over a certain level is taxed at the highest marginal rate of tax (45% for **2017/18**). The rules apply to income, including capital gains, derived by the minor directly or through a trust. Where the minor is a resident, the special rules do not apply if the relevant income is $416 or less.

The low income earner's rebate (¶15-300) is no longer available for the unearned income of minors.

[FTR ¶51-452 – ¶51-462]

¶2-170 Which minors are within the rules?

Persons to whom the special rules apply are called "prescribed persons". A prescribed person is any person under 18 years of age at the end of the income year *except* (ITAA36 s 102AC):

- a person who is classed as being in a "full-time occupation"
- an incapacitated child in respect of whom a carer allowance or a disability support pension was paid or would, but for eligibility tests, be payable
- a double orphan or a permanently disabled person, provided they are not dependent on a relative for support.

Full-time occupation exception

The main exception is the full-time occupation exception. A minor will be treated as being engaged in a full-time occupation if he/she was either: (a) actually engaged in a full-time occupation on the last day of the income year; or (b) engaged in a full-time occupation during the income year for at least three months (not necessarily continuously). If the minor engages in a course of full-time education after a period of full-time occupation, the period of full-time occupation is disregarded in calculating the three months (s 102AC(6), (7)).

In either case, the Commissioner must also be satisfied that, on the last day of the income year, the minor intended engaging in a full-time occupation during the whole or a substantial part of the *next* year and did not intend returning to full-time education during that next year (s 102AC(8)).

"Occupation" includes any office, employment, trade, business, profession, vocation or calling (ITAA36 s 102AA(1)). It does not include a course of education at a school, college, university or similar institution. A period during which a person is in receipt of unemployment benefits does not constitute a period of engagement in a full-time occupation.

[FTR ¶51-465, ¶51-480]

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Special rules apply for determining the amount of excepted trust income of a beneficiary in a discretionary trust.

[FTR ¶51-530]

¶2-220 Calculating the tax of minors

Where a minor derives income subject to the special rules, that income (net of deductions relating to the income) is generally taxed at the top marginal rate. The net income subject to the special rules is called "eligible taxable income".

Any taxable income of the minor that is not eligible taxable income is taxed at general resident rates where the minor is a resident (or at non-resident rates where the minor is a prescribed non-resident).

For **2017/18**, the rules for calculating the tax on eligible taxable income where the minor is a resident are as follows (*Income Tax Rates Act 1986* (ITRA), s 13; Sch 11).

(1) If the eligible taxable income is $416 or less, the special rules do not apply. The whole of the taxable income is simply taxed in the normal way.

▶ Example 1

Jill, a minor, has a taxable income of $11,000 for 2017/18 of which $400 is eligible taxable income. As the eligible taxable income does not exceed $416, the whole of the taxable income is taxed at ordinary resident rates in the normal way. Applying 2017/18 rates (¶42-000), the tax payable by Jill is therefore nil. (She is not liable for the Medicare levy as her taxable income does not exceed the threshold.)

(2) If the eligible taxable income exceeds $416 but is less than $1,308, the tax on the eligible taxable income is the greater of:

(a) 66% of the excess over $416, and

(b) the difference between tax on the whole of the taxable income and tax on so much of the taxable income that does not qualify as eligible taxable income.

▶ Example 2

Nathan, a minor, has a taxable income of $20,000 for 2017/18 of which $1,200 is eligible taxable income. The tax payable on the $1,200 is the greater of:

(a) 66% × ($1,200 − $416) = $517.44, and

(b) tax on $20,000 (ie $342) less tax on ($20,000 − $1,200) (ie $114) = $228.

As (a) exceeds (b), tax payable on the $1,200 of eligible taxable income is $517.44. The total tax payable by Nathan would be $517.44 (tax on eligible taxable income) plus $114 (tax on taxable income other than eligible taxable income). The total tax payable by Nathan would be $631.44, less any rebates or credits. (He is not liable for the Medicare levy as his taxable income does not exceed the levy threshold.)

(3) Where the eligible taxable income exceeds $1,307, tax is payable on the whole of the eligible taxable income at the rate of 45%.

▶ Example 3

Rohan's only income is eligible taxable income of $40,000. Tax payable for 2017/18 (excluding Medicare levy) is $18,000 (ie 45% of $40,000) (less any rebates or credits).

▶ Example 4

Brad's income for 2017/18 consists of eligible taxable income of $15,000 and other taxable income of $10,000. The tax payable, excluding any rebates or credits, is:

Tax on $15,000 at 45%	$6,750
Tax on $10,000 at ordinary resident rates (¶42-000)	0
Tax payable (excluding Medicare levy)	$6,750

Prescribed non-residents

Where the minor is a "prescribed non-resident" (¶2-120), the $416 exemption threshold does not apply. The eligible taxable income is taxed as follows (ITRA s 15; Sch 11).

- If the eligible taxable income does not exceed $416, the tax payable on that income is the greater of: (a) 32.5% of the eligible taxable income; and (b) the difference between tax on the total taxable income and tax on the taxable income other than the eligible taxable income, using in both cases the rates applicable to non-residents.
- If the eligible taxable income exceeds $416 but does not exceed $663, the tax payable on that income is the greater of: (a) $143.52 plus 66% of the excess over $416; and (b) the difference between tax on the total taxable income and tax on the taxable income other than the eligible taxable income, using in both cases the rates applicable to non-residents.
- Where the eligible taxable income exceeds $663, tax is payable on the whole of the eligible taxable income at the rate of 45%.

[FTR ¶860-470]

¶2-250 Tax payable on income from trust estate to minor

Where a presently entitled beneficiary of a trust estate is a prescribed person (¶2-180), so much of the beneficiary's share of the net income of the trust estate as falls within the special rules is taxed to the trustee under ITAA36 s 98 at the rates that would have applied had the income been derived directly by the minor (¶2-220). Where the minor is a beneficiary in more than one trust estate and the aggregate of the amounts of eligible taxable income exceeds $416 but is less than $1,308 (or exceeds $0 but is less than $663 in the case of a non-resident beneficiary), shading-in rates do not apply but the Commissioner has a discretion to reduce the tax payable (*Income Tax Rates Act 1986*, s 13(8); Sch 11). If, in the case of a beneficiary who is a resident minor, the aggregate of the amounts does not exceed $416, no tax is payable under the special rules applying to minors.

A beneficiary who has income from other sources or from more than one trust estate is taxed on his/her share of the income of the trust estate(s) together with any other eligible income, at the special rates, with credit being allowed for the tax paid by the trustee.

[FTR ¶860-470]

Medicare Levy

¶2-290 Who is liable to pay Medicare levy?

An individual who is a resident of Australia at any time during the income year is liable to pay a Medicare levy of 2% (a proposal to increase the Medicare levy to 2.5% from 1 July 2019 will not proceed) of his/her taxable income for the year, subject to some concessions. For Medicare levy purposes, taxable income excludes the taxable component of a superannuation lump sum that attracts a tax offset under ITAA97 s 301-20, which reduces the effective tax rate on the lump sum to zero (*Kowalski*). The levy is also payable by some trustees (¶6-250).

From 1 July 2016, residents of Norfolk Island are treated as residents of Australia for the purposes of the Medicare levy and no longer exempt from it. Residents of Christmas or Cocos (Keeling) Islands are also liable for the levy.

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Persons temporarily living overseas who retain Australia as their permanent place of abode are considered to be residents for tax purposes and are therefore liable for the Medicare levy. Furthermore, because of the differences in the residency tests in the income tax legislation and the health insurance legislation, a person may be liable for the Medicare levy, but not eligible for Medicare benefits and vice versa (IT 2615).

Special concessions apply to Defence Force members, veterans' entitlement beneficiaries, blind pensioners, sickness allowance recipients and foreign government representatives (¶2-340). Relief is also provided for low income earners (¶2-330).

Those on higher income without adequate private patient hospital insurance may be liable for the Medicare levy surcharge (¶2-335).

The penalty tax provisions (Chapter 29) apply equally to the Medicare levy and surcharge, as the terms "income tax" and "tax" in those provisions include the Medicare levy and surcharge (ITAA36 s 251R(7)). A person who makes a false or misleading statement affecting liability to pay the levy may be guilty of an offence (¶29-700).

The legislation governing the levy is contained in ITAA36 s 251R to 251Z and in the *Medicare Levy Act 1986*.

[FTR ¶778-300, ¶779-880]

¶2-300 Meaning of married for Medicare purposes

Income thresholds for the Medicare levy (¶2-330) and the Medicare levy surcharge (¶2-335) depend on whether the taxpayer is married but the definition is quite wide. A taxpayer's spouse may be treated as a dependant of the taxpayer for levy purposes (¶2-310).

For these purposes, an individual, whether of the same or different sex, who is in a registered relationship under a prescribed state or territory law with another individual or who lives with another individual as a couple on a genuine domestic basis, during any period, the couple will be treated as if they were married to each other and to no one else for that period (ITAA36 s 251R(2), (2A)).

A person whose spouse has died during the income year and who has not remarried will be treated as married at year's end. A couple who have separated (and remain separated at year-end) will be treated as not being married (MLA s 8(3)).

[FTR ¶778-350, ¶778-800]

¶2-310 Who is a dependant for Medicare levy purposes?

Entitlement to exemption from all or part of the Medicare levy (¶2-340) and liability to the Medicare levy surcharge (¶2-335) may depend on whether a taxpayer has dependants. For these purposes, a person is a dependant of a taxpayer if the person, whose maintenance a taxpayer contributes to, is a resident of Australia and is:

- the spouse of the taxpayer — a "spouse" includes an individual, whether of the same or different sex, who is in a registered relationship under a prescribed state or territory law with another individual (¶14-270), and an individual who lives with another individual as a couple (if either individual was legally married to another person then that relationship is disregarded)
- a child of the taxpayer under 21 — a "child" includes the individual's adopted child, stepchild, ex-nuptial child, spouse's child or a child of the individual within the meaning of the *Family Law Act 1975*, or

- a child of the taxpayer who is 21 or more but less than 25 and in receipt of full-time education at a school, college or university, provided the taxpayer is entitled to a notional dependants rebate (¶15-160 – ¶15-190) for the child (ITAA36 s 251R(3), (4)). For levy surcharge, but not levy, purposes, a student will be a dependant regardless of the level of the student's "adjusted taxable income" (¶2-133).

A spouse may be taken to be a dependant of a person who has contributed to his/her maintenance. Unless shown otherwise, a person will be taken to have contributed to the maintenance of another person during any period in which they resided together (s 251R(6)). This means, for example, that a husband and wife living together who are each in receipt of income are, for levy purposes, each treated as a person who has a dependant. Each is a dependant of the other.

It is open to persons living together to prove that they have not contributed to the maintenance of each other by providing evidence establishing that each was self-supporting. Generally, the starting point in such an exercise would be a detailed record of actual household expenses and the amounts contributed by each person. Normal domestic sharing arrangements, eg a common account to which each person contributes and which is used to meet joint expenses, is not ordinarily sufficient to establish that one person has not contributed to the maintenance of the other (TR 93/35; but see also *Thompson*).

Where the parents of a child are living separately and apart from each other and are both eligible for a specified percentage of Family Tax Benefit Part A for a child, the child is a dependant of each parent for Medicare levy exemption purposes for so much only of the shared care period as represents that percentage of the period (s 251R(5)).

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▶ Example

Val and Don, although living apart, are each eligible for a 50% share of Family Tax Benefit Part A for their child Aidan. For Medicare levy exemption purposes, Aidan is a dependant of each parent for 50% of the time they share his care.

In certain circumstances, a dependant of a taxpayer who is a Defence Force member, a veterans' entitlement beneficiary, a blind pensioner or a sickness allowance recipient is not treated as being a dependant for Medicare levy purposes (¶2-340).

[FTR ¶2-395, ¶778-800]

¶2-320 Rate of Medicare levy

The basic rate of the Medicare levy is 2% of the taxpayer's taxable income for **2017/18**. The government has announced that a proposal to increase the Medicare levy from 2% to 2.5% of taxable income from 1 July 2019 will not proceed. There is no ceiling on the amount of levy payable.

▶ Example

Buddy's taxable income is $40,000. The Medicare levy is calculated as 2% of $40,000 = $800. This is additional to Buddy's ordinary tax.

Note that those on higher incomes without adequate private patient hospital insurance may be liable to an additional 1% to 1.5% Medicare levy surcharge (¶2-335).

[FTR ¶860-100]

¶2-330 Relief from Medicare levy for low income earners

Relief from the Medicare levy is provided to certain low income earners. For example, no levy is payable by a person whose taxable income for **2017/18** is $21,980 or less. Where the taxable income exceeds $21,980 but does not exceed $27,476, the levy is shaded in at the rate of 10% of the excess over $21,980 (MLA s 7).

▶ Example 1

For 2017/18, the levy payable by a single person with a taxable income of $23,000 is $102.00 (ie 10% × ($23,000 – $21,980)).

A higher threshold applies if the taxpayer is married (¶2-300) on the last day of the income year. In these cases, no levy is payable if the family income does not exceed $37,089. That threshold amount increases by $3,406 for each dependent child or student for whom the taxpayer or the taxpayer's spouse is entitled to a notional dependants rebate for them. Where the taxpayer is not married on the last day of the year of income, the threshold amount only increases if the taxpayer is entitled to family assistance (MLA s 8(6)). In the case of a married couple (¶2-300), "family income" means the combined taxable income of both spouses. For any other taxpayer, it simply means the taxpayer's own taxable income (MLA s 8).

Where a taxpayer's family income exceeds the family income threshold by a small amount, the levy payable is shaded in, with the general effect that the levy payable cannot exceed 10% of the excess of the family income over the family income threshold (see further below). The following table shows the income thresholds for payment of the levy and the range of incomes to which a reduced rate of levy applies (as per the tax return instructions). These thresholds apply if a taxpayer does *not* qualify for the Senior Australians tax offset (see below).

2017/18 income thresholds and shading-in ranges

Category of taxpayer (col 1)	No levy payable if taxable income (or family income) does not exceed . . . (col 2)	Reduced levy payable if taxable income (or family income) is within the range (inclusive) . . . (col 3)	Ordinary rate of levy payable where taxable income (or family income) is or above . . . (col 4)
Individual taxpayer	$21,980	$21,981–$27,475	$27,476
Families* with the following children and/or students:			
0	$37,089	$37,090–$46,361	$46,362
1	$40,495	$40,496–$50,618	$50,619
2	$43,901	$43,902–$54,876	$54,877
3	$47,307	$47,308–$59,133	$59,134
4	$50,713	$50,714–$63,391	$63,392
5	$54,119	$54,120–$67,648	$67,649
6	$57,525#	$57,526#–$71,906†	$71,907†

* These figures also apply to taxpayers who are entitled to a dependant (invalid and carer) tax offset and those who are notionally entitled to a rebate for a dependant child or student (including sole parents).

Where there are more than six dependent children and/or students, add $3,406 for each extra child or student.

† Where there are more than six dependent children and/or students, add $4,257 each extra child or student.

Shading-in rules

The following rules apply where the family income falls within the relevant shading-in range (column 3 of the table), thereby attracting a reduced levy.

(1) Where one spouse only derives taxable income, the amount of levy payable by that spouse is 10% of the excess of the taxable income over the relevant threshold shown in column 2 of the table.

▶ Example 2

Tanya is married with two children. Her taxable income in 2017/18 is $45,000. Her husband has no income. The relevant family income threshold is $43,901 and the levy payable by Tanya is limited to 10% × ($45,000 – $43,901) = $109.90.

(2) Where each spouse has a taxable income in excess of $27,476 and the family income falls within the shading-in range, the levy payable by each represents his/her proportion of 10% of the excess of the family income over the relevant threshold. The proportion is calculated by dividing the spouse's taxable income by the family income.

▶ Example 3

For 2017/18, Adrian has a taxable income of $29,000 and his wife Jill has a taxable income of $27,000, giving a total family income of $56,000. They have four children, so the family income falls within the relevant shading-in range ($50,714 to $63,391).

The amount of levy payable by Adrian is calculated as:

$$\frac{\$29,000}{\$56,000} \times 10\% \times (\$56,000 - \$50,713)$$

= $273.79

The amount of levy payable by Jill is calculated as:

$$\frac{\$27,000}{\$56,000} \times 10\% \times (\$56,000 - \$50,713)$$

= $254.91

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(3) Where one spouse has a taxable income in excess of $21,980 and the other spouse does not, the lower earner is not liable for any levy. The higher earner pays a levy calculated by subtracting a "reduction amount" from the levy otherwise payable. The reduction amount equals 2% of the relevant family income threshold minus 8% of the excess of the family income over the threshold.

▶ Example 4

Frida has a 2017/18 taxable income of $30,000 and her husband Benny has a taxable income of $17,000, giving a total family income of $47,000. They have one child, so the family income falls within the relevant shading-in range ($40,496 to $50,618).

Since Benny earns less than $21,980, he pays no levy. The levy otherwise payable by Frida is $600 (ie 2% × $30,000). This amount is reduced by the "reduction amount", which is calculated as:

(2% × $40,495) – (8% × ($47,000 – $40,495))
= $289.50

The amount of levy payable by Frida is therefore $310.50, ie $600 – $289.50.

(4) Where one spouse has a taxable income in excess of $27,476 and the other has a taxable income in excess of $21,980 but not in excess of $27,476, the "reduction amount" (see (3) above) is apportioned on the basis of each spouse's contribution to the family income. However, if the reduction amount as apportioned exceeds the levy otherwise payable by one spouse, the excess goes in reduction of the levy payable by the other (s 8(4)).

▶ Example 5

Bill has a taxable income of $28,000 in 2017/18 and his wife Honey has a taxable income of $23,000, giving a total family income of $51,000. They have three children, so the family income falls within the relevant shading-in range ($47,308 to $59,133).

The reduction amount is calculated as follows:

(2% × $47,307) – (8% × ($51,000 – $47,307))
= $650.70

The reduction amount is apportioned between Bill and Honey as follows:

Bill: $\frac{\$28,000}{\$51,000} \times \$650.70$ = $357.25

Honey: $\frac{\$23,000}{\$51,000} \times \$650.70$ = $293.45

Levy liability of Honey

The amount of levy payable by Honey equals the amount of levy otherwise payable (ie 10% × ($23,000 – $21,980) = $102.00) minus her share of the reduction amount.

ie $102.00 – $293.45
= –$191.45

In other words, no levy is payable by Honey and the excess goes to reduce the amount of levy payable by Bill.

Levy liability of Bill

The amount of levy payable by Bill equals the amount of levy otherwise payable (ie 2% × $28,000 = $560) minus his share of the reduction amount and minus the excess from Honey.

ie $560.00 – $357.25 – $191.45
= $11.30

For the thresholds relevant to trust income, see ¶6-250.

Senior Australians and pensioners

The **2017/18** Medicare levy thresholds and phase-in limits for Senior Australians and eligible pensioners (¶15-310) are as follows:

Class of people	Medicare levy low income threshold (no Medicare levy payable at or below this level)	Phase-in limit (level above which the Medicare levy is payable at the full rate)
Senior Australians and eligible pensioners	$34,758	$43,447

Medicare levy is payable at the rate of 10 cents for every dollar between those lower and upper thresholds.

The **2017/18** family income thresholds for taxpayers who qualify for the Senior Australians and Pensioners Tax Offset are as follows:

Number of dependent children or students	Medicare levy low income threshold (no Medicare levy payable at or below this level)	Phase-in limit (level above which the Medicare levy is payable at the full rate)
0	$48,385	$60,481
1	$51,791	$64,738
2	$55,197	$68,996
3	$58,603	$73,253
4	$62,009	$77,511
5	$65,415	$81,768
6	$68,821	$86,026

Note: If more than six dependent children or students, for each additional child or student the lower income limit increases by $3,406 and the upper income limit increases by $4,257. The upper income limit includes the effect of rounding.

[FTR ¶860-100, ¶860-150]

¶2-335 Medicare levy surcharge

Individual taxpayers on higher incomes who do not have adequate private patient hospital insurance for themselves and their dependants may be liable for an additional Medicare levy surcharge (MLS), 1%, 1.25% or 1.5% of "income for surcharge purposes", depending on their income level. A taxpayer may be liable for the surcharge for a period that is less than a full year, eg where private patient hospital insurance is taken out during the year. Medicare levy surcharge is imposed on a taxpayer's taxable income by MLA s 8B to 8D and on reportable fringe benefits by the *A New Tax System (Medicare Levy Surcharge — Fringe Benefits) Act 1999*.

For **2017/18**, individual taxpayers who earn more than $90,000 for the year or, if a member of a couple, have a combined income of $180,000 and do not have private health insurance are potentially liable for the MLS. Higher thresholds apply where dependants are involved.

The tables below indicates how the MLS rules apply in conjunction with the private health insurance rebate rules (¶15-330).

2017/18 income year

	Income			
Singles	$0–$90,000	$90,001–$105,000	$105,001–$140,000	$140,001 and over
Families*	$0–$180,000	$180,001–$210,000	$210,001–$280,000	$280,001 and over
	Private health insurance rebate			
	Base Tier	**Tier 1**	**Tier 2**	**Tier 3**
Under 65 years of age	25.934% / 25.415 [illegible]	17.289% / 16.943% #	8.644% / 8.471% #	0%
65–69 years of age	30.256% / 29.651% #	21.612% / 21.180% #	12.966% / 12.707% #	0%
70 years of age and over	34.579% / 33.887% #	25.934% / 25.415% #	17.289% / 16.943% #	0%
	Medicare levy surcharge			
Percentage rate	0%	1%	1.25%	1.5%

* The families' threshold is increased by $1,500 for each dependent child after the first. Families include couples and single parent families.

The first rebate percentage specifies the rebate percentage that applied from 1 July 2017 to 31 March 2018. The second percentage specifies the rebate percentage that applies from 1 April 2018 to 30 June 2018.

The income thresholds that determine the tiers for the Medicare levy surcharge and the private health insurance rebate remain the same to 30 June 2021. Not adjusting the income thresholds may result in individuals with incomes just below each threshold moving into a higher income threshold sooner if their income increases.

The private health insurance rebate is indexed annually. The rebate contribution from the government is annually adjusted by a universal Rebate Adjustment Factor.

A tax offset is provided to certain taxpayers who become liable for the Medicare levy surcharge (or an increased Medicare levy surcharge) due to the receipt of a lump sum payment in arrears (¶15-350).

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Trustees liability for Medicare levy surcharge

A trustee assessed under ITAA36 s 98 in respect of a beneficiary may be liable to pay the Medicare levy surcharge (under MLA s 8E, 8F and 8G) on the beneficiary's trust income. Essentially, a trustee will be liable for the Medicare levy surcharge if the beneficiary is a high income earner without adequate private patient hospital insurance.

Specifically, Medicare levy surcharge is payable by a trustee in respect of the net income of the trust estate to which the beneficiary is presently entitled ("beneficiary's trust income") if:

- the beneficiary on behalf of whom the trustee is assessed is not covered by an insurance policy that provides private patient hospital cover, and
- if the beneficiary is single, the amount of the beneficiary's trust income exceeds the beneficiary's singles Tier 1, Tier 2 or Tier 3 threshold for the year of income, or
- if the beneficiary is married, the sum of the beneficiary's trust income and the beneficiary's spouse's income for surcharge purposes exceeds the beneficiary's family Tier 1, Tier 2 or Tier 3 threshold for the year of income and the amount of the beneficiary's trust income exceeds $21,980 (for **2017/18**).

The rate of the Medicare levy surcharge will be 1%, 1.25% or 1.5%, depending on whether the Tier 1, Tier 2 or Tier 3 threshold applies. Where the relevant provisions do not apply to the beneficiary for the whole year, for example if the beneficiary is married for only part of the year, the Medicare levy surcharge is apportioned.

A beneficiary is also assessable on their share of the net income of a trust if that person is a beneficiary in more than one trust or has income from other sources (eg salary or wages, rent, interest or dividends). In such a case, the beneficiary's individual interest in the net income of the trust is aggregated with their other income (ITAA36 s 100; ¶6-120), with the result that the Medicare levy surcharge is payable by the beneficiary in their own right. This prevents a beneficiary from splitting income to potentially avoid paying the Medicare levy surcharge.

For Medicare levy surcharge purposes, any amount that is not assessable as a result of family trust distribution tax having been paid on it (¶6-268) is reinstated as part of the beneficiary's trust income (MLA s 3(2A)).

Persons with exempt overseas employment income

Taxpayers who are residents of Australia for tax purposes, and who have *both* taxable income and exempt overseas employment income (ITAA36 s 23AG; ¶10-860), are advised by the ATO to complete item M2 of the individual tax return, ie the Medicare levy surcharge item. This is because while they may not be separately liable for the Medicare levy surcharge (eg because they are under the surcharge threshold), the exempt overseas employment income is added to their taxable income to determine the average rate of tax, including Medicare levy and Medicare levy surcharge (if applicable), on their notional income. That average rate of tax is then applied to their taxable income (¶10-865).

[FITR ¶109-215; FTR ¶778-360, ¶860-100, ¶862-035]

¶2-340 Exemptions from Medicare levy for prescribed persons

Full or partial exemption from the Medicare levy is provided to a taxpayer who qualifies as a "prescribed person" (ITAA36 s 251T).

A "prescribed person" is:

(1) a person entitled to full free medical treatment as a member of the Defence Forces or as a relative of, or as a person otherwise associated with, a Defence Force member

(2) a person entitled under veterans' entitlement or military rehabilitation and compensation (repatriation) legislation to full free medical treatment

(3) a blind pensioner or a sickness allowance recipient

(4) a person who is not a resident of Australia for tax purposes (the Medicare levy exemption that applied to Norfolk Island residents is repealed from 1 July 2016)

(5) a person who is attached to a diplomatic mission or consular post established in Australia or a household member of the person's family, provided the person is not an Australian citizen and is not ordinarily resident in Australia

(6) a person certified by the Health Minister as not being entitled to Medicare benefits (ITAA36 s 251U(1)).

For those persons not entitled to Medicare benefits, an exemption from the Medicare levy can be claimed in their tax return. To claim the exemption, the person must have a Medicare Entitlement Statement that can be obtained from the Department of Human Services by completing the relevant application form.

Prescribed persons are not liable for the levy if:

- they have no "dependants" (¶2-310), or
- all of the person's dependants are themselves prescribed persons of any type (s 251U(2)).

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If a prescribed person in category (1), (2) or (3) has any dependants who do not qualify as described above, that person will be treated as a prescribed person for one-half of the year, and will therefore be liable for one-half of the levy otherwise payable (¶2-360). (Prescribed persons in categories (4), (5) and (6) are fully liable for the levy if they have dependants who are not prescribed persons.)

For these purposes, prescribed persons in categories (1), (2) and (3) will be treated as *not* having dependants — and will thereby remain exempt from the levy — in certain situations (ITAA36 s 251R(6A) to (6J)). The relevant rules are as follows.

(1) Where the taxpayer has a dependant who is liable for the levy, that dependant is not treated as a dependant of the taxpayer.

▶ Example

Bruce is a blind pensioner. Bruce's spouse is a clerk liable for the levy. They have no children. Bruce's spouse is not treated as a dependant and Bruce is exempt from the levy.

(2) A child is not a dependant of the taxpayer where the taxpayer has a spouse who is liable for the levy and who contributes to the maintenance of the child.

▶ Example

Leonie is a blind pensioner. Leonie's spouse is a teacher who is liable for the levy. They have one child and they each contribute to that child's maintenance. The child is not classed as Leonie's dependant and Leonie is not liable for the levy.

(3) A child may be treated as a dependant of only one member of a married couple who are both prescribed persons (two persons, whether of the same sex or different sexes, who are in a registered relationship under a prescribed state or territory law or who lived together as a couple are treated as if they were married; if either person was legally married to another person then that latter relationship is disregarded. Further, a child of an individual includes an adopted child, stepchild, ex-nuptial child, a child of the individual's spouse and a child of the individual within the meaning of the *Family Law Act 1975*).

In these cases, only one spouse will be liable to pay half the levy on account of the child and the other spouse will be completely exempt. To qualify for this treatment, the couple must enter into a "family agreement" at or before the time of lodgment of the return of income of the person claiming the exemption. The agreement must state that, for the purposes of the levy, the child is to be treated as a dependant of only one of them and must specify which one. The tax return instructions contain a form of agreement for this purpose which can be completed by the parties. The person claiming the exemption must, depending on the complexity of their tax

2018/19 repayment income	Rate of repayment*
$80,198–$86,855	6%
$86,856–$91,425	6.5%
$91,426–$100,613	7%
$100,614–$107,213	7.5%
$107,214 and above	8%

* The repayment rate is applied to the repayment income.

2017/18 HELP repayment thresholds and rates

The HELP repayment income thresholds and repayment rates for the 2017/18 income year are as follows:

2017/18 repayment income	Rate of repayment*
Below $55,874	Nil
$55,874–$62,238	4%
$62,239–$68,602	4.5%
$68,603–$72,207	5%
$72,208–$77,618	5.5%
$77,619–$84,062	6%
$84,063–$88,486	6.5%
$88,487–$97,377	7%
$97,378–$103,765	7.5%
$103,766 and above	8%

* The repayment rate is applied to the repayment income.

A person with a spouse and/or dependant(s) is not liable to make repayments if no Medicare levy is payable on their taxable income for that income year or if the amount of levy payable on their taxable income is reduced (HESA s 154-1(2)). The Commissioner (or the AAT) has the discretion to amend a HELP assessment so as to reduce or defer an amount payable if he is of the opinion that payment of the assessed amount has or would cause serious hardship to the person, or there are other special reasons that make it fair and reasonable to amend the assessment (HESA s 154-50; *Case 12/2004*).

Student start-up loans

The student start-up scholarship has been replaced with an income-contingent loan, the student start-up loan. There is a limit of two loans a year of $1,025 each (indexed from 2017). The loans are available on a voluntary basis, and are repayable under similar arrangements to HELP debts. Amendments to ITAA36 s 82A ensure that repayments of loans do not form part of deductible self-education expenses (¶16-450).

Higher education contributions cannot be claimed as a tax deduction, regardless of whether they are paid by the student, a parent, an employer or some other person, unless incurred in providing a fringe benefit (ITAA97 s 26-20).

A checklist summarising other tax measures relevant to students is at ¶44-140.

[FTR ¶865-050]

¶2-385 Tertiary Student Financial Supplement Scheme

Tertiary students who were eligible for the Youth Allowance, an Austudy payment or an ABSTUDY grant, or tertiary students who would be eligible for such a payment but for the parental income test and whose parents' adjusted income was less than a certain amount per year, were eligible to receive a voluntary financial supplement (FS) under the *Student Assistance Act 1973* or the *Social Security Act 1991*.

The FS was in the form of an interest-free private sector loan paid under the former Student Financial Supplement Scheme, which was subsidised by the Commonwealth. A separate FS loan contract was entered into for each year of financial assistance. Five years after an FS contract was entered into, the Commonwealth purchased the relevant FS debt, and the borrower became liable to repay the indexed amount of the accumulated debt through the taxation system. The Student Financial Supplement Scheme closed on 31 December 2003. Existing FS debts continue to be collected through the tax system. Annual repayments calculated as a percentage of the borrower's taxable income are required once a minimum level of taxable income is reached (essentially the same as HELP ''repayment income''), the repayment rate increasing as taxable income increases.

Where a person owes both a HELP debt and an FS debt, the required FS debt repayment is *in addition to* any required HELP repayment. A discount was offered for voluntary repayment of all or part of the FS debt during the initial five-year period. FS debt repayments cannot be claimed as a tax deduction unless incurred in providing a fringe benefit (ITAA97 s 26-20).

2018/19 income year

The income thresholds and the repayment rates for 2018/19 are as follows:

2018/19 repayment income	Rate of repayment*
Below $51,957	Nil
$51,957–$64,306	2%
$64,307–$91,425	3%
$91,426 and above	4%

* The repayment rate is applied to the repayment income.

2017/18 income year

The income thresholds and the repayment rates for 2017/18 are as follows:

2017/18 repayment income	Rate of repayment*
Below $55,874	Nil
$55,874–$68,602	2%
$68,603–$97,377	3%
$97,378 and above	4%

* The repayment rate is applied to the repayment income.

[FTR ¶865-060]

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income if the disposal occurs in the course of the carrying on of the taxpayer's business (*Memorex*). The treatment of gains realised on the sale of depreciated equipment forming part of the ordinary course of the taxpayer's business is discussed at ¶17-630.

Partly-manufactured goods are normally treated as trading stock. Amounts received for other types of work in progress are specifically made assessable (ITAA97 s 15-50; ¶16-158).

A payment in respect of accrued leave entitlements of an employee transferred from one employer to another is assessable income of the employer who receives the payment where the payment is made under: (a) a Commonwealth, state or territory law; or (b) an award, order, determination or industrial agreement under any such law (ITAA97 s 15-5).

Fees or commissions for procuring a loan of money are generally ordinary income (*National Mortgage*). A fee for guaranteeing the repayment of a loan may also be assessable as ordinary income or under ITAA97 s 15-2 (¶10-060) (*Case W26*).

Interest, non-refundable premiums, etc, received by banks and finance companies are assessable income. All amounts received from an insured in connection with the writing of general insurance contracts, including stamp duty, fire brigade charges and reinsurance commissions, are assessable income of the insurer. Special rules govern how and when insurance premiums are assessed (¶9-050). The taxation of life assurance companies is considered at ¶3-480 and following.

For the tax treatment of sale and leaseback arrangements, see ¶23-240.

The question of *when* income is derived can depend on the nature of the income and the income-earning activities of the taxpayer. The timing of the derivation of income arising from a range of transactions and income-earning activities is examined at ¶9-050.

[FITR ¶18-300, ¶19-210, ¶19-400, ¶53-050]

¶10-112 Isolated transactions

The profit arising from an isolated business or commercial transaction will be ordinary income if the taxpayer's purpose or intention in entering into the transaction was to make a profit, notwithstanding that the transaction was not part of the taxpayer's daily business activities (*Myer*). This is called the *Myer* principle. In *Myer*, the taxpayer company lent $80m to a subsidiary (at commercial rates of interest) as part of an extensive plan to diversify its operations. A few days later, the taxpayer assigned to a finance company for a lump sum of $45m its right to receive interest under the loan to the subsidiary. The High Court held that the $45m was received as part of a profit-making scheme and was, therefore, ordinary income (¶10-020). An important factor in this decision was that the two transactions were integral elements in the plan to diversify (the taxpayer would not have made the loan if the finance company had not agreed to take the assignment of the right to interest).

Compensation received for the compulsory acquisition of land acquired by a taxpayer for sandmining and eventual subdivision was assessable pursuant to the *Myer* principle (*Moana Sand*). A gain realised on the disposal of land by a taxpayer who carried on a building and project management business was also assessable as the land had been acquired to prevent the former owner opposing the rezoning of a site which was the subject of a development project to be coordinated by the taxpayer (*Richardson*). A payment to a solicitor to vacate leased office premises, one year after exercising an option to renew the lease for a further three-year term, was held to be income (*Case 57/94*).

For the *Myer* principle to apply, profit-making must be a significant (but not necessarily the sole or dominant) purpose or intention (TR 92/3). Although the taxpayer's purpose or intention is usually to be ascertained from an objective consideration of the circumstances of each case, the taxpayer's subjective purpose or intention may be the determining factor (*Westfield*). The Commissioner considers that it does not matter if the

profit is obtained by a means which was not specifically contemplated when the taxpayer entered into the transaction (TR 92/3), but there are statements in *Myer* and *Westfield* which suggest otherwise. The factors which the Commissioner considers to be relevant in determining whether an isolated transaction amounts to a business or commercial transaction are set out in TR 92/3.

The *Myer* decision does not mean that every profit made by a taxpayer in the course of a business activity is income. For example, in *Westfield*, the profit made by a shopping centre developer from the sale of land acquired for a shopping centre it planned to build and manage itself, but which it eventually built for another company, was capital and not income. The resale of land was not part of the taxpayer's ordinary business activities and, at the time the land was acquired, the taxpayer intended to develop the land itself and not to realise a profit by resale. In the *Hyteco Hiring case*, a taxpayer which carried on a business of hiring out forklifts was not assessable on the profits from the sale of forklifts which were no longer suitable for hire as the profits were not an ordinary incident of its business. Of course, a capital receipt may be assessable under the CGT provisions.

On the basis of *Myer*, the ATO considers that indemnification amounts paid to a non-resident lender by a borrower against the liability for interest withholding tax will normally be income of the lender. Those amounts will therefore be assessable if their source (¶21-070) is in Australia (TR 2002/4).

[FITR ¶18-235, ¶18-300]

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¶10-114 Cancellation or variation of business contracts

Ordinarily, amounts received in connection with the variation, cancellation or breach of ordinary commercial contracts are income in nature (eg *Heavy Minerals*; *Toyota Manufacturing*). In one case, however, compensation for the variation of a long-term supply contract paid to a wholly-owned subsidiary, where the subsidiary had given no consideration for the payment and the payment was not a product of any business or revenue-producing activity carried on by it, was not assessable in the hands of the subsidiary (*Federal Coke*). If the compensation had been paid to the supplier itself, it would have been assessable. (The CGT provisions would be relevant if the case were heard today.)

Where compensation is received for the cancellation, assignment, variation or breach of an agency agreement, and the agency is one of several held by the taxpayer so that its cancellation, etc, may be regarded as a normal trading risk in the course of carrying on the business, the receipt will be treated as ordinary income. For example, a payment received as compensation for termination of an agency agreement relating to the distribution of a particular product was held to be income where the agency constituted only one section of the taxpayer's many business activities — the taxpayer had not parted with a substantial part of its business undertaking and the payment was essentially designed to compensate the taxpayer for the loss of profits anticipated to flow from the agency agreement (*Allied Mills Industries*).

On the other hand, where the agency or other agreement in question is the source of the whole or the greater part of the business earnings, so that the cancellation of the agreement constitutes a destruction of the taxpayer's profit-making structure, the receipt will be capital. See, for example, *Case Y24* where a company whose sole business was to deliver newspapers and magazines received a payment on the cancellation of the delivery contract. In those circumstances, the payment will be assessable only to the extent that the CGT provisions apply. In *Co-operative Motors*, a company's long-standing motor vehicle distributorship was effectively terminated. The company had no right to compensation, but it did receive a $500,000 ex gratia payment from the vehicle manufacturer in recognition of its past services. The company argued that the payment was a gift, but the Federal Court ruled that it was a product of the company's income-earning activities and, accordingly, was assessable income.

The assessability of an ex gratia compensation payment arising from a government decision prohibiting or restricting the commercial operations of a business will be determined in accordance with the principles outlined above. If the business is forced to close down completely, the payment is likely to be capital but may be assessable under the CGT provisions.

[FITR ¶19-250, ¶19-255]

¶10-115 Amounts received for restrictive covenants/sterilisation of assets

Amounts received in consideration of a restrictive covenant, where the recipient undertakes not to use specified assets or to trade only with the other party to the agreement, are of a capital nature (*Dickenson*). They are therefore only assessable to the extent that the CGT provisions apply (¶11-280). Nevertheless, in some circumstances, an amount received for limiting or restricting the operations of the recipient may be of a revenue nature, eg where it is in the nature of an amount intended to replace profits which would otherwise have been made.

Amounts received for the sterilisation of assets are capital receipts (eg a lump sum payment as consideration for surrendering valuable stock options: *McArdle's case*), except where the asset is merely rendered partially inoperative for a limited period. If the asset was acquired on or after 20 September 1985, the CGT provisions may apply, although in some limited circumstances roll-over relief may be available. A lump sum or instalments of a lump sum received by a service station proprietor for exclusive trade ties to an oil company are generally regarded as capital.

A lump sum payment received as compensation for the forfeiture to the Crown of a beneficial interest in coal mines and seams was held to be a capital sum in *Northumberland Development*.

[FITR ¶18-300, ¶19-097]

¶10-116 Lease incentives

In general, a cash incentive paid to a business taxpayer to enter into a lease of business premises is assessable income (*Montgomery*; *Cooling*; *O'Connell*). In *Montgomery*, the High Court held that payments received by a law firm as an incentive to enter into a lease of premises were assessable income, even though they were not received by the firm in the ordinary course of its business. The court considered that the firm used or exploited its capital (whether taken to be the entering into the lease agreement or the firm's goodwill) to obtain the incentive payments.

A lease surrender payment received by a service company for a large firm of solicitors was assessable as ordinary income (*Rotherwood*). In TR 2005/6, the Commissioner states that a lease surrender receipt would constitute assessable income under ITAA97 s 6-5 if received:

(1) (a) *in the case of a lessee*, in the ordinary course of carrying on a business of trading in leases; or (b) *in the case of a lessor*, in the ordinary course of carrying on a business of granting and surrendering leases

(2) as an ordinary incident of business activity (even though it was unusual or extraordinary compared to the usual transactions of the business), or

(3) as a profit or gain from an isolated business operation or commercial transaction entered into by the lessee or lessor (otherwise than in the ordinary course of carrying on a business), with the intention or purpose of making the relevant profit or gain.

A lease surrender receipt of a lessor is otherwise of a capital nature. A lease surrender receipt of a lessee is of a capital nature when received for the surrender of a lease that formed part of the profit-yielding structure of the business of the lessee. For details of the CGT treatment of lease surrender receipts, see ¶11-270 and ¶12-680.

The Commissioner considers that an amount paid to a business tenant to vary a lease to take up extra space or to relocate within the same building, or to encourage the tenant to remain in the same leased premises, is also assessable. However, an incentive paid to a taxpayer entering into a lease to commence an entirely new business is unlikely to be ordinary income although, in the Commissioner's opinion, it would constitute an assessable capital gain under the CGT provisions (IT 2631; ¶11-300).

Non-cash lease incentives

Non-cash lease incentives which are convertible to cash (eg vehicles, boats, paintings or computer equipment), and which are received by business taxpayers in relation to business premises, have an income character, either inherently or by virtue of ITAA36 s 21A (¶10-030), and are taxable at their full monetary value. If the incentive qualifies as depreciable plant or equipment and is used for income-producing purposes, the taxpayer is entitled to a depreciation deduction (¶17-010).

Non-cash lease incentives which are not convertible to cash are assessable by virtue of s 21A except where the ''otherwise deductible'' rule applies or where it is non-deductible entertainment expenditure (¶10-030). The Commissioner's views on the application of s 21A to non-cash lease incentives can be summarised as follows (IT 2631):

- rent-free period — effectively tax-free
- interest-free loan — effectively tax-free, provided it is a genuine business loan and not a disguised cash payment
- free fit-out:
  - if owned by the landlord — effectively tax-free
  - if owned by the tenant — assessable but a deduction will be allowed for depreciation to the extent that the fit-out qualifies as depreciable plant or articles
- free holiday — a complete holiday package comprising travel, accommodation, meals and recreation will be effectively tax-free to the tenant, as the cost will not be deductible to the landlord
- payment of removal costs — fully taxable except to the extent that the costs relate to revenue items such as trading stock
- payment of surrender value of existing lease — fully taxable.

Where s 21A applies, the ''arm's length value'' of the incentive is assessable (¶10-030).

[FITR ¶19-210; FTR ¶7-175]

Realisation of Real Property and Securities

¶10-120 Realisation of real property

The proceeds from the mere realisation of a capital asset or from the change of an investment do not give rise to income according to ordinary concepts or to a profit arising from a profit-making undertaking or plan within the meaning of ITAA97 s 15-15 (for property acquired before 19 September 1985) (¶10-340), even if the realisation or change

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is carried out in the most advantageous manner — these being an affair of capital. Of course, the CGT provisions may apply in relation to property acquired on or after 20 September 1985.

In the *NF Williams case*, the High Court commented that an owner of land who holds it until the price of land has risen and then subdivides and sells it is not thereby engaging in an adventure in the nature of trade or carrying out a profit-making scheme, even if the landowner seeks and acts on the advice of experts as to the best method of subdivision and sale or carries out work such as grading, levelling, road building and the provision of water and power. More examples of the principle that the proceeds from the mere realisation of a capital asset are not assessable as ordinary income are *Statham* (profits realised on the sale of subdivided farming land); *Ashgrove* (receipts under agreements for the sale of timber growing on the taxpayers' land); *Casimaty* (progressive sale of farming property); and *McCorkell* (profits from the sale of a subdivided orchard).

The distinction between the mere realisation of an asset and a business venture is not always clear and, in some cases, the development of land may be so extensive that the taxpayer is in fact engaged in a business venture (ultimately it is a question of fact). In *Whitfords Beach*, the taxpayer company acquired 1,584 acres of land for non-commercial purposes. Thirteen years later, the original shareholders sold out and the company, under its new ownership, adopted an entirely new set of articles; it then embarked on a long and complex course of activity which involved the land being rezoned and developed as a residential subdivision. Vacant lots were sold over a period of many years for a substantial profit. The High Court held that the taxpayer's activities amounted to more than the mere realisation of a capital asset and constituted the carrying on of an actual business of subdividing and selling land. See also *Stevenson*, *Abeles* and *August*. Similarly, where properties are sold by a property investment company as part of its normal business operations, the profits will be assessable as ordinary income (*CML Services*).

The Commissioner considers that, in the following circumstances, the net profit on the sale of land is assessable as ordinary income, although each case must be determined on its facts:

- where land is acquired in an isolated commercial transaction for the purpose of development, subdivision and sale, but the development and subdivision do not proceed and the land is subsequently sold (TD 92/126)
- where land is acquired for development, subdivision and sale but the development is abandoned and the land is sold in a partly developed state (TD 92/127)
- where land is acquired for development, subdivision and sale but, after some initial development, the project ceases and is recommenced in a later income year (TD 92/128).

The Commissioner's views on how to value subdivided farm land are set out in TD 97/1.

It should be noted that land can be trading stock in the hands of a land dealer (*St Hubert's Island*) (¶9-150; TD 92/124) in which case the net profit is assessable income at the time of settlement, not when the contract was entered into (*Benwerrin*; *Gasparin*).

If a gain is not assessable as ordinary income or under ITAA97 s 15-15, it may be assessable under the CGT provisions (¶11-000). Where a capital gain arises under the CGT provisions (CGT event A1), the gain is assessable at the time the contract was entered into, not at the time of settlement (¶11-250).

[FITR ¶18-300, ¶19-525]

¶10-130 Realisation of securities

The basic rules governing the tax treatment of gains from the realisation of shares or other securities are the same as for other property. For further discussion, see ¶23-350. Special rules apply to the disposal or redemption of "traditional securities" (¶23-340) and the conversion of semi-government securities (¶23-355).

[FTR ¶16-260]

¶10-140 Foreign exchange and futures transactions

For details of the tax treatment of foreign exchange gains and losses, see ¶23-075. For investments and speculation in futures contracts, see ¶23-370.

Bounties and Subsidies

¶10-160 Treatment of bounties and subsidies

Ordinarily, bounties and subsidies received in relation to carrying on a business are assessable as ordinary income. Such items are included in assessable income on an accruals basis where the items represent trading income of the taxpayer (¶9-030).

Bounties and subsidies received in relation to carrying on a business which are not assessable as ordinary income (ie receipts of a capital nature) are expressly included in assessable income by ITAA97 s 15-10. In this situation, the amount is included in assessable income in the year of receipt, unless the amount has been prepaid.

The following payments have been held to be ordinary income:

- distributions by a Totalisator Agency Board to racing clubs (the distributions were also held to be subsidies) (*Brisbane Amateur Turf Club*; *Case K48*)
- an R&D grant made to a manufacturing company to reimburse the company for expenditure of a revenue nature (the grant was also held to be a bounty or subsidy) (*Reckitt and Colman*).

Guidelines on the tax treatment of government payments to industry to assist entities to commence, continue or cease business are set out in TR 2006/3.

A payment by a state government to a building society following the winding up of a compulsory contingency fund was assessable under s 15-10 as a subsidy (*First Provincial Building Society*), as was a grant received by a taxpayer under the Dairy Regional Assistance Program (*Plant*). Grants under the First Home Owner Grant Scheme are not assessable. The ATO considers that the wine producer rebate is assessable as ordinary income (ATO Fact Sheet "Wine Equalisation Tax — new wine producer rebate" (NAT 11779)).

Grant payments received under the Sustainable Rural Water Use and Infrastructure Program are usually assessable as ordinary income or under s 15-10 to the extent that they are not consideration for the surrender of water rights. However, taxpayers may choose to make the payments non-assessable non-exempt income (and to disregard any capital gain or loss from transferring water rights) in which case the expenditure that is made from the payments will not be deductible (and will not form part of the cost base of the asset) (¶18-080).

For details of the tax treatment of various government payments, see ¶10-197. A payment from a fund comprised of public donations is characterised as a gift (¶10-070).

[FITR ¶53-100]

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Compensation Payments

¶10-170 Compensation for loss of trading stock and profits

Insurance payments or other receipts in respect of lost trading stock, eg by fire, compulsory takeover or destruction, etc, and amounts received for loss of profits or income due to an interruption to business, eg caused by fire, rain, etc, are assessable either as ordinary income under ITAA97 s 6-5 or statutory income under ITAA97 s 15-30 or s 70-115. So, for example, the following payments have been held to be assessable:

- compensation paid to a poultry farmer for loss of income suffered when many of the farmer's hens died or became sick because of excessive amounts of pesticide in their feed (*Gill v Australian Wheat Board*)
- damages awarded to a landlord against a tenant remaining unlawfully in occupation, and which represented the difference between the rent paid by the tenant and the rent obtainable on the open market (*Raja's Commercial College v Gian Singh & Co*)
- damages for lost profits awarded to a lift installation and maintenance company against a manufacturer which supplied it with defective lift equipment (*Liftronic*)
- compensation received by tax agents from the ATO under the Scheme for Detriment Caused by Defective Administration (*Pope*).

For special provisions relating to insurance recoveries for live stock and timber losses, see ¶18-150. A right under an insurance policy may be an asset for CGT purposes and an insurance recovery may give rise to a capital gain (¶11-880). In addition, a right to recover damages would be an asset for CGT purposes (¶11-380) and an award of damages may give rise to a capital gain (¶11-650). Further, balancing adjustments must usually be made where assets for which depreciation or other similar deductions have been allowed are lost, destroyed, etc (¶17-630).

Compensation payments for injury to business reputation are usually capital, even if assessed by reference to lost profits (*Sydney Refractive Surgery Centre*).

[FITR ¶19-070, ¶19-087, ¶53-300]

¶10-175 Damages paid in undissected lump sum

Lump sum damages, or a lump sum out-of-court settlement, representing compensation for losses of an income nature only, will be assessable income in accordance with ordinary principles (¶10-010; TD 93/58).

Where the relevant payment can be dissected into its income and capital components, the income components (such as interest on the principal sum: ¶10-185) will be assessable income. However, where lump sum damages are a lesser amount received in settlement of an unliquidated claim covering both income and capital elements but cannot be dissected into those elements, the whole amount is treated as capital (*McLaurin*; *Allsop*; *CSR*).

This treatment of undissected amounts was clearly favourable to taxpayers before the advent of CGT. However, the CGT provisions now treat the right to sue for damages (or the right to give up the right to sue) as an asset (¶11-380) which can be disposed of by obtaining an award of damages or by accepting a settlement. Generally there will be a better CGT outcome if the amount received can be attributed at least partly to an "underlying asset" (eg damaged property) rather than solely to the asset embodied in the right to sue. If the amount is an undissected amount and the taxpayer cannot make a reasonable estimate of the income and capital components, the whole amount will be taken to relate to the disposal of the taxpayer's right to sue (TR 95/35; ¶11-650).

[FITR ¶19-095]

¶10-180 Workers compensation

Weekly or other periodical workers compensation payments (or periodical payments under other legislation) received as compensation for loss of wages (whole or partial) are fully assessable as ordinary income (they are not assessable under ITAA97 s 15-2: ¶10-060) (*Inkster*; *Case Y47*; *Maher*). The same generally applies to a lump sum paid in lieu of the right to receive weekly payments of income or for loss of employment (*Coward*; *Brackenreg*; *Riley*; *Edwards*; *Gupta*; TD 2016/18). However, if the commutation to a lump sum can only be made under certain circumstances, and its calculation requires consideration of other factors, it may possibly be capital (*Barnett*). A lump sum commutation referable to the period after the taxpayer reached the age of 65 years has also been held to be capital (*Coward*).

A fixed sum workers compensation award for loss of a limb, eye, finger, etc, is not assessable, nor is a payment for medical, etc, expenses. Likewise, a fixed sum awarded in full satisfaction of an employee's workers compensation claim against an employer, even though it represents in part unpaid periodical payments as well as compensation for loss of a limb, etc, and loss of earning capacity. For guidelines on when the receipt of a lump sum compensation/settlement amount is assessable, see TD 93/58.

In *Rayner*, it was held that a taxpayer who had to repay workers compensation payments after receiving a lump sum settlement was not entitled to have a previous assessment amended to exclude the compensation payments. In *Reiter*, workers compensation payments received by a taxpayer after he had recovered damages were not assessable income as they were required to be repaid under Victorian "double dipping" legislation.

In *Cooper*, a lump sum payment representing arrears of invalidity benefits was assessable in the year of receipt. The same applies to arrears of workers compensation paid as a lump sum (*Vargiemezis*) and a lump sum compensation payment received by a Reserve Force member in respect of lost civilian income (ID 2003/260).

[FITR ¶19-110, ¶53-358]

¶10-185 Personal injury compensation

The general position is that lump sum compensation payments for personal injury (including any pre-judgment interest component) are not assessable as ordinary income or statutory income (ITAA97 s 51-57). They are also exempt under the CGT provisions (¶11-650), although a component of a lump sum that is identifiable as compensation for loss of earnings is taxable (ID 2003/260). A lump sum awarded to the spouse of the injured person in recognition of the care the spouse provides may be non-assessable (ID 2002/583 (withdrawn)). However, where the personal injury component of an undissected lump sum termination settlement could not be separately identified, no part of the payment was exempt as personal injury compensation (TR 95/35; *Dibb*).

Compensation payments that provide the victim with an income stream are generally assessable. Deferred lump sums may also be assessable under ITAA36 Div 16E if they fall within the definition of a qualifying security (¶23-320).

Normally, if an annuity is purchased out of a lump sum tax-free payment, it may be assessable to the extent that the annuity payments include a component related to the investment earnings on the underlying lump sum (ITAA36 s 27H).

In *Brackenreg*, a lump sum settlement, which had been commuted from a weekly compensation payment, was assessable income. In *Maher*, weekly compensation payments under the *Safety, Rehabilitation and Compensation Act 1988* were assessable income. In *Case 9/2006*, weekly workers compensation paid in arrears as part of a clearly dissected lump sum was assessable income.

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Division 54 exemption for structured settlements and orders

ITAA97 Div 54 provides an exemption for certain annuities and lump sums provided to personal injury victims under structured settlements or structured orders.

A *structured settlement* is one that meets all of the following five conditions:

(1) The claim must be for compensation or damages for personal injury suffered by a person and the claim must be made by the injured person or by his/her legal personal representative.

(2) The claim must be based on the commission of a wrong or on a right created by statute.

(3) The claim cannot be an action against a defendant in his/her capacity as an employer, or an associate of an employer, or a claim made under workers compensation law, or a claim that could instead be made under workers compensation law.

(4) The settlement must be in a written agreement between the parties to the claim. This applies whether or not the agreement is approved by an order of a court or is in a consent order made by a court.

(5) The terms of the settlement must provide for some or all of a lump sum award of compensation or damages to be used by the defendant or the defendant's insurer to purchase from one or more life insurance companies or state insurers:

- an annuity or group of annuities to be paid to the injured person (or his/her trustee), or
- an annuity or group of annuities combined with one or more deferred lump sums to be paid to the injured person (or his/her trustee).

A *structured order* is essentially an order of a court that satisfies conditions (1), (2), (3) and (5) above but is not an order approving or endorsing an agreement as mentioned in (4) above.

Exempt personal injury annuities

A personal injury annuity is an annuity purchased under the terms of a structured settlement or structured order. A personal injury annuity will be eligible for exemption (ITAA97 s 54-15) if (broadly) the following conditions are met:

- The compensation payment or damages, if paid in the form of a lump sum at the date of settlement or order, would not have to be included in the assessable income of the injured person (eg it is not compensation for lost earnings) (ITAA97 s 54-20).
- The annuity instrument only allows for payments of the annuity to be made to the injured person, his/her trustee, a reversionary beneficiary or the injured person's estate and contains a statement to the effect that the annuity cannot be assigned and cannot be commuted except by a reversionary beneficiary (ITAA97 s 54-25).
- The annuity instrument provides that the payments of the annuity are to be made at least annually over a period of at least 10 years during the life of the injured person or for the life of the injured person. Annuity payments may be guaranteed up to 10 years after the date of settlement. In the event the injured person dies during the guarantee period, the remaining payments may be made to either the injured person's estate or a reversionary beneficiary (ITAA97 s 54-30; 54-35).
- The annuity or annuities in total provide a minimum monthly level of support over the annuitant's life (ITAA97 s 54-40).

Exempt personal annuity lump sums

Structured settlements and structured orders may include non-annual lump sum payments that are made to claimants at regular intervals to fund expected purchases, eg a payment every five years to replace a wheelchair. A personal injury lump sum is a lump sum that is purchased under the terms of a structured settlement or structured order. Personal injury lump sums will be exempt from income tax if all of the following conditions are met (ITAA97 s 54-45 to 54-60):

- There is at least one personal injury annuity provided under the same structured settlement or structured order that satisfies the eligibility conditions described above.
- The lump sum would not have been taxable if it had been paid as a lump sum at the time of settlement.
- The annuity instrument identifies the structured settlement or structured order under which the personal injury lump sum is provided and only allows for payments of the annuity to be made to the injured person or his/her trustee, or contains a statement to the effect that the right to receive the lump sum cannot be assigned or commuted/cashed out.
- The contract specifies the date and amount of the payment of the lump sum. The lump sum can only be increased through appropriate indexation or by a specified percentage.

Payments to reversionary beneficiaries

A reversionary beneficiary will be exempt from income tax on the periodic payments or the lump sum payment if the payment(s) would have been exempt from income tax in the hands of the injured person (ITAA97 s 54-65).

Payments to/from trustee

Broadly, structured payments that would have been exempt if paid directly to the injured person or reversionary beneficiary will be exempt when received by a trustee for the injured person or reversionary beneficiary, and when paid out by the trust (ITAA97 s 54-70). The exemption does not extend to investment earnings of the trust.

A payment of a lump sum to an injured person's estate or testamentary trust will also be exempt (s 54-70(3)).

[FITR ¶102-620, ¶104-000]

¶10-187 Native title payments

An amount or benefit that an indigenous person or indigenous holding entity receives directly from entering into an agreement or as compensation under the *Native Title Act 1993* (ie a native title benefit) is non-assessable non-exempt income (ITAA97 s 59-50). An indigenous holding entity includes distributing bodies, trusts and registered charities (ITAA97 s 59-50(6)). This will apply retrospectively to native title benefits received from 1 July 2008.

[FITR ¶108-087]

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Social Security, etc, Pensions

¶10-190 Overview of social security, etc, pensions

Most pensions paid under the social security and the veterans' entitlement legislation to persons of pensionable age (65 for men and a sliding scale of between 60 and 65 for women) and to wives of men of pensionable age are assessable. Some of these pensions are assessable *irrespective* of the age of the recipient. For details of the treatment of pensions, benefits and allowances, see ¶10-195 – ¶10-204.

Where sickness allowances are repaid by a taxpayer on receipt of a lump sum settlement, the assessments for the years in which the allowances were received may be amended so as to exclude the allowances from the assessable income of those years (ITAA97 s 59-30; ¶10-895). However, this provision does not apply to amounts repaid because a taxpayer received a lump sum as compensation or damages for a wrong or injury suffered in their occupation.

Where Australia has concluded a tax treaty with another country, pensions received from that country are generally assessable only in Australia (¶22-150).

In certain circumstances, tax offsets are available to reduce or eliminate tax on assessable pensions and benefits (¶15-310 – ¶15-315).

¶10-195 Assessability of social security payments

Most social security payments are assessable (¶10-190), with a portion of the payment being exempt (ITAA97 s 52-5 to 52-40). However, special rebates are allowable for recipients of some types of social security payments.

One of the criteria for exemption is whether the recipient is of "pension age". For a man, pension age is 65 years. For a woman born before 1 July 1935, pension age is 60; for a woman born on or after 1 January 1949, it is 65. For women born between those two dates, there is a sliding scale:

Date of Birth	Pension age
1 July 1935 – 31 December 1936	60 years, 6 months
1 January 1937 – 30 June 1938	61 years
1 July 1938 – 31 December 1939	61 years, 6 months
1 January 1940 – 30 June 1941	62 years
1 July 1941 – 31 December 1942	62 years, 6 months
1 January 1943 – 30 June 1944	63 years
1 July 1944 – 31 December 1945	63 years, 6 months
1 January 1946 – 30 June 1947	64 years
1 July 1947 – 31 December 1948	64 years, 6 months

Pension age from 2017/18 onwards

From 1 July 2017, the pension age for both men and women will increase from 65 years to 65 years and 6 months. Thereafter, the pension age will rise by six months every two years, reaching 67 years by 1 July 2023.

Pensions and other benefits under Social Security Act

The table below shows the status of pensions, benefits and allowances payable under the *Social Security Act 1991*.

Pension, benefit or allowance	Basic amount	Supplementary amount
Advance pharmaceutical supplement	Exempt	N/A
Age pension	Assessable	Exempt[1]
Australian Government Disaster Recovery Payment	Exempt	N/A
Australian Victim of Terrorism Overseas Payment	Exempt	N/A
Austudy payment	Assessable	Exempt[1]
Bereavement allowance	Assessable	Exempt[1]
Carer allowance and one-off payment to carers (carer allowance related)	Exempt	N/A
Carer payment:		
– carer or care receiver is pension age or over	Assessable	Exempt[1]
– carer and care receiver under pension age (or care receiver deceased)	Exempt	Exempt[1]
– one-off payments (carer payment related)	Exempt	N/A
Carer supplement	Exempt	N/A
Child disability assistance	Exempt	N/A
Crisis payment	Exempt	N/A
Disability support pension:		
– over pension age	Assessable	Exempt[2]
– under pension age	Exempt	Exempt[2]
Double orphan pension	Exempt	N/A
Economic security strategy payment	Exempt	N/A
Education entry payment supplement	Exempt	N/A
Energy supplement	Exempt	N/A
Fares allowance	Exempt	N/A
Mature age allowance:		
– pre-1 July 1996	Assessable	Exempt[1]
– post-30 June 1996	Assessable	Exempt[3]
Mature age partner allowance	Assessable	Exempt[1]
Mobility allowance	Exempt	N/A
Newstart allowance	Assessable	Exempt[3]
Parenting payment:		
– benefit PP (partnered)	Assessable	Exempt[3]
– pension PP (single)	Assessable	Exempt[3]
Partner allowance	Assessable	Exempt[3]
Pension education supplement	Exempt	N/A
Quarterly pension supplement	Exempt	N/A
Sickness allowance	Assessable	Exempt[1]
Special benefit	Assessable	Exempt[1]
Special needs age pension	Assessable	Exempt[1]
Special needs disability support pension:		
– pension age or over	Assessable	Exempt[1]
– under pension age	Exempt	Exempt[1]
Special needs widow B pension	Assessable	Exempt[1]

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Pension, benefit or allowance	Basic amount	Supplementary amount
Special needs wife pension:		
– taxpayer or partner pension age or over	Assessable	Exempt[1]
– taxpayer and partner under pension age (or partner deceased)	Exempt	Exempt[1]
Telephone allowance	Exempt	N/A
Training and learning bonus	Exempt	N/A
Utilities allowance	Exempt	N/A
Widow allowance	Assessable	Exempt[3]
Widow B pension	Assessable	Exempt[1]
Wife pension:		
– taxpayer or partner pension age or over	Assessable	Exempt[1]
– taxpayer and partner under pension age (or partner deceased)	Exempt	Exempt[1]
Youth allowance	Assessable	Exempt[3]
Bereavement payments:		
– special provisions apply where a lump sum social security payment is made because of the death of the taxpayer's partner and the payment is an age pension, carer pension, disability support pension, mature age (pre-1 July 1996) allowance, mature age partner allowance, special needs age pension, special needs disability support pension, special needs wife pension or wife pension.		

(1) Increased amounts by way of: rent assistance; remote area allowance; pharmaceutical allowance; and incentive allowance.

(2) Increased amounts by way of: rent assistance; remote area allowance; pharmaceutical allowance; incentive allowance; language, literacy and numeracy supplement; pension supplement; and clean energy supplement.

(3) Increased amounts by way of: rent assistance; remote area allowance; pharmaceutical allowance; language, literacy and numeracy supplement; pension supplement; and clean energy supplement.

Changes to benefits

The government has enacted measures to create a single JobSeeker Payment that will replace the Newstart allowance and six other existing payments as the main payment for people of working age, commencing on 20 March 2020. Between March 2020 and January 2022, the following pensions will be phased out progressively: the widow B pension, wife pension, bereavement allowance, sickness allowance, widow allowance and partner allowance.

[FITR ¶103-000, ¶103-510]

¶10-197 Other exempt government payments

In addition to the social security and veterans affairs payments listed at ¶10-195 and ¶10-200, the federal government also makes a range of other payments. These include the following exempt payments (special conditions may apply):

- family tax benefit (ITAA97 s 52-150)
- child care benefit and child care rebate (ITAA97 s 52-150)

- education tax refund, schoolkids bonus and back to school bonus (ITAA97 s 52-150; 52-162)
- single income family bonus and single income family supplement (ITAA97 s 52-150)
- Commonwealth education or training supplementary payment (ITAA97 s 52-140)
- economic security strategy payment (ITAA97 s 52-150; 52-160)
- household stimulus payment (ITAA97 s 52-165)
- clean energy payments under the *Social Security Act 1991* (ITAA97 s 52-10)
- disability services payment made under the Commonwealth Rehabilitation Work Training Scheme (ITAA97 s 53-10, item 2)
- disaster recovery payments to New Zealand special category visa (subclass 444) holders (ITAA97 s 51-30)
- payments from the Thalidomide Australian Fixed Trust (ITAA97 s 51-30)
- matched savings scheme (income management) payment and the voluntary income management incentive payment (ITAA97 s 52-10)
- tobacco industry exit grant (ITAA97 s 53-10)
- Outer regional and remote payment under the Helping Children with Autism scheme (ITAA97 s 52-170)
- Outer regional and remote payment under the Better Start for Children with Disability initiative (ITAA97 s 52-172)
- payment under the Continence Aids Payment Scheme (ITAA97 s 52-175)
- National Disability Insurance Scheme (NDIS) payment (ITAA97 s 52-180)
- Prime Minister's Prizes for Australian History and Science (ITAA97 s 51-60)
- Prime Minister's Literary Awards (ITAA97 s 51-60).

[FITR ¶40-340, ¶102-560]

¶10-200 Veterans' pensions and similar benefits

The table below shows the status of pensions, benefits and allowances payable under the *Veterans' Entitlements Act 1986* (ITAA97 s 52-60 to 52-110). Payments made because of a person's death are exempt (ITAA97 s 52-65(4)). In the case of non-exempt service pensions, a special rebate may be allowable to the recipient (¶15-310).

Pension, benefit or allowance	Basic amount	Supplementary amount
Age service pension	Assessable	Exempt[1]
Attendant allowance	Exempt	N/A
Carer service pension:		
– both taxpayer and partner are under pension age and partner receiving an invalidity service pension	Exempt	Exempt[1]
– taxpayer under pension age and invalidity service pensioner partner deceased	Exempt	Exempt[1]
– other	Assessable	Exempt[1]
Clean energy payment	Exempt	N/A

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Pension, benefit or allowance	Basic amount	Supplementary amount
Clean energy payment under Veterans' Children Education Scheme	Exempt	N/A
Clothing allowance	Exempt	N/A
Decoration allowance	Exempt	N/A
Defence Force income support allowance:		
– where the whole of the underlying social security payment for which the allowance is paid is exempt	Exempt	N/A
Energy supplement	Exempt	N/A
Funeral benefit (veterans)	Exempt	N/A
Funeral benefit (dependants of deceased veterans)	Exempt	N/A
Income support supplement:		
– taxpayer under pension age and permanently incapacitated for work	Exempt	Exempt[1]
– both taxpayer and severely handicapped person constantly cared for under pension age	Exempt	Exempt
– both taxpayer and invalidity service pensioner or disability support pensioner partner under pension age	Exempt	Exempt
– both taxpayer and permanently incapacitated partner under pension age	Exempt	Exempt
– other	Assessable	Exempt[1]
Invalidity service pension:		
– pension age or over	Assessable	Exempt[1]
– under pension age	Exempt	Exempt[1]
Loss of earnings allowance	Exempt	N/A
Partner service pension:		
– both taxpayer and invalidity service pensioner partner under pension age	Exempt	Exempt
– taxpayer under pension age and invalidity service pensioner partner deceased	Exempt	Exempt[1]
– other	Assessable	Exempt[1]
Pension for defence-caused death or incapacity	Exempt	N/A
Pension for war-caused death or incapacity	Exempt	N/A
Quarterly pension supplement	Exempt	N/A
Recreation transport allowance	Exempt	N/A
Special assistance	Exempt	N/A
Travelling expenses	Exempt	N/A
Vehicle Assistance Scheme	Exempt	N/A
Veterans supplement	Exempt	N/A
Victoria Cross allowance	Exempt	N/A
Bereavement payment:		
– payments made after the death of a person for a number of the above pensions, benefits and allowances are exempt		

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(1) Increased amounts because of: rent assistance; dependent children; remote area allowance; pension supplement; and clean energy supplement.

Continuing payments under former Repatriation Acts

Pensions, attendants' allowances and similar payments under former Repatriation Acts — the *Repatriation Act 1920*, the *Repatriation (Far East Strategic Reserve) Act 1956*, the *Repatriation (Special Overseas Service) Act 1962* and the *Interim Forces Benefits Act 1947* — which continued to be paid under the *Veterans' Entitlements (Transitional Provisions and Consequential Amendments) Act 1986*, are generally exempt except for the part of a pension that is:

- an alternative to a widow's pension paid to the mother of a deceased member of the Forces, or
- an alternative to a social security pension paid to a parent of a deceased member of the Forces where the parent is of pension age (s 52-105).

[FITR ¶103-060, ¶103-090]

¶10-202 Pensions similar to veterans' pensions

Payments by the Australian and United Kingdom governments that are of a similar nature to exempt payments listed in ¶10-200 are also exempt (ITAA97 s 53-20). See, for example, ID 2008/7 about a UK War Widows Supplementary Pension. However, the exemption does not extend to ordinary Commonwealth Public Service or Defence Force superannuation or retirement payments (ITAA97 s 55-5).

An amount paid to a former soldier under the *Safety, Rehabilitation and Compensation Act 1988* was not exempt, as it was in the nature of workers compensation and was not similar to an income support pension payable to war widows and widowers under the *Veterans' Entitlements Act 1986* (*Davy*).

Certain service-related wounds and disability pensions that are of a kind specified in *Income and Corporation Taxes Act 1988* (UK) s 315(2) *and* similar to a payment of the kind discussed in ¶10-195 or ¶10-197 are exempt (ITAA97 s 53-10, item 5). The UK legislation exempts wounds pensions granted to members of the armed forces of "the Crown" and disablement or disability pensions granted to members, other than commissioned officers, of the armed forces on account of medical unfitness attributable to or aggravated by military service. The Commissioner accepts that the exemption applies to relevant pensions payable by "any Government" (IT 2586). The exemption applies to pensions paid to the person who suffered the wounds or disability but not to pensions paid to a surviving spouse (*Case T2*).

[FITR ¶103-510, ¶103-520, ¶104-510]

¶10-204 War-time compensation payments

A payment to an Australian resident person from a source in a foreign country is exempt from income tax if it is in connection with:

- any wrong or injury
- any loss of, or damage to, property, or
- any other detriment,

that the recipient, or another individual, suffered as a result of:

- persecution by the National Socialist regime of Germany during the National Socialist period
- persecution by any other enemy of the Commonwealth or by an enemy-associated regime during the Second World War

- flight from such persecution
- participation in a resistance movement during the Second World War against forces of the National Socialist regime of Germany or against forces of any other enemy of the Commonwealth (ITAA97 s 768-105).

The exemption extends to the legal personal representative of an individual, and to the trustee of a trust established by the will of a deceased individual, in the same way as it would apply to the individual. It also extends to compensation received in relation to an injury or wrong suffered by another person. However, for the exemption to apply, the payment must not be received from an associate of the recipient. ''Associate'' has the same meaning as in ITAA36 s 318, which covers a broad range of entities that are associates of natural persons, companies, partnerships and trustees. A similar exemption is provided by s 118-37 for a capital gain or loss made by an Australian resident individual as a result of receiving such compensation (¶11-650).

[FITR ¶585-210]

Insurance Proceeds — Accident/Disability/Life

¶10-210 Accident and disability policies

Periodical payments received by a taxpayer during a period of total or partial disability under a personal accident, income protection or disability insurance policy taken out by the taxpayer are assessable on the same principle as workers compensation (¶10-180), ie they are assessable where they are paid to fill the place of lost earnings (see, for example, *DP Smith*). This also applies to lump sums paid to settle all outstanding claims under the policy (*Sommer*).

An amount payable under a trauma insurance policy to an employee or self-employed person does not replace earnings lost by the taxpayer and is therefore not assessable income (and may also be exempt from CGT).

As to the deductibility of premiums paid on accident and disability policies, see ¶16-560.

¶10-220 Insurance on directors and employees

Amounts received by an employer under an *accident* (or term) policy taken out in respect of its directors and other employees are assessable as ordinary income if the purpose of the insurance is to fill the place of a revenue item (eg to replace profits lost through the loss of the employee's services). This principle applies equally where the insured receiving the proceeds is not the actual employer but is a holding company which takes out accident insurance in relation to its subsidiary's employees (*Carapark Holdings*).

The proceeds of these policies will not be assessable as income if the purpose of the insurance is to guard against a capital loss. This would apply where, for example, insurance is taken out by a company in respect of a director for the purpose of providing, in the event of the director's death by accident, funds for the payment to the estate of a debt owing to the director.

The proceeds of a *life* (or endowment) policy taken out by an employer in respect of employees or a director are not assessable as income (IT 155).

The above rules also apply where insurance is taken out by a partner in respect of another partner or by a taxpayer in respect of a ''key'' business associate, even though the person is not an employee (eg a supplier).

For the application of the CGT provisions to insurance recoveries, see ¶11-880.

[FITR ¶53-358]

¶10-230 Life assurance and endowment policies

The lump sum proceeds of a life assurance or endowment policy are capital and not assessable as income even though they may be received in more than one instalment of the fixed capital sum. Similarly, an amount received on the surrender of such a policy is capital.

If, however, the policy provides for the payment of a pension or annuity and not a fixed sum, or allows the beneficiary the choice between a fixed sum and a pension, the pension payments are wholly or partly assessable. See further ¶14-220.

Where the holder of a life insurance policy has control over the investment of the funds paid over as life insurance premiums, the income credited to the investor's account is assessable income of the investor derived at the time of crediting (TD 92/166). This does not apply where the investor merely has the right to direct that the investment be placed in a particular class of investment operated by the insurer for investors generally.

For the application of the CGT provisions in relation to life insurance, see ¶11-880.

[FITR ¶53-358]

¶10-240 Bonuses on insurance policies

There are difference types of bonuses payable on life insurance policies: (1) annual bonuses; and (2) reversionary bonuses paid on maturity, forfeiture or surrender of a life policy.

Annual bonuses are assessable.

Annual bonuses assessable (ITAA97 s 15-75). However, the assessable income of a complying superannuation fund does not include a non-reversionary bonus on a life assurance policy (ITAA97 s 295-335, item 1; ¶13-140).

Reversionary bonuses received under short-term life policies taken out after 28 August 1982 are subject to the following special tax treatment if the risk commenced after 7 December 1983 (ITAA36 s 26AH):

(1) if received, reinvested or otherwise dealt with on the taxpayer's behalf or as he/she directs in the first 10 years, tax is phased in as follows: within eight years of the commencement of risk — assessable in full; in the ninth year, assessable as to two-thirds; in the tenth year, assessable as to one-third (s 26AH(6)), unless the Commissioner gives a discretionary reduction (where the policy is forfeited or surrendered early and it would be unreasonable to include the full amount (s 26AH(8))). However, a tax offset of 30% is available (ITAA36 s 160AAB)

▶ Example

On 1 January 2012, A takes out a life policy. Six years later he surrenders the policy and receives a bonus of $1,200. The whole of the $1,200 forms part of A's assessable income in 2017/18. However, he is entitled to a tax offset under s 160AAB. The amount of the tax offset is calculated by applying the standard rate of tax to $1,200.

(2) if received after 10 years, not assessable.

Exemptions

Exemptions also apply to:

- bonuses paid on pre-28 August 1982 policies
- amounts received as a result of death, accident, illness or other disability
- amounts received under a policy held by a superannuation fund or ADF (whether complying or not), PST or RSA provider, or effected for the purposes of a complying or non-complying superannuation scheme

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Expenditure	ITAA97 deduction	ITAA36 deduction	Reference
Rehabilitating mining, quarrying and petroleum sites	Former 330-435	Former 124BA	¶19-100
Horticultural plant establishment	Former Subdiv 387-C	Former 124ZZF; 124ZZG	¶18-070
Drought mitigation	—	Former 628; 636	¶18-000
Spectrum licences	Former Subdiv 380-A; 380-C	—	¶17-630
Software	Former Subdiv 46-B; 46-C; 46-D	—	¶17-490
GST plant	Former 25-80	—	
Petroleum resource rent tax	Former 330-350	Former 72A	¶19-005

Subdivision 20-A applies to recoupments of deductible rates and taxes, eg payroll tax, sales tax or FBT. It does not, however, apply to recoupments of income tax (¶16-856) or higher education contributions (except where incurred in providing a fringe benefit) (¶16-452) as these are not deductible.

A government rebate received by a rental property owner is an assessable recoupment where the owner is not carrying on a property rental business and receives the rebate for the purchase of a depreciating asset (eg an energy-saving appliance) for use in the rental property (TD 2006/31). However, an amount received as compensation for the estimated loss in value of depreciating assets is not an assessable recoupment (TR 2006/3).

Amount included in assessable income

Where the loss or outgoing was deducted in a single year, the assessable recoupment is included in assessable income in the year of receipt to the extent of the amount of the loss or outgoing. An assessable recoupment received in advance of the year in which the loss or outgoing is deducted is treated as having been received in the deduction year (s 20-35).

▶ Example 1

Retail Co writes off as bad in 2016/17 a trade debt of $1,000 previously included in assessable income and claims a deduction of $1,000 under ITAA97 s 25-35. In the 2017/18 year Retail Co recovers $700 from the debtor. The $700 receipt is an assessable recoupment and is included in Retail Co's assessable income in 2017/18.

In 2018/19 Retail Co receives a further payment of $400 from the debtor in respect of the same debt. The $400 receipt is also an assessable recoupment. Only $300 of this amount is included in Retail Co's assessable income in 2018/19. The balance of $100 is not assessable. (It is assumed in this example that the receipts of $700 and $400 are not ordinary income or statutory income because of a provision outside Subdiv 20-A.)

Where the loss or outgoing is deductible over several income years, the amount of assessable recoupment included in assessable income in the year of receipt is limited to the total amount deducted to date (including deductions in the year of receipt). Amounts may also be included in assessable income in subsequent income years to the extent deductions for the loss or outgoing are available in those years. The total amount of assessable recoupment included in assessable income over all income years cannot, however, exceed the loss or outgoing (s 20-40).

▶ Example 2

Manufacturing Co incurs $10m in 2015/16 for the acquisition of plant which it commences to use in 2015/16. Its expenditure on the plant is deductible on a prime cost basis over 10 years commencing in 2015/16.

In 2017/18 Manufacturing Co receives a $5m grant from the state government in respect of its plant expenditure. The $5m receipt is an assessable recoupment and is included in assessable income as follows:

Income year	Deduction ($m)	Assessable recoupment ($m)	Assessable income ($m)
2015/16	1	—	—
2016/17	1	—	—
2017/18	1	5	3
2018/19	1	—	1
2019/20	1	—	1
2020/21	1	—	—
2021/22	1	—	—
2022/23	1	—	—
2023/24	1	—	—
2024/25	1	—	—
Total	10	5	5

Where the assessable recoupment relates to property for which a balancing charge has been included in assessable income in the current year or in an earlier year, the total amount deducted in respect of the property is taken to be reduced for recoupment purposes by the balancing charge (s 20-45).

▶ Example 3

Assume that in the previous example: (a) Manufacturing Co sells the plant at the end of 2016/17 for $9m so that a balancing charge of $1m is recognised in that year; and (b) Manufacturing Co still receives a $5m grant in 2017/18. The amount of assessable recoupment included in Manufacturing Co's assessable income (in 2017/18) is still limited to the total of amounts deducted for the plant. However, this total ($2m) is taken to be reduced by the balancing charge ($1m) so that the amount included in assessable income under Subdiv 20-A is limited to $1m.

In the case of *partly* deductible losses or outgoings, the amount of the assessable recoupment is taken to be correspondingly reduced and the amount of the loss or outgoing itself is taken for recoupment purposes to be only the *deductible* portion (s 20-50).

▶ Example 4

Heidi owns a rental property that is used 75% for income-producing purposes in 2017/18. She incurs expenditure of $800 on local council rates. In June 2018, Heidi receives a payment of $200 by way of reimbursement for this expenditure.

Heidi is taken to have received an assessable recoupment of $150 (ie 75% × $200). The expenditure incurred by her for Subdiv 20-A purposes is taken to be $600 (ie 75% × $800). As the deemed assessable recoupment of $150 does not exceed the deemed outgoing of $600, an amount of $150 is included in Heidi's assessable income in 2017/18.

Special rules apply where a taxpayer entitled to deductions in respect of an outgoing did not incur it, and the recoupment is received by the entity who incurred the outgoing. If the outgoing is deductible only to the taxpayer, Subdiv 20-A will apply as if the taxpayer had incurred the outgoing and received the recoupment (s 20-60). If the outgoing is deductible to two or more taxpayers (which may include the entity who incurred the outgoing), each taxpayer will be taken to have incurred the outgoing and to have received the recoupment to the extent to which deductions have been claimed by that taxpayer (deductions will be recouped in the order in which they were claimed) (s 20-65).

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However, if the disposal of the car is a taxable supply, the consideration receivable does not include an amount equal to the GST payable on the supply (s 20-115(3)).

An "associate" is defined broadly for these purposes (ITAA97 s 995-1(1)).

Subdivision 20-B does not apply where the person selling the car inherited it (ITAA97 s 20-145).

[FITR ¶60-430 — ¶60-450, ¶766-350]

¶10-400 Amount assessable under Subdiv 20-B (disposal of leased car)

Where there is a profit (¶10-390) on the disposal of the car, the amount included in assessable income cannot exceed the lowest of:

- the amount of notional depreciation attributed to the lessee in respect of the lease period (¶10-410)
- the amount of deductible lease payments paid under the lease, or
- in a case where the disposal is not the first disposal after the acquisition of the car from the lessor — the amount by which the consideration receivable exceeds the cost of the car to the entity who acquired it from the lessor (including any capital expenditure incurred on the car by that entity) (ITAA97 s 20-110(2); 20-125(2)).

The assessable profit is also reduced by any amount included in assessable income under any other provision apart from the depreciation balancing charge provisions, eg where the profit is income according to ordinary concepts (¶10-112) (ITAA97 s 20-150).

Where a car has been the subject of more than one lease to the taxpayer or an associate, the amount of profit included in assessable income is worked out by reference to the aggregated first and second limits for each lease (ITAA97 s 20-110(3); 20-125(3); 20-130).

Where there is a sequence of disposals involving the lessee and associates, the maximum amount assessable in respect of any disposal after the first one is determined by reference to the three limits noted above, as further reduced by any amount(s) included in assessable income by virtue of any previous operation of ITAA97 Subdiv 20-B or another provision apart from the depreciation balancing charge provisions (ITAA97 s 20-140). Once a vehicle is disposed of by a lessee or an associate for a consideration that is not less than market value, Subdiv 20-B does not apply in relation to any subsequent disposal (ITAA97 s 20-135). Special rules apply where there is a disposal of only a part-interest in a car (ITAA97 s 20-160).

[FITR ¶60-440 — ¶60-490]

¶10-410 Calculation of notional depreciation under Subdiv 20-B (disposal of leased car)

One of the ceilings imposed on the profit which is assessable under ITAA97 Subdiv 20-B is the amount of notional depreciation attributed to the lessee for the lease period (¶10-400). This is a notional calculation; no depreciation would in fact have been allowed because the lessee was not the owner of the car.

The amount of notional depreciation is calculated by comparing the car's cost to the lessor for depreciation purposes as worked out under Div 40 (¶17-080) with the car's termination value (¶17-640), in accordance with the following formula (ITAA97 s 20-120):

$$\text{notional depreciation} = (\text{cost} - \text{termination value}) \times \frac{\text{number of days in lease period}}{\text{number of days lessor owned car}}$$

Where the termination value equals or exceeds the cost, the notional depreciation is zero.

▶ Example

Lease Co purchases a car for $30,000 on 1 July 2016 and, on 1 September 2016, leases the car to Mary for two years. The lease expires on 31 August 2018 and Mary purchases the car from Lease Co for $22,000. The notional depreciation is calculated as follows:

$$\text{notional depreciation} = \$(30{,}000 - 22{,}000) \times \frac{731}{793} = \$7{,}374.52$$

If the car is subject to the car (depreciation) limit (¶17-200), both the cost and the termination value will be adjusted for the purposes of the notional depreciation calculation. See the example at ¶10-420.

[FITR ¶60-460]

¶10-420 Example of calculation under Subdiv 20-B (disposal of leased car)

The following example illustrates how the amount assessable under ITAA97 Subdiv 20-B on sale is calculated.

▶ Example

Assume that:

(1) on 1 March 2016, Cindy leases a BMW for a period of 36 months

(2) the lease payments are $1,600 per month

(3) use of the car by Cindy is 70% business and 30% private

(4) Cindy acquires the BMW from the lessor, Car Leasing Services, on expiry of the lease (ie 28 February 2019) for $40,000, its residual value

(5) Cindy sells the car in April 2019 for $60,000, and

(6) Car Leasing Services acquired the car on 15 February 2016 for a cost of $80,000 but it is subject to the car depreciation limit ($57,466 for the 2015/16 year) for the purpose of calculating the notional depreciation (¶17-200).

Cindy's actual profit on the acquisition and sale is $20,000 (ie $60,000 − $40,000). However, the amount included in Cindy's assessable income under Subdiv 20-B cannot exceed the lesser of:

- the amount of notional depreciation for the lease (see below), and
- the deductible lease payments of $40,320 (ie $1,600 × 36 × 70%).

Calculation of notional depreciation

The cost of the car to Car Leasing Services is limited to $57,466. The termination value for Car Leasing Services is adjusted as follows:

$$\text{termination value} = \$40{,}000 \times \frac{\$57{,}466}{\$80{,}000} = \$28{,}733$$

The notional depreciation is calculated as follows:

$$\text{notional depreciation} = \$(57{,}466 - 28{,}733) \times \frac{1{,}096}{1{,}110} = \$28{,}370$$

Since the actual profit ($20,000) is less than the amount of the notional depreciation ($28,370) and also the amount of the deductible lease charges ($40,320), the amount to be included in Cindy's assessable income in 2017/18 is $20,000.

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¶10-422 Profit on sale of other leased equipment

An amount received by a taxpayer as a result of the sale, at a profit, of plant or equipment previously leased by the taxpayer (including a car, in which case special provisions also apply: ¶10-380) and used in the conduct of its business may be assessable as ordinary income; alternatively, the CGT provisions may apply (the CGT provisions do not apply to cars). Similarly, where a previously leased asset is traded in and the trade-in credit reduces the cost of a replacement asset or the lease payments under a lease for the new asset, all or part of the trade-in credit may be assessable under the depreciation provisions (if depreciation was allowed before the trade-in and the trade-in credit exceeds the written down value), or as ordinary income or under the CGT provisions (TR 98/15).

The assessability as ordinary income of gains realised on the sale of leased equipment is illustrated by *Reynolds*, where a log haulier sold a leased truck with the approval of the lessor. The surplus of the sale price over the amount required to pay out the lease was held to be income according to ordinary concepts because its receipt was closely related to the taxpayer's business. See also *Case X57*, where the profit arising on the trade-in of a leased truck for a new leased truck was assessable.

For the position where leases are assigned, see ¶23-230.

[FITR ¶19-225]

Gambling Wins • Prizes • Awards

¶10-430 Betting and gambling wins

Betting and gambling wins are not assessable (and losses not deductible) unless the taxpayer is carrying on a business of betting or gambling. The principal criteria for determining whether such a business is being carried on were summarised in *Brajkovich's case* as follows:

- whether the betting or gambling is conducted in a systematic, organised and businesslike way — betting activities did not amount to a business where the taxpayer did not maintain an office, employ staff, use a computer or keep detailed records (*Evans*; *Babka*)
- the volume and size of the betting or gambling — these factors of themselves are seemingly not conclusive (*Evans*). In *Case 49/96*, the taxpayer played blackjack at a casino for 30 hours a week using a card counting system. The AAT ruled that, even if his technique did turn the odds more in his favour, the modest size of his bets meant that it was simply not a business proposition
- whether the betting or gambling is related to, or part of, other activities of a businesslike character, such as bookmaking or training or breeding racehorses (eg *Trautwein*). In *Shepherd's case*, however, a taxpayer with a "passion for horses" who looked after the few racehorses she owned was not assessable on her betting wins and prize winnings (whether horse-breeding, training and/or racing activities constitute a business is considered in TR 2008/2)
- whether the form of betting or gambling is likely to reward skill and judgment or depends largely on chance — in the latter case, eg roulette or two-up, gambling is unlikely to ever constitute a business
- whether the taxpayer is betting or gambling principally for profit or for pleasure — merely indulging in a passion or satisfying an addiction will not constitute a business (eg *Martin*) and a pastime does not become a business merely because a person devotes considerable time to it (*Babka*).

The Commissioner will apply the above criteria in determining whether a business is being carried on, although ultimately each case depends on its own facts. However, there appears to be no Australian case in which the winnings of a mere punter or gambler have been held to be assessable (or the losses deductible). As stated in *Babka's case*, "the intrusion of chance into the activity as a predominant ingredient" will usually preclude such a finding (IT 2655).

Winnings from betting or other forms of gambling do not give rise to a capital gain under the CGT provisions (¶11-660), although the disposal of an asset constituting such winnings may give rise to a capital gain (or a capital loss) (¶11-660).

[FITR ¶19-310]

¶10-440 Prizes and awards

Windfall gains resulting from winning a prize in a lottery or in a competition are generally non-assessable. However, where a taxpayer makes regular appearances on radio or television programs, the rewards for appearing, whether appearance fees or prizes in cash or kind, may be assessable (IT 167).

The value of any prize under an investment-related lottery is assessable (ITAA36 s 26AJ). An investment-related lottery is one where the chance to win the prize arises because the taxpayer holds an investment with an investment body such as a bank. The section will not apply if the chance to win the prize or the prize itself is otherwise taxable. The time when the prize is taxed and the value at which it will be taxed depend on whether the prize is in the form of cash, a loan or other property or services. The taxpayer will be assessed even if the prize is provided to an associate or to another person under an arrangement to which the taxpayer or associate is a party. The section does not affect ordinary lotteries, games such as Lotto and Tattslotto, art unions and raffles, nor does it apply to loans provided by the Starr-Bowkett building societies.

Prizes or awards won as an incident of the taxpayer's income-producing or business activities will be assessable, eg an author's literary competition prize, the "Farmer of the Year" award, and prizes and awards made to a taxpayer carrying on a business as a sportsperson (¶10-050). On this basis, the cash proceeds of the sale of a car won by a newsagent in a newspaper's sales competition were assessable (*Case V6*).

BHP Awards for the Pursuit of Excellence are not assessable in the hands of recipients. Although they are sometimes made for achievements directly connected to the winner's vocation or business, the Commissioner accepts that they are personal windfalls which are tax-free (IT 2145).

Prizes or winnings from a lottery, game or competition do not give rise to a capital gain under the CGT provisions, although the disposal of an asset constituting such a prize or winnings may give rise to a capital gain (or a capital loss) (¶11-660).

[FITR ¶19-300; FTR ¶15-980]

¶10-450 Illegal gains

The tests for determining whether the proceeds from illegal activities or transactions (such as drug dealing, prostitution, SP bookmaking, insider trading or theft) are income according to ordinary concepts are the same as for receipts from legal activities or transactions (TR 93/25). For example, if illegal activities are such as to constitute a business, the proceeds will be income in nature (¶10-110).

Amounts received from an illegal activity or transaction which are later repaid or recovered are not deductible, but relevant assessments may be amended, subject to the appropriate time limits (¶25-300), to exclude such amounts from assessable income. See also ¶16-010.

Interest on government and semi-government securities is assessable in the same way as other interest. See also ¶23-400 and ¶23-410. For the sale of securities cum interest, see ¶23-430.

Interest payable by the Commissioner under the *Taxation (Interest on Overpayments and Early Payments) Act 1983* (¶25-440, ¶28-170) is assessable under ITAA97 s 15-35 in the year in which it is received or otherwise applied against any tax liability of the taxpayer.

Interest paid by the Commonwealth from 1 July 2013 on unclaimed moneys reclaimed (bank accounts, corporate property and life insurance amounts) is exempt (s 51-120). For the treatment of interest on unclaimed superannuation moneys reclaimed, see ¶13-850.

For rules distinguishing interest paid to a company creditor from returns on equity in the company, see ¶23-100.

[FITR ¶19-035, ¶53-400]

¶10-480 Interest from children's savings accounts

Interest earned on a child's savings account may in some circumstances be treated as income of the parent, rather than the child. The Commissioner's views are set out in TD 2017/11 as follows:

- if the money in the account really belongs to the parent, in the sense that the parent provided the money and may spend it as he/she likes, then it will be treated as belonging to the parent and the interest should be included in the parent's return. If the money belongs to the child and the child's total income (excluding wages and other payments for work personally performed) for 2017/18 is less than $416 (¶2-160), no tax is payable and a tax return will not be required (a return will be required if the child receives wages from which PAYG instalments have been withheld: ¶24-010)
- where a parent operates an account on behalf of a child, but the Commissioner is satisfied that the child beneficially owns the money in the account, the parent can nonetheless show the interest in a tax return lodged for a child. The lodgment of a trust tax return will not be necessary
- where interest income on a bank account is assessable to a child under 18, that income may be subject to higher rates of tax under the rules in ITAA36 Pt III Div 6AA that apply to the income of certain children (¶2-160).

[FITR ¶28-090]

Dividends and Distributions

¶10-490 Dividends and distributions

For details of the tax treatment of dividends, see ¶4-100. For the treatment of *deemed* dividends, eg payments by private companies to associated persons and distributions in the liquidation of a company, see ¶4-200.

Rents and Royalties

¶10-500 Rents and premiums

Rents under a lease and hiring charges (eg for the use of plant or machinery) are assessable as ordinary income. They are generally assessable on a receipts basis (¶9-050). Rental income earned by co-owners of a property must generally be shared according to their legal interests except where they can establish that their equitable interests are

different; a partnership agreement varying profit and loss entitlements only has effect where there is also a partnership at general law, ie where ownership constitutes a business (TR 93/32) (¶5-000). Amounts received from a lessee, whether as damages or otherwise, for non-compliance with a lease obligation to repair business premises are specifically assessable under ITAA97 s 15-25 to the extent that they are not of an income nature.

Payments which are not in a true sense rental but are premiums received for the grant, assignment or surrender of a lease, or amounts received for the lessor's consent to such action, are generally capital receipts. However under ITAA36 s 26AB, a premium (or a payment in the nature of a premium) received in respect of the assignment (or assent to the assignment) of a lease of property granted before 20 September 1985 which, at the time of the assignment, was not intended by the assignee (or some other person) to be used for income-producing purposes is, with certain exceptions (eg a mining lease), assessable. If part of the property was, at the relevant date, intended to be used for income-producing purposes, only a portion of the premium will be assessable (s 26AB(3)). A premium received in respect of the assignment (or assent to the assignment) of a lease granted on or after 20 September 1985 may be assessable under the CGT provisions (¶11-320). The CGT implications of granting a lease are discussed at ¶11-300.

A lump sum payment received for granting a life time right for a relative to reside in an investment property is assessable where the tenant has a right to a pro rata refund on vacating the property (ID 2003/526).

There are no tax consequences where the owner of a residence permits persons to share it on the basis that all the occupants, including the owner, bear an appropriate proportion of the costs actually incurred on food, electricity, etc (IT 2167). Amounts received by host families under educational "homestay" arrangements would normally be treated as non-commercial and not assessable (ID 2001/381).

The taxation of cash and non-cash lease incentives is considered at ¶10-116. For the treatment of rental income received through the sharing economy, see ¶10-055.

[FITR ¶53-300; FTR ¶15-750]

¶10-505 Improvements by lessee

The value of improvements effected on leasehold land by a lessee, which, on termination of the lease, by effluxion of time or otherwise, eventually benefit the lessor, are generally capital and not assessable to the lessor as ordinary income. The relevant CGT provisions are considered at ¶12-680.

¶10-510 Royalties

The word "royalty" is used in two senses for income tax purposes: its ordinary meaning and the extended statutory definition in ITAA36 s 6(1) — see below. Royalties in the ordinary sense of the word are assessable under ITAA97 s 6-5 if they are of an income nature, and are assessable under ITAA97 s 15-20 if they are capital in nature. Payments which are *not* royalties within the ordinary meaning of the word, but which fall within the extended statutory definition in s 6(1), are assessable under s 6-5 provided they are of an income nature. Payments falling within the extended definition which are not royalties in the ordinary sense and which are capital in nature may be taxable under the CGT provisions. *Case U33* (noted below), which pre-dated the commencement of the CGT provisions, provides an example of a royalty which fell within the statutory definition but was not assessable because it was a capital receipt.

Royalties are generally assessable only when actually or constructively received. But note that advance payments on account of royalties, if they are truly advances and are not intended to be repaid, are assessable.

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In the case of royalties derived from overseas, if withholding tax is deducted at source before the royalties are paid, the taxpayer remains assessable on the gross amount of the royalties, not just the net amount actually received (*Case V122*), although the taxpayer may be entitled to a foreign income tax offset (¶21-680). A withholding tax applies to royalties paid or credited to non-residents (¶22-030).

Ordinary meaning of royalty

The ordinary meaning (ie dictionary definition) of ''royalty'' for income tax purposes encompasses the following types of payment:

- a payment to a land-owner by the lessee of a mine in return for the privilege of working it
- a payment to the owner of a patent for the use of it
- a payment to an author, editor, or composer for each copy of a book, piece of music, etc, sold by the publisher, or for the representation of a play.

Thus the word royalty, in its ordinary sense, has been used to describe payments made to a singer in respect of recordings made of his songs, sums paid for a right to cut timber where based on the quantity cut and payments for removing furnace slag from land.

Payments for the provision of ''know-how'' have been held not to be royalties within the ordinary meaning of the word (*Sherritt Gordon Mines*), although they would now be caught by the extended statutory definition. A payment to a taxpayer for sharing its knowledge of how to maintain the purity of uncontaminated breeding stock was also not a royalty within the ordinary meaning of the term, although it fell within the statutory definition of royalty (see below). The payment was not of a capital nature as the taxpayer was entitled to continue to use its know-how; the payment was therefore assessable as ordinary income (*Case W10*).

Monthly payments received by a milk producer for assigning its right to a source of future income were held not to be royalties within the ordinary meaning of the term as they did not relate to the frequency, value or volume of milk supplied, although they were assessable as ordinary income (*Moneymen*). On appeal, the Full Federal Court upheld the decision that the payments were assessable as ordinary income (¶10-020) and did not need to consider whether they were assessable as royalties.

A lump sum will be a royalty if it is a pre-estimate or after the event recognition of the amount of use made of the privilege or right. However, in one case, a lump sum characterised in the agreement under which it was payable as an advance payment in respect of royalties was held, on the proper construction of the agreement, to be consideration for the grant of an exclusive licence to ''make, have made, use and sell'' the relevant item. Accordingly, the lump sum was not a royalty within the ordinary meaning of the term and also was not income (*Case U33*). Note that the CGT provisions may now apply in a case of this kind. In contrast, in the *Henry Jones (IXL) case* a lump sum payment received from a financial institution as consideration for the taxpayer assigning its rights to receive annual royalties under a licence agreement was held to be assessable income (¶10-020).

Extended definition of royalty

The extended definition of ''royalty'' in s 6(1) includes any amount paid or credited, however described or computed, and whether the payment is periodical or not, to the extent to which it is paid or credited as consideration for:

(1) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade mark, or other like property or right (eg payments to an author for the use of the author's copyright in an article: TD 2006/10)

(2) the use of, or the right to use, any industrial, commercial or scientific equipment (''equipment'' does not have a narrow meaning and includes things such as machinery and apparatus: IT 2660)

(3) the supply (presumably by any means whatsoever and including indirectly through an agent or employee: IT 2660) of scientific, technical, industrial or commercial knowledge or information (eg the knowledge shared in *Case W10* — see above)

(4) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any property, right, equipment, knowledge or information mentioned in (1) to (3)

(5) the use of, or the right to use, motion picture films, films or video tapes for use in connection with television, or tapes for use in connection with radio broadcasting

(6) the reception of, or the right to receive, visual images and/or sounds transmitted to the public by satellite, cable, optic fibre or other similar technology

(7) the use of, or the right to use, in connection with television or radio broadcasting visual images and/or sounds transmitted by satellite, cable, optic fibre or other similar technology

(8) the use of, or right to use, part of the spectrum specified in a spectrum licence, and

(9) a total or partial forbearance in relation to any property, right, equipment, knowledge, information, assistance, etc, specified in (1) to (8) (this would cover, for example, a payment to the owner of technology not to make the technology available to any other person).

The Commissioner points out in IT 2660 that the extended definition of ''royalty'' encompasses a payment for the use of, or the right to use, a right, property, knowledge, etc, even though it is not used physically by the person making the payment or is not supplied directly by the person to whom the payment is made (eg a payment by a film distributor to a non-resident for the distributor's right to exploit a film by allowing cinema owners to exhibit it). Guidelines on when amounts paid as consideration for the assignment of copyright are royalties under the extended definition are set out in TR 2008/7.

IT 2660 also deals with the distinction between royalty payments and payments for services. Payments for services are not royalties, unless they are ancillary to, or part and parcel of, enabling relevant technology, information, know-how, copyright, machinery or equipment to be transferred or used. Whether a payment is a royalty payment or a payment for services depends on the nature and purpose of the arrangement having regard to the circumstances of the particular case. A contract for the supply or use of a ''product'' which is already in existence (or substantially in existence) is more likely to be a contract for the supply of know-how, payments under which will be royalties. In the Commissioner's view, a contract for services is likely to involve a much greater level of expenditure. If both know-how and services are supplied under the same contract, an apportionment of the two elements may be necessary.

As regards payments in relation to computer software, a payment is considered to be a royalty (including under the statutory definition) where it is consideration for: (a) the granting of a licence to reproduce or modify a computer program in a manner that would, without such a licence, constitute an infringement of copyright (eg payments for the right to manufacture copies of a program from a master copy for distribution and for the right to modify or adapt a program); or (b) the supply of know-how (eg payments for the supply of the source code or algorithms of a program) (TR 93/12). However, the following are *not* considered to be royalties for income tax purposes: (a) payments for the transfer of all rights relating to copyright in the program; (b) payments for the granting of a licence which allows only simple use of the software; (c) payments for the provision of services in the modification or creation of software; and (d) the proceeds from a sale of

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To be deductible, the debt must be in existence at the time it is treated as a bad debt and claimed as such. A release of a debt extinguishes it, leaving nothing to be incurred within the meaning of s 8-1, nor to be written off as bad under s 25-35 (*Point*). This is also the case wherever a debt is released, compromised or otherwise extinguished by the voluntary or acquiescent act of the creditor (*GE Crane Sales*). Where a commercial debt is forgiven, the debtor may be affected by the debt forgiveness provisions (¶16-910). In addition, a deemed dividend may arise where a private company forgives a debt owed by a shareholder (¶4-200).

The Commissioner's views as to the tax position where there is a sale of property held as security against a debt, or property is taken in satisfaction of the debt, are contained in TR 92/18. For the position where a life insurance company forgives an agency development loan made to an insurance agent, see TR 2001/9.

No deduction is allowable for the bad debts of a foreign branch of a moneylender where assessable income has not been derived from those debts because the branch income is exempt from Australian tax (¶21-098). Where some of the income derived from such a debt is assessable to Australian tax, the deduction will be apportioned (ITAA36 s 63D). Losses arising on the non-recovery of a debt that qualifies as a traditional security will not give rise to a loss in certain circumstances (¶23-340).

There is a limit on the amount a taxpayer may deduct for a bad debt relating to lease payments for the lease of a luxury car (¶17-220). Lease payments written off as bad debts by the lessor may only be deducted up to the amount of the finance charge reduced by the amounts of earlier deductions.

A deduction for a bad debt may, in certain circumstances, be denied if a tax avoidance scheme is involved (¶16-110). The recoupment of an amount deductible in respect of a debt written off as bad gives rise to an assessable amount (¶10-270).

Special provisions apply for bad debts in relation to consolidated groups (¶8-020).

[FITR ¶33-740 – ¶33-790, ¶65-240ff]

¶16-582 Deductibility of bad debts under s 25-35

To qualify for a bad debt deduction under ITAA97 s 25-35, the debt or part of a debt must not only be objectively bad (*Case X9*) but must satisfy the two conditions set out below.

(1) The debt must be written off as bad during the year of income in which the deduction is claimed. There must be a physical writing off of the debt — not necessarily a book entry but something in writing to indicate that the creditor has treated the debt as bad. It is not sufficient that the debt is written off when the accounts are completed after the close of the income year (in conformity with usual accounting practice) and merely relates back to the income year just closed (*Point*).

(2) Except in the case of taxpayers in the business of lending money, the debt must have been brought to account by the taxpayer as assessable income (eg *Case 7/2000*). This requirement will not be satisfied by a taxpayer who lodges returns on a cash basis because those debts will not have been brought to account as assessable income (*Case P78*). Thus, an employee who is paid by a dishonoured cheque cannot claim a bad debt deduction (TD 92/201).

The Commissioner's views on when a debt is bad are set out in TR 92/18. It appears the Commissioner will generally require a taxpayer to have taken the appropriate steps in an attempt to recover a debt, including the obtaining and enforcement of a judgment against the debtor and valuation of any securities held against the debt.

A beneficiary of a trust is not entitled to a bad debt deduction under s 25-35 for unpaid present entitlement amounts that have been written off as bad debts (TD 2016/19). Also, in *Pope*, a trustee had the power to create a present entitlement to trust income by setting it aside in a loan account for a beneficiary. A beneficiary subsequently wrote off their outstanding loan balance as bad, and a s 25-35 bad debt deduction was denied. This was because there was no continuing identity between the amount included in the taxpayer's assessable income (being a trust distribution to which he was presently entitled), and the subsequently written off debt (being an investment the beneficiary had made in the trust's business).

Moneylending business

A bad debt in respect of money lent in the ordinary course of a moneylending business carried on by the taxpayer is deductible even though it has not previously been brought to account as assessable income. The taxpayer must be in the business of moneylending at the time the loan is made, but not necessarily at the time the debt is written off (TR 92/18).

Whether a taxpayer is carrying on a business of lending money is a question of fact, as determined by reference to the context in which the business is carried on, rather than by reference to the way in which a major bank might carry on its business. For example, a subsidiary which in the course of the business of lending money, made loans to other subsidiaries of the parent company could deduct certain bad debts (*BHP Billiton Finance Ltd; Ashwick Qld*). It is not necessary for each loan to be motivated by the profit-making purpose to be regarded as part of the continuing business (*BHP Billiton Finance*).

Moneylending need not be the only or principal business of the taxpayer. Nevertheless, it must be established that moneylending is a distinct business as opposed to a subordinate activity carried on as an adjunct to the taxpayer's main business. To qualify as carrying on a business of lending money, the taxpayer does not have to be ready and willing to lend to all and sundry — it is sufficient if the taxpayer lends money to a certain class of borrowers, provided it does so in a businesslike manner with a view to yielding a profit (TR 92/18).

Further, the loan must have been made in the *ordinary* course of the moneylending business. Thus, an inter-company loan between two moneylending companies would not necessarily qualify, although the High Court has held that a transaction different from the usual moneylending transactions of the business at the time may nevertheless be *in the ordinary course* of a moneylending business and that only transactions not entered into for business purposes are excluded (*Fairway Estates*). Moreover, said the court, a business may be found to exist although there is no more than an *intention* and one sole transaction in pursuance of it. This "ordinary course of business" requirement does not exist, as such, in an alternative claim under the general deduction provision (¶16-584).

A deduction is also available where the bad debt was bought by the taxpayer in the ordinary course of the taxpayer's moneylending business. In this case, the deduction cannot exceed the amount incurred in buying the debt. If only part of the debt is written off, only the amount incurred in buying the debt less the amount which has not been written off can be claimed.

The head company of a consolidated group can obtain a deduction for a debt that is written off as bad by a subsidiary member where the debt is in respect of money lent by the subsidiary in the ordinary course of its business of lending money before consolidation (TD 2005/23).

[FITR ¶65-240]

¶16-584 Deductibility of bad debts under s 8-1

A bad debt that, for one reason or another, is not deductible under ITAA97 s 25-35 (¶16-582) may, nevertheless, be deductible under ITAA97 s 8-1.

To be deductible under s 8-1, the bad debt must have been *incurred* and must be a loss (or non-receipt) relating to the production of the taxpayer's assessable income. It will not qualify for deduction if it is a loss of capital or a loss of a private or domestic nature.

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However, the debt need not be brought to account as assessable income. Normal business loans may be deductible as bad debts under the general deduction provision, but advances of capital made to salvage or protect an investment threatening to go bad are not.

In the case of company taxpayers (¶3-150) and trusts (¶6-262) there must be a physical writing off of the debt before a deduction will be allowed.

Factoring discount fees may be deductible under s 8-1. Debt factoring arrangements may be acceptable for tax purposes where the arrangement is explicable by reference to ordinary business or commercial standards. The parties to a debt factoring arrangement do not need to be at arm's length but, where they are not, the arrangement will be examined to determine whether it is commercially realistic (IT 2538; TD 93/83).

[FITR ¶33-740 – ¶33-780]

¶16-586 Debt/equity swaps

A deduction is allowable for losses incurred where a debt is extinguished as part of a debt/equity swap (ITAA36 s 63E). Debt/equity swap deductions are subject to the rules in ITAA36 s 63D (¶16-580). Companies (¶3-150) and trusts (¶6-262) wishing to claim such deductions must meet stringent preconditions (s 63E(5A)).

A debt/equity swap occurs where, under an arrangement, a taxpayer discharges, releases or otherwise extinguishes a debt in return for equity in the form of shares or units in the debtor. For the rules to apply, the debt must have been brought into account by the taxpayer as assessable income in an income year or the debt was in respect of money loaned in the ordinary course of the taxpayer's business of lending money. The deductible loss is the amount by which the book value of the extinguished debt exceeds the value of the equity received in return for extinguishing the debt. The value of the equity is the greater of the market value of the shares or units and their value shown in the taxpayer's accounts at the time they were issued to the taxpayer. A swap loss deduction is reduced to the extent that it has previously been allowed under other provisions of the tax law, or under s 63E itself (ITAA36 s 63F).

Profits or losses realised on a subsequent disposal, cancellation or redemption of equity acquired in a debt/equity swap are assessable income or allowable deductions, as the case requires.

See generally TR 92/18.

[FTR ¶34-142, ¶34-146]

¶16-590 Deductibility of losses through theft or misappropriation

A loss of money caused by theft, stealing, embezzlement, larceny, etc, by an employee or agent of the taxpayer is deductible in the year in which it is discovered if the money was included in the taxpayer's assessable income of that or an earlier year (ITAA97 s 25-45). The deduction is not available where the loss was caused by the actions of persons acting in a private capacity (eg a non-employee spouse; *Case 15/2004*). The requirement that the wrongdoing be committed by an employee or agent may not be satisfied where the wrongdoing is by directors who were acting as the mind and will of the company taxpayer (*EHL Burgess*), or possibly by partners in the firm.

Once money received as income is deployed by the taxpayer, personally or by way of an agent, for expenditure or investment, the characterisation as income is no longer appropriate and the loss cannot be said to have been incurred in respect of the money included in assessable income (*Lean*). In other words, the money must be traceable (*EHL Burgess*; *Grima*).

The deduction is further limited in that the offences covered by the provisions have technical meanings and limited scope. However, a loss incurred through robbery, theft or misappropriation may qualify for deduction under ITAA97 s 8-1 provided it is a loss of such a character as to be the kind of casualty, mischance or misfortune that is a natural or recognised incident of the taxpayer's operations (*Charles Moore*).

Under s 25-47, a deduction is also allowable for amounts or non-cash benefits that are misappropriated (by theft, embezzlement, larceny or otherwise) by an employee or agent and that have been included in the termination value of a depreciating asset under the balancing adjustment provisions referred to at ¶17-640. The deduction is available in the year in which the misappropriation occurs. The amount that can be deducted is reduced to reflect any use of the asset for a non-taxable purpose and for certain taxpayers and second-hand assets, use in a residential rental property. If a misappropriation is discovered in a later year of income, the taxpayer may request an amendment within four years, starting immediately after the taxpayer discovers the misappropriation. Any subsequent recoupment of the misappropriated amount is assessable in the year of the recoupment.

Capital proceeds from a CGT event are reduced in the case of misappropriation by an employee or agent (¶11-510). The recoupment of an amount deductible under s 25-45 or s 25-47 gives rise to an assessable amount (¶10-270).

Deductions under s 8-1 were available in respect of:

- losses, through armed robbery, of the day's takings (*Charles Moore*; *Gold Band Services*)
- cheques forged by an employee (*Case H114*) and reimbursement to a trust for stolen trust funds held for clients of a real estate agency (ID 2010/207)
- a solicitor having to make good a loss to clients' funds caused by an employee's fraudulent misrepresentation (*Webber*) or by a former partner's misappropriation (*Sweetman*) (although a different result was reached in *Ash*).

No deductions are available for losses relating to income gained from illegal activities (¶16-105).

An employee, such as a flight attendant, who deals with customers' money can claim a deduction for any cash shortages that they are required to repay (TR 95/19; ID 2002/397). An investor's legal costs of seeking to recover investment funds that had been misappropriated were not deductible (ID 2001/42).

The theft of a depreciating asset would be treated as an involuntary disposal, entitling the owner to a balancing adjustment offset (¶17-720).

[FITR ¶33-785, ¶65-360]

Special Occupations

¶16-635 Deductions for taxpayers in special occupations

The Commissioner has released many rulings and other guidelines about the types of deductions that can be claimed by taxpayers in particular occupations and these can be used as a handy reference. For example, the Commissioner has issued rulings on the following occupations: airline industry employees (TR 95/19); Australian Defence Force members (TR 95/17); civil marriage celebrants (IT 2409); employee building workers (TR 95/22); employee cleaners (TR 95/8); employee factory workers (TR 95/12); employee journalists and radio and television presenters (TR 98/14); employee lawyers (TR 95/9); employee performing artists (TR 95/20); employee shop assistants (TR 95/10); hairdressers (TR 95/16); hospitality industry employees (TR 95/11); itinerant employees (TR 95/34); members of parliament (TR 1999/10); nurses (TR 95/15);

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- interest on moneys borrowed to purchase or refinance the property (¶16-740) or to effect repairs (¶16-700)
- advertising
- expenses of preparation, registration and stamping of leases, assignments and surrenders in respect of rented premises (¶16-640). This includes stamp duty, and preparation and registration costs in respect of the "acquisition" of a rental property situated in the ACT
- servicing expenses.

In the case of a residential rental property, the deductible amount includes any GST component of the outgoing relating to the rent (¶16-860).

The provision of lease incentives will usually give rise to a deduction for the lessor, except where the true purpose of providing the incentive is not to induce the entering into of the lease (eg to benefit an associate or to shift income to an associate with carry-forward losses). Where the incentive takes the form of a rent-free or reduced rent period, the lessor will not be allowed a deduction for the rent forgone.

Lease surrender payments made by a lessor are generally not deductible, except under the special rules set out in ¶16-159.

Where a landlord undertook to meet the tenants' indebtedness to a bank in the case of the tenants' default, amounts paid by the landlord under the undertaking were not sufficiently connected with rental income and were not deductible (*Case 38/96*).

An employee who leases their private residence to their employer and then salary sacrifices rent is not entitled to deductions for property expenses of the residence (TD 2004/26).

A landlord's claims will need to be apportioned where only part of the property is let, the property is let for only part of the year or the property is let for a mixture of commercial and non-commercial purposes. Where only part of the property is let and the rest is used for private purposes, the claim is normally apportioned on a floor-area basis.

Where rent is received from a short-term commercial letting of a holiday house, the losses and outgoings are normally apportioned on a time basis according to the period that the property is actually let (*Case R118*). Any period that the property was available for letting may also be taken into account in making the apportionment, provided it can be shown that active and bona fide efforts were made to obtain tenants during that time (IT 2167; see also *Case V133* and *Bonaccordo*). In *Case 3/2012*, a taxpayer was allowed deductions for lawn mowing, insurance, electricity and advertising. The ATO has issued a *Decision Impact Statement* on the case stating that it had a narrow application and would not impact the ATO's view on the deductibility of these expenses generally.

Leasing a house to a relative for a low rental has often been seen as a way of conferring a benefit on the relative while still retaining the tax advantages of being a landlord, ie by disclosing the rental as income and claiming a relatively substantial deduction for outgoings. In extreme cases, eg where the rental is only a token amount, the Commissioner may treat such a "lease" as a domestic arrangement with no tax consequences (*Groser*). Alternatively, where the transaction has both business and private elements, apportionment may be appropriate (*Kowal*). For example, where a property was rented to a relative at 25% of market rental, it was appropriate to allow 25% of the deductions claimed or an amount equal to the rental income returned (*Madigan*).

However, where the property is let to relatives on a normal commercial basis, the landlord will be treated in the same way as any other owner in a comparable arm's length situation (IT 2167). In *Bocaz*, the AAT held that the rental agreement that a taxpayer entered into with her son was commercial where the rent received was higher than the median rent figure submitted by the Commissioner. The taxpayer also received rent that was close to the median rent figure from a property leased to her ex-husband with whom

she had an arrangement to undertake renovation work. The taxpayer was able to deduct interest and other expenses incurred in respect of the rental properties to reflect her share and period of ownership.

In cases involving non-commercial elements, the Commissioner may also seek to limit the deduction for outgoings to the amount of income received if insufficient evidence to justify a higher claim is provided (IT 2167). See further ¶16-740.

Where the taxpayer purchases a property with the intention of deriving income, a deduction for interest and other expenses may be available even if no income is ever derived (*Ormiston*; ¶16-740). However such taxpayers may be asked to demonstrate that they purchased the property with the intention of deriving rental income and that they continued to hold it for that purpose. The *Dram Nominees* and *Fogarty* decisions highlight the importance of possessing relevant evidence.

It is proposed that from 1 July 2019, expenses associated with holding vacant land will not be deductible, targeting deductions claimed for land not genuinely held for the purpose of earning assessable income (2018/19 Budget). Exclusions will apply for land used to carry on a business, eg land held for commercial development

The cost of moving furniture to a new main residence in order to lease a previous main residence is a private or domestic expense and is not deductible (*Wray-McCann*).

Where a landlord is the sole owner of a mortgaged rental property, but the mortgage is held in joint names with a spouse, the landlord can nevertheless claim the full amount of the mortgage interest paid (TR 93/32). A taxpayer's share of rental property expenses may be claimed against rental income received from their co-owner who lives in the property (see "Rental Properties 2016" on the ATO website, and the now withdrawn ID 2010/193).

For the appropriate exchange rate to be used to translate foreign currency rental deductions into Australian dollars for tax purposes where an average rate of exchange has not been used, see the ATO website at "Translation of foreign currency rental expenses" (¶23-070).

[FITR ¶33-995]

Investment Income Expenses and Losses

¶16-660 Expenses in deriving investment income

A taxpayer who derives assessable income from investments (ie dividends and interest) may deduct certain expenditure incurred in connection with that income (eg collection expenses, bookkeeping and secretarial expenses, interest, borrowing expenses and audit fees where an audit is reasonably necessary). Appropriate documentation should be maintained (*Sobel Investments*).

The Commissioner considers that a fee paid to a financial planner or adviser for drawing up a new financial plan (eg for a statement of advice) is not deductible, even if some of the investor's existing investments are included in the plan. In contrast, ongoing management fees or retainers paid to advisers, or costs of servicing and managing an investment portfolio, are deductible (IT 39; TD 95/60). The cost of advice to change the mix of investments, whether by the original or a new adviser, is treated as part of the cost of managing a portfolio and is deductible, provided it does not amount to a new financial plan (TD 95/60). However, the Commissioner considers that if the advice covers other matters, or relates in part to investments that do not produce assessable income, only a proportion of the fee is deductible. No deduction is available for management fees debited to a retiree's allocated pension account (ID 2004/968).

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A deduction is allowable for travel costs of consulting with interstate brokers and attending interstate stock exchanges as part of servicing an investment portfolio (IT 39). This may also cover travel costs genuinely attributable to attending an annual general meeting of a company in which the investor holds shares (*Elder*). The cost of overseas travel has been held to be deductible to the extent that it was incurred to consult financial advisers in connection with the management of the taxpayer's investment portfolio and properties (*Case T8*).

A deduction is allowable for the cost of subscriptions to share market information services and investment journals (including periodicals such as the *Financial Review*) to the extent that they relate to the gaining or producing of interest and dividends from a share or bond portfolio and that they are not a capital cost of setting up the investment. A share investor is more likely to show the required connection with the income (being interest and dividends, rather than simply capital gains) if he/she is actively involved in managing an investment portfolio (TD 2004/1; *Case T96*). Depreciation on share trading software may also be claimed (¶17-370). In *Petrovic*, investment seminar fees were an investment of capital made to prepare the taxpayer for the future commencement of a property investment business and were therefore not deductible.

As a general rule, interest on moneys borrowed to acquire investments (eg shares) is deductible where it is expected that income (eg dividends) will be derived (¶16-742). Bank charges and borrowing expenses may also be deductible (¶16-800), as may certain legal expenses (¶16-830). However, a once-only payment for service fees incurred in the acquisition of units in a property trust was held not to be deductible (*Case U53*; IT 2428). For the deductibility of scrip loan fees and call option payments made where a taxpayer borrows "cum dividend" shares, see TD 2003/32.

Where taxpayers were involved in a previous tax avoidance scheme, no deduction may be available for debts relating to that scheme that have been forgiven or for repayments of the debt that have been refunded (TA 2008/6).

Managed investment schemes (MIS)

For the deductibility of expenses incurred under MIS, see ¶18-020 (non-forestry), ¶18-125 (forestry) and ¶30-170 (anti-avoidance provisions). Investors' contributions to an agricultural MIS which are incurred in the course of carrying on a business and are of a revenue nature are deductible (*Decision Impact Statement* on *Hance*). Where failure to plant all the trees intended to be established under a forestry MIS results in no deduction being allowable under the special forestry MIS rules (¶18-125) in respect of a participant's initial contribution to the scheme, a deduction may be available under s 8-1 if the conduct of the MIS constitutes the carrying on of a business (TD 2010/15). See also TD 2010/14. The disposal or termination of an interest in a non-forestry MIS arising out of circumstances outside the taxpayer's control does not result in the denial of previously allowed deductions (TD 2010/8).

The Commissioner has issued a number of product rulings dealing with the application of the deduction provisions and the anti-avoidance provisions to specified investment projects (generally afforestation and primary production projects) (¶24-540).

▶ Planning point

Many tax shelters marketed towards the end of each income year involve tax-deferral through the investment of borrowed funds (ie the creation of deductions are generated in the early years of the transaction), with assessable income being generated in later years. This can be of benefit in the case of a high income earner and generate significant cash flow advantages. If tempted to invest in tax shelters, seek independent professional advice, check any product rulings, and refer to www.ato.gov.au/General/Tax-planning. The ATO has issued practice instructions to ATO staff on the treatment of aggressive tax planning (PS LA 2008/15).

[FITR ¶33-300]

¶16-665 Investment losses

Losses made on investments such as shares and other securities are deductible under ITAA97 s 8-1 if the taxpayer is carrying on a business of investing for profit or of trading in investments. Whether a taxpayer is carrying on such a business is often difficult to determine and depends on the facts of the particular case (¶16-015, ¶10-105). Relevant factors include the frequency, volume and scale of transactions and whether they are carried out in a businesslike way (*Radnor*; *Firth*; *Wong*). The taxpayer's purpose in entering into the transactions may also be relevant. In one case, a deduction was allowed for a loss made on reselling the first two houses purchased by a taxpayer in the business of buying and selling houses for profit, even though the taxpayer did not purchase other houses due to a slump in property prices (*Case 15/98*). Similarly, a taxpayer who bought more and sold less shares during the year due to the global financial crisis was considered to be carrying on a share trading business in that year, even though he had decided to hold on to the shares instead of making a short term loss (*Case 10/2011*). See also *Price Street Professional Centre*.

A mere speculator in shares is not accepted as a share trader (*AC Williams*) nor is an investor (*Case 9/94*). A taxpayer who worked full time for an international bank and conducted various buying and selling transactions in shares on his own account, was not carrying on a business as share trader as he did not exhibit a discernible pattern of trading and held the relevant shares for periods longer than a share trader would, and did not take profits as they arose (*Smith*; see also *Case 15/2004* and *Case X86*). However, a taxpayer involved in systematic arbitrage operations was found to be carrying on a business, albeit for a short time only (*Shields*). Similarly, in *Mehta*, the activities amounted to the carrying on of a business as the taxpayer had intended his activities to constitute a business, had applied his mind to the carrying on of that business and had followed expert advice. Where a taxpayer is carrying on a business of a share trader, the shares, etc, are trading stock (¶9-150).

The mere fact that a loss from an investment is made by an entity in its capacity as trustee of a trust is not conclusive as to whether the loss is on revenue or capital account. The loss is on revenue account if no provision specifically treats it as being on capital account and, after consideration of all of the relevant factors, it is determined that the loss was from a normal operation in the course of carrying on a business of investment, an extraordinary operation by reference to the ordinary course of that business but one entered into with the intention of making a profit or gain, or a one-off or isolated transaction where the investment was acquired in a business operation or commercial transaction for the purpose of profit-making (TD 2011/21).

The ATO has warned taxpayers about arrangements whereby: (a) a taxpayer's shareholding status is changed from that of a long term capital investor to a trader in shares in order to re-characterise capital losses as revenue losses (TA 2009/12); and (b) a purported partnership is inserted into an investment in an afforestation, agricultural or horticultural Managed Investment Scheme in order to generate deductions for the newly inserted partners (TA 2009/13).

Losses incurred in investing in a commodity futures trading trust (*Case X38*) and on the surrender of an insurance bond were not deductible (*Case Y36*) but a deduction was allowed to a building company for the loss it suffered when a finance company with which it had funds on short-term deposit collapsed (*Marshall and Brougham*).

Where shares (and similar assets, such as units in unit trusts, that are listed and traded on the stock exchange) are held by a taxpayer as revenue assets but not as trading stock (eg shares held by an insurance company or a bank), any loss on disposal is ascertained in accordance with the principles set out in TR 96/4.

Losses incurred by a taxpayer in buying and selling stapled securities (consisting of a note and a preference share) in the ordinary course of business are deductible (TA 2008/1). Land impairment trust arrangements (involving land being sold at a loss)

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inside of the bake furnace in an aluminium smelter, and refurbishment and upgrade of the fume scrubber (including waste gas ductwork) in the furnace was a repair and not renewal (*Alcoa*). The taxpayer's depreciation for accounting purposes of individual components on a ''line by line'' basis was not determinative of whether the bake furnace was or was not an entirety. On the other hand, in a case involving the demolition and reconstruction of a slipway, the slipway was held to be an entirety in itself. For tests to identify an entirety, see TR 97/23. For instance, a stove, a refrigerator, a complete fence or a building is an entirety.

Painting, conditioning gutters, maintaining plumbing, repairing electrical appliances, mending leaks, replacing broken parts of fences and windows and repairing machinery would generally constitute deductible repairs. See also ID 2002/291 and ID 2002/292 (partial rebuilding of an external protective wall was repair but complete rebuilding was not), and ID 2004/796 (repeat hydraulic fracture stimulation).

Improvement versus repair

Repairs generally improve the condition of the property and a minor or incidental degree of improvement may be done and still constitute a repair. However, substantial improvements, additions, alterations, modernisations and reconstructions are not repairs. While reconstructions are not repairs, a progressive restoration over a period of time may involve a series of deductible repairs. The Commissioner accepts that the character of a repair does not necessarily change because it is carried out at the same time as an improvement. If individual parts of an extensive renovation or restoration project combining repairs and improvements can be characterised as repairs, and if their cost can be segregated and accurately quantified, those items are repairs (TR 97/23). The ATO intends to issue a new ruling (complementing TR 97/23) that will consider, among other things, the difference between a repair and an ''extension, alteration, or improvement'' under the Div 43 capital works provisions (¶20-480).

Some of the factors pointing to an improvement rather than a repair are whether:

- the modification work has effected an improvement to the asset
- there is greater efficiency of function of the property
- there is an increase in the value of the asset
- the expenditure reduces the likelihood of future repairs.

The following are considered to be improvements, not repairs:

- the replacement of a dilapidated ceiling with an entirely new and better ceiling (*Western Suburbs Cinemas*)
- the replacement of canvas awnings on the balconies of holiday flats with sound-resistant double glazed partitions to prevent noise pollution (*Case M60*)
- the replacement of a rotten wooden floor in a block of flats with a better, longer-lasting and more moisture resistant concrete floor (*Case N61*)
- the replacement of cupboards as part of the refurbishment of the whole kitchen (*Case 6/99*)
- landscaping or insulating a house (www.ato.gov.au).

Use of different material, however, does not necessarily prevent the work from being a repair, provided the work merely restores a previous function to the property or restores the efficiency of the previous function (TR 97/23). For example, the following work constituted deductible repairs:

- replacing rotten timbers in a wall and cladding the wall with ''Celluform'' instead of painting it (*Case R102*)
- removing worn carpets and polishing the existing floorboards in a rental property (ID 2002/330)
- re-paving a container terminal even though the new bitumen was of a better quality and was laid more thickly and over a better foundation (*Case W93*).

Repairs are not limited to rectifying defects that have already become serious. The Commissioner accepts that repairs include work done to remedy defects, damage or deterioration even though the work is partly (and even largely) done to prevent or anticipate defects or damage, or to rectify defects in their very early stages. However, the costs incurred by an oil refinery in encasing wooden piles on a wharf in concrete to stop marine organisms from further damaging the piles was considered to be an improvement, not a repair, since the work involved something more than the restoration of something lost or damaged (*BP Oil Refinery (Bulwer Island)*).

Maintenance work such as oiling or cleaning something that is in good working condition in order to prevent future defects is not a repair (but may be deductible under the general deduction provisions). It follows that preventative measures to control future health risks (eg asbestos and chlorofluorocarbon gases removal) will not qualify as a repair unless the work remedies a defect, damage or deterioration to property. Where such work does not qualify as a repair, the expense may be deductible under the general deduction provisions or as environmental protection expenditure (¶19-110). Work done to meet the requirements of regulatory bodies is only deductible as a repair if it is done to remedy defects, damage or deterioration to the property (TR 97/23).

No deduction is allowed for the cost of repairs to plant or equipment to the extent that it is used for the provision of non-deductible entertainment (¶16-390). For the types of repairs allowable to taxpayers in specific occupations, see the taxation rulings referred to at ¶16-635.

For the deductibility of natural disasters recovery expenses including repair costs, see ¶44-130.

"Initial repairs"

If an asset was in disrepair at the time of its acquisition, the cost of ''initial repairs'' to remedy those defects is of a capital nature and non-deductible (*Law Shipping*). This also applies in relation to property acquired by inheritance, and in relation to a purchaser who knew nothing of the defects until after the purchase. An apportionment on a time basis may be made to allow a deduction where the initial repairs remedy deterioration arising from the holding of the property for income purposes after its acquisition (TR 97/23). The cost of initial repairs is included in the cost base of the asset for CGT purposes (¶11-550) or depreciable cost of the asset (Chapter 17).

▶ Planning point

If property requiring repairs is to be transferred, effect the repairs *before* the transfer (with an appropriate adjustment to the purchase price).

Deductibility of warranty/maintenance repair costs

Costs (eg on labour and parts) incurred in carrying out repairs under a warranty or maintenance agreement are deductible under the general deduction provision in the year in which they are incurred. This may apply even though the business has ceased since the warranted goods were sold (¶16-010; ID 2002/174). Estimated repair costs are not deductible if there is no presently existing liability (TR 93/20) (¶16-040).

[FITR ¶65-120ff]

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Computer Hardware and Software

¶16-725 Deductions for computer hardware and software

Computer hardware costs

Computer hardware (eg laptops, screens, backup drives, routers, modems, and scanners) are normally depreciating assets, or parts of depreciating assets. Their cost may be written off as an ordinary capital allowance (Div 40; ¶17-330, ¶17-480), or as a small business capital allowance (Div 328; ¶7-250).

Computer software

Computer software is the digital system comprised of the programs, data and associated documentation, that instructs other parts of a computer, and may include website content. A general deduction is available for revenue expenditure on computer software used for income producing purposes (s 8-1; ¶16-010).

A capital allowance is available for "in-house software" (s 40-30(2)(d)) used for an income producing purpose usually over five years, or as part of a software development or low value pool (Div 40). Alternatively, the small business capital allowance regime may apply (Div 328; ¶7-250). Sometimes, an immediate deduction may instead be available for capital expenditure on in-house software. See ¶17-370 for further details.

To the extent that software costs are not general deductions (s 8-1; ¶16-010), or are not in-house software, the costs may be recognised in the CGT cost base of a CGT asset (typically, the first or fourth elements; s 110-25). Otherwise, as a last resort, the costs might be recognised as blackhole expenses (s 40-880; ¶16-156).

Deductions for expenditure on intellectual property and related expenditure are discussed at ¶16-727.

Commercial website costs

Business taxpayers will often incur expenditure on acquiring, developing, maintaining or modifying a website used in the business (commercial website expenses). The following table summarises the Commissioner's views (in TR 2016/3) about the characterisation of common commercial website expenses as deductible revenue expenses, or as capital expenses for which a capital allowance may be available (¶17-370):

Type of commercial website expense	Deductible revenue expense	Capital expense
Labour costs (eg employee or contractor costs)	• Website labour costs for operational matters	• Website labour costs that enhance a business's profit-yielding structure
Off-the-shelf software costs	• Periodic licence fees • Periodic payments to lease a commercial website from a web developer, provided the lessee does not have a right to become the website's owner	• Costs to acquire off-the-shelf products that enhance a business's profit-yielding structure
Usage fees	• Periodic operating or registration fees	*****

Type of commercial website expense	Deductible revenue expense	Capital expense
Website acquisition or development costs	*****	• Costs of acquiring or developing a website for a new or existing business (note: such expenditure might be for in-house software)
Website maintenance/ modification costs (*)	• Costs to make changes that add minor functionality or enhancements to an existing website • Costs to remedy software faults • Periodic costs to upgrade existing website software so webpages appear correctly on new mobile devices, browsers and operating systems • Costs to make routine or piecemeal modifications (eg ID 2003/931) • Costs to preserve the useful life of a website	• Costs to make changes that add new functionality (back-end or front-end), or that materially expand existing functionality, and which provide a structural advantage (see below) • Costs to replace a material part of a website • Modification costs related to a work program that significantly upgrades or improves a website • Costs to extend the useful life of a website
Content migration costs	• Content migration costs involved in upgrading an existing website, that do not significantly enhance or replace the website	• Content migration costs involved in establishing a new website
Social media costs	• Costs of maintaining a social media presence (eg updating social media content)	• Costs of establishing a presence on a social media site
(*) Some website maintenance activity requires no modifications (eg website monitoring). Other maintenance requires modifications, such as: updating content, embedding (plug-in) applications and security software, bug fixes, search engine optimisation (SEO), and data restoration after a power surge.		

The factors used to determine whether a modification represents a structural advantage to a business include: the website's role in the business; the nature of the modification to the website; the degree of planning and amount of resources employed in effecting the modification; the level of approval required for the modification; and the expected useful life of the modification.

Commercial website costs are not deductible to the extent they are incurred in producing exempt income or non-assessable non-exempt (NANE) income. If commercial website costs are partly on revenue and capital account, they are apportioned on a reasonable basis.

Commercial website costs of a capital nature may be incurred before a business commences (eg as part of a hobby). If such costs form part of the cost of a depreciating asset (namely, the website), then the decline in value and adjustable value of the website is calculated from the time it is held (s 40-60; ¶17-480). The private-use component of the decline in value will obviously not be deductible.

Domain names

The Commissioner's view is that domain name usage rights (along with computer hardware, and website content with an independent value to a business) are not considered part of a commercial website. Domain name registration costs and server hosting fees that relate to a taxpayer's business are usually deductible revenue expenses (s 8-1).

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A domain name can not be owned; but, a right to use a domain name can be owned and sold separately from a website's software. Such a right is a CGT asset, which can lapse if registration is not maintained.

The right to use a commercially desirable domain name can have considerable market value which does not diminish over time. A one-off payment to secure the right to use a domain name (eg through a public auction) is likely to be capital expenditure, and included in the first element of the right's CGT cost base. Where a right to use a new domain name is not secured by payment and has no market value, but is acquired only in conjunction with paying a registration fee for the initial period, the CGT cost base of the right would be nil (TR 2016/3).

[FITR ¶32-675; ¶86-915]

Intellectual Property

¶16-727 Deductions for intellectual property and related expenditure

Intellectual property (IP) is defined for tax purposes (tax IP) as the rights an entity has as the owner or licensee of a patent, registered design or copyright (or equivalent rights under a foreign law): s 995-1. Although narrower than the legal concept of IP, the tax IP concept is mainly relevant to the deductibility of expenditure under the capital allowance regime (see below) where it is not held as trading stock. The tax IP definition excludes, for example, rights under trademarks and plant breeder's rights. Rights relating to intangible assets such as goodwill, unregistered trademarks, domain name rights and business name rights are also excluded. The principles set out below apply to expenditure on both tax IP and expenditure on related intangible assets and rights, unless specific reference is made to tax IP.

IP expenditure is deductible when incurred provided the necessary connection exists between the expenditure and the assessable income producing activity, and the expense is of a revenue nature (s 8-1; ¶16-010). For example, patent renewal fees, salary or wage costs incurred to maintain software, and costs of acquiring IP held as trading stock on hand are deductible under s 8-1 if the necessary connection exists. Royalties paid periodically for the use of another entity's IP in the ordinary course of the taxpayer's business are deductible under s 8-1, provided withholding tax is paid if the recipient is a non-resident: s 26-25 (¶22-030). Revenue costs incurred to enable a licensee to use the taxpayer's IP are deductible under s 8-1, if the amounts received for granting the right (eg royalties) are assessable income (¶10-510).

IP expenditure of a capital nature is not deductible under s 8-1 and the tests outlined in ¶16-060 are used to characterise the expense.

Capital allowance (or depreciation) deductions are available for items of tax IP (not held as trading stock), in-house software (¶17-370), and other intangible assets included in the s 40-30 "depreciating asset" definition (¶17-015), to the extent they are used for an income producing purpose. An explanation of the costs which may be included when depreciating tax IP commences at ¶17-080. The effective life of IP-related depreciating assets is set out in s 40-95(7) (¶17-280). The prime cost method (¶17-490) is used to calculate the decline in value of tax IP. An immediate deduction is available in limited situations where the cost does not exceed $300 (¶17-330) or $100 for business taxpayers (¶16-153). In some cases, pooling rules may apply to low-cost tax IP assets (¶17-810) and expenditure on in-house software may be allocated to a software development pool (¶17-370). Capital costs incurred in seeking to obtain a right to tax IP may qualify as a project amount (s 40-840(2); ¶19-060) with a deduction potentially available under the project pool expenditure rules (¶19-050).

The disposal of tax IP on capital account, which was held for an income producing purpose, will trigger a balancing adjustment event with a deduction available if the termination value (¶17-640) is less than the adjustable value (¶17-485) (and an assessable

income inclusion arising in the converse situation): s 40-285 (¶17-630). The disposal of tax IP on capital account, which was held partly for an income producing purpose, may result in a capital gain or loss under CGT event K7 (¶11-350).

Small business entities can choose to take advantage of the capital allowance rules discussed at ¶7-250 when depreciating and disposing of tax IP on capital account.

The grant or assignment of an interest in tax IP (eg by way of a licence) on capital account results in: (i) the original tax IP asset being split into two parts; (ii) a disposal of the part that is the subject of the grant or assignment; and (iii) a balancing adjustment event occurring for the disposed part, which may give rise to a deduction (or an assessable income inclusion) depending on the calculation (s 40-115(3); ¶17-630). The grant or assignment of interests in CGT assets that are not tax IP (on capital account) might result in a capital gain or loss from CGT event D1 (¶11-280). If so, only non-deductible incidental costs (¶11-550) relating to the creation of the relevant rights are included to reduce the capital gain or increase the capital loss: s 104-35.

Companies that incur IP expenditure related to eligible research and development activities may qualify for a tax offset rather than a deduction (¶20-150).

A deduction for the decline in value of film copyright acquired from 1 July 2004 is generally available over its effective life using the prime cost method (¶17-490) or diminishing value method (¶17-500). The cost of the copyright may be reduced if the "producer offset" is available (¶20-340). Other concessions related to films are outlined at ¶20-330.

The cost of tax IP and other related assets might be reset when transferred into a consolidated group by a joining entity, which can affect the head company's capital allowance deductions and CGT exposure on any subsequent disposal: s 701-55 (¶8-210; ¶8-220). The tax cost of IP and other related assets that a subsidiary takes with it when exiting a consolidated group is explained at ¶8-400.

Goodwill, trademarks, domain name rights and business name rights are CGT assets and IP expenditure that satisfies the cost base (or reduced cost base) elements (¶11-550) is recognised in calculating the capital gain or loss on their disposal to the extent the costs have not already been deducted. The CGT discount (¶11-033) or small business CGT concessions (¶7-110) might be available for the disposal of such CGT assets.

If IP-related capital costs are not deductible elsewhere and are not included in the cost base (or reduced cost base) of a CGT asset (eg capital expenditure to acquire or develop trade secrets or know-how), then they might be deductible as a business-related capital cost under s 40-880 (¶16-156).

Non-arm's length amounts paid by an Australian enterprise to a foreign associate for IP-related expenditure might be adjusted under the transfer pricing rules thereby affecting the deductibility of the expenditure (¶22-580). The receipt of a royalty from a non-resident might give rise to a foreign income tax offset (and not a deduction) for foreign royalty withholding tax (¶21-670).

[FITR ¶86-910]

Spare Parts

¶16-730 Deductions for spare parts

Expenditure on spare parts and consumable stores is deductible as an ordinary business expense (ITAA97 s 8-1). The deduction may be claimed on an "expenditure incurred" basis (ie in the year of purchase) where the intention is simply to ensure continuity of production. Where, however, a store of spare parts is being built up, the

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Commissioner considers that the deduction is more properly claimable on a "usage" basis — ie in the year in which the particular item is used (IT 333). For the deductibility of spares purchased with plant, see ¶17-015.

As to whether spare parts are included in *trading stock*, see ¶9-150. As to deductions for large-scale purchases of low-cost items, see ¶16-153, ¶17-330, ¶17-810 and ¶7-250.

[FITR ¶33-640]

Interest

¶16-740 Deductions for interest expenses

Interest is deductible to the extent to which it is incurred in gaining or producing assessable income or in carrying on a business for that purpose and is not of a capital, private or domestic nature (ITAA97 s 8-1). Interest is not normally a capital outgoing because it is a recurrent expense which does not secure an "enduring advantage"; rather, it simply secures the use of borrowed money during the term of the loan. This applies even where the borrowed funds are used to purchase a capital asset (*Steele*). Interest paid to secure a capital sum or keep it in circulation was on revenue account (*Ashwick (Qld)*). However, no deduction is available for interest on borrowings relating to the production of exempt income (*Case Y5*; *Case Z33*).

The same principles apply to determine the deductibility of both ordinary interest and compound interest as both are simply the cost of borrowed funds (*Hart*; *R & D Holdings*). The deductibility of compound interest is not necessarily determined by the use to which the original loan funds were put (TD 2008/27).

▶ Planning point

Interest to acquire vacant land which did not produce income is not deductible but may form part of cost base of assets acquired after 20 August 1991 (¶11-550), which however is not subject to inflation indexing (where applicable) and is not taken into account in calculating a capital loss.

The "use" and "purpose" test

In determining the deductibility of interest, the courts and tribunals have looked at the purpose of the borrowing and the use to which the borrowed moneys have been put (TR 2004/4). For example, interest on borrowed moneys may be deductible where the moneys are used to acquire income-producing assets (eg property for rental, shares for dividends: IT 2606, but not options: TR 2004/4), to finance business operations (eg as working capital) or to meet current business expenses (eg overdraft moneys used to pay business outgoings such as wages, purchase of trading stock or materials). The security given for the borrowed money is totally irrelevant (TD 93/13). Penalty interest for early repayment of a loan will generally be deductible if the payment is made to rid the taxpayer of a recurring obligation to pay interest on the loan where the interest would itself have been deductible if incurred (TR 93/7). For the deductibility of interest on funds borrowed to pay tax, see ¶16-856.

Debenture interest payments made by a bank to a subsidiary were of a capital nature because the predominant purpose of the payments was to enable it to comply with the capital adequacy requirements thus securing a structural advantage (*St George Bank*; see also *Macquarie Finance Ltd*). Such payment would now be subject to the rules referred to at ¶23-100 and ¶23-020.

In PR 2010/16 and PR 2010/17 (Investments in Macquarie Flexi 100 Trust June 2010 Offer), the Commissioner accepted the deductibility of interest under full recourse and limited recourse borrowings.

Relevance of other factors and "negative gearing"

While the main test is the "use" test, it may also be necessary to consider other factors in particular circumstances, eg where the interest on the borrowings exceeds the return on the investment. In *Fletcher's case*, which involved a complex and highly artificial annuity scheme, the income derived from the annuity was less than one-eighth of the deduction claimed for interest. The High Court accepted that the interest was deductible to the extent of the income derived. However, beyond that point, the deductibility of the interest had to be determined by weighing up the whole set of circumstances, including the direct and indirect objects and advantages that the taxpayer sought in making the outgoing. The court took the view that if, on consideration of all those factors, the whole of the interest could be characterised as "genuinely and not colourably incurred in gaining or producing assessable income", the interest would be fully deductible. If only part of the outgoing could be so characterised, apportionment between the pursuit of assessable income and of other objectives was necessary. See also *Spassked*. In TR 95/33, the Commissioner accepts the effectiveness of commonly encountered negative gearing arrangements (¶31-170). It is important to note that the relevant factual considerations can change over the term of the loan so that the facts relevant to the criteria for deductibility in one year will not necessarily mirror those in another year (*Spassked*; TD 2008/27).

Where the taxpayer had no intention or expectation to derive assessable income by reason of its borrowings and continued, deliberately, not to derive dividend income, the occasion of the incurrence of the interest was the creation of the deduction in a non-income earning company which was in a position to transfer the resulting losses to other group companies, and therefore no interest was deductible (*IEL Finance*).

If funds are borrowed for income-producing purposes as part of a larger loan, the interest is deductible if the taxpayer is able to trace the original borrowing to the funds on which the interest accrues (*Case 14/2000*).

▶ Planning point

An outgoing may be deductible in a year of income although the assessable income motivating the outgoing is not generated until a subsequent year of income. Where deductions associated with an investment exceed the assessable income derived from the investment in a particular income year, the excess can be used to reduce the tax payable on other assessable income of the investing taxpayer. Therefore, negative gearing can be particularly useful to taxpayers on high incomes.

Where borrowed funds are on-lent

A similar approach to that in *Fletcher's case* was taken in *Ure's case* where the taxpayer borrowed money at commercial rates of interest (up to 12.5%) and on-lent it to his wife and a family company at 1% interest — they in turn used the money for non-business purposes. The deduction for interest was limited to the 1% interest returned as assessable income. In *Tanti*, no deduction was available for interest paid by the sole shareholder and director on funds borrowed and on-lent interest-free to an unprofitable company as there was no prospect of deriving any income from the company, whether as dividends or interest (*Case 26/94*; *Brian Reilly Freighters*). Similarly, interest incurred on funds borrowed and on-lent to a company by a joint shareholder and director was not deductible as there was no connection between the interest and the gaining or deriving of assessable interest or dividends by the taxpayer (*Knox*).

On the other hand, in the case of a continuing business, the fact that a low rate of interest or no interest at all is charged by the taxpayer for borrowed moneys on-lent to an associated entity may not necessarily preclude a deduction for the whole of the interest. This is illustrated by the *Total Holdings case* where money was on-lent interest-free to a subsidiary with the intention that, once the subsidiary became profitable, the profits would be remitted to the parent company by way of dividends and interest. The Commissioner has said that a deduction will be allowed in a substantially similar case (IT

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2606). Thus in *Economedes*, a deduction was allowed for interest on borrowed funds which were on-lent by the taxpayer to a company controlled by him and his wife, on the basis that the loan was intended to render the company profitable as soon as possible.

Interest and bank expenses incurred on money borrowed from a foreign bank, which the taxpayer on-lent immediately on receipt to associated companies by way of interest-free loans, were not connected with the production of any assessable income and could not be deducted (*Fitzroy Services*; ¶16-010). In *Rawson Finances Pty Ltd*, the taxpayer established that funds received from a foreign bank were loans (and not income as alleged by the Commissioner), as this reflected the intended and enforceable reality of the transactions. It followed that interest payments on the contentious loans were deductible because they were incurred in deriving income from related entities to which the taxpayer had on-loaned the funds.

For further examples involving company groups, see *Metropolitan Oil Distributors (Sydney)*; *Rocca* and TD 2004/36.

Preservation of income-producing assets

Interest on borrowings applied to private purposes (eg the purchase of a residence) is not deductible, even though the borrowing enables the taxpayer to use other funds or existing investments to produce assessable income, eg by renting out a former residence or by keeping other funds on high interest-bearing deposit (*Case Z18*). Similarly, interest on money borrowed to satisfy a Supreme Court order under testator family maintenance provisions was not deductible, even though the loan enabled the executor to retain the income-producing assets of the estate without encumbrance (*Hayden*).

Linked or split loans, redraw or credit line facilities

A typical "linked" or "split" loan facility involves two or more loans or sub-accounts. One is for private purposes and the other(s) for business purposes. Repayments are allocated to the private account and the unpaid interest on the business account is capitalised. This maximises the potential interest deduction by creating interest on interest. However, in *Hart*, the High Court ruled that the arrangement triggered the general anti-avoidance provisions of ITAA36 Pt IVA and that the additional interest was not deductible (¶31-170). In TD 2012/1 the Commissioner takes the view that the general anti-avoidance provisions could apply to "investment loan interest payment arrangements" despite the taxpayer's purpose of "paying their home loan off sooner". See also TR 98/22.

In contrast, interest incurred under a refinanced investment loan of the kind set out in PR 2013/22 or PR 2014/7, which is part of a scheme designed to accelerate the repayment of a refinanced home loan, is deductible. Some distinguishing features of these schemes is that they do not involve: (i) the capitalisation of any interest or a line of credit for the investment loan; (ii) a linked or split loan facility as set out in TR 98/22; or (iii) an "investment loan interest payment arrangement" as described in TD 2012/1.

Non-capital costs of ownership that are disallowed under ITAA36 Pt IVA do not form part of the cost base of an asset unless the Commissioner makes a compensating adjustment to that effect. However, in the case of split loan arrangements, a compensating adjustment is not available (TD 2005/33).

The Commissioner adopts the same approach to certain line of credit facilities that involve capitalisation of interest (TD 1999/42). Where no capitalisation of interest is involved, and funds drawn down on a line of credit facility or a redraw facility are used only partly for income-producing purposes, interest on the funds is apportioned between the income-producing and the other purposes in accordance with the principles set out in TR 2000/2. The deductibility of interest on a further borrowing of money under a redraw or line of credit facility depends upon the use to which the funds redrawn or drawn down are put, regardless of the purpose of the original borrowing. See also *Domjan*.

The Commissioner has questioned the deductibility of interest under "mortgage management" arrangements in which the taxpayer refinances a home loan and establishes purported investment loans to fund the purchase of shares in companies controlled by the promoter of the arrangement (TA 2009/20).

"Refinancing" principle

Interest on money borrowed by a partnership to repay money advanced by a partner, which was used as working capital, is deductible (*Roberts & Smith*). This "substitution of partnership capital principle" or "refinancing principle" applies to allow companies a deduction for interest on borrowings to fund a declared dividend or a repayment of share capital, where the payment is made out of a realised profit reserve or out of capital or working capital employed in the company's income-producing business (TR 95/25). For the application of the refinancing principle to trusts and to partnerships, see ¶6-080 and ¶5-070 respectively.

Connection with income of earlier years

In accordance with general principles (¶16-010), interest on funds used to purchase a business remains deductible if the occasion of the outgoing is found in the taxpayer's income-producing business operations, even if the interest is incurred in a year later than the year in which the income was derived, or the business has ceased to exist or the assets representing those funds have been lost to the taxpayer.

For example, in *Brown*, a deduction was allowed for interest on a loan used to purchase a business where the interest was incurred during a period after the business had been sold. Similarly, in *Jones*, interest on a loan taken out to purchase equipment for a partnership business was held to be deductible for some time after the business ceased on the death of one of the partners. The deduction continues to be available even after the loan has been re-financed and even though the taxpayer has the legal right to repay the loan early, thus preventing further interest accruing. However, in the case of a "roll-over" business loan facility, as distinct from a loan that runs for an agreed term unless the taxpayer decides to repay early, the deduction may cease to be available if a taxpayer with the resources to pay out such a roll-over loan decides not to do so, and rolls the loan over instead (*Brown*; *Jones*).

In TR 2004/4, the Commissioner accepts that interest incurred after the cessation of the business activities may be deductible even though the loan is not for a fixed term, the taxpayer has the legal entitlement to repay the loan before maturity, with or without penalty, or the original loan is refinanced. However, no deduction is available if: (a) the loan is kept on foot for reasons unassociated with the former income-earning activities; or (b) the taxpayer makes a conscious decision to extend the loan for a commercial advantage unassociated with the former income-earning activities. Legal or economic inability to repay suggests that the loan was not kept on foot for purposes other than income-producing purposes. The same principles apply to non-business activities (eg passive investments).

In *Davies*, the amount of time that elapsed between when the loan was first taken out and when the taxpayer accepted liability to make payments on the loan, and the taxpayer's refusal to make payments on the loan, indicated that the connection between the payments and the income-producing activities no longer existed (*Riverside Road Lodge*; *Brown*; *Steele*). On the other hand, in *Guest* and *R & D Holdings* the connection was present despite a significant time period having elapsed. In *Willersdorf-Greene*, interest on a loan used to satisfy a guarantee which had been integral to the income-producing activities was deductible, even though the loan was taken out after the relevant income producing activities had ceased.

Interest incurred on a loan to acquire an asset after the asset has been disposed of, will only be deductible if the sale proceeds are used for income-producing purposes (TD 95/27).

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If the amount worked out using the formula is negative, the instalment for the third month of the instalment quarter is $0 and the taxpayer is able to revise the instalment income in the second instalment month and, if that is insufficient, the first instalment month.

The rules that apply to the operation and administration of quarterly PAYG instalment payers apply to monthly payers, including penalties where the varied instalment rate is too low.

[FTR ¶977-160]

Calculation of Instalment Income

¶27-260 General rule for calculation of instalment income

A taxpayer's instalment income for a period includes the taxpayer's ordinary income derived during that period, but only to the extent that it is assessable during the income year that is, or includes, the period (TAA s 45-120(1)).

▶ Example

A primary producer derives a tax profit of $500,000 from the forced disposal of live stock. The $500,000 would be considered to be ordinary income in the month/quarter/year derived. However, the primary producer can elect to spread this profit over a five-year period such that only $100,000 is assessable income in the year of derivation. In this case, only $100,000 is considered to be instalment income. In Years 2, 3, 4 and 5, the $100,000 returned as assessable income from the forced disposal does not constitute ordinary income and, therefore, is not part of the primary producer's instalment income for those years. Of course, the taxpayer's instalment rate could be expected to increase in this situation.

Ordinary income includes amounts such as sales (excluding GST and gross of expenses), fees, interest, dividends (excluding franking credits) and royalties (¶10-010). Ordinary income from shipping activities that relate to a vessel in respect of which the taxpayer expects to be issued with a shipping exempt income certificate can be excluded from instalment income (ID 2013/45).

An entity can include a net forex realisation gain in instalment income if the entity accounts for forex realisation gains and losses on a net basis in its books of account, and the net basis of accounting is reflected in the manner in which the entity reported information about forex realisation gains and losses in the income tax return (before reconciliation to taxable income) on which the instalment rate for that instalment period is based (PS LA 2005/17). However, the net forex realisation gain cannot include a forex realisation loss that is known to be material, at the time of determining instalment income. (Note that PS LA 2005/17 does not apply to individuals who do not derive income from a business or entities that pay PAYG instalments on the basis of GDP-adjusted notional tax.) A forex realisation gain made under ITAA97 s 775-55 upon payment for the acquisition of foreign currency denominated trading stock (other than livestock) is ordinary income (TD 2006/29).

Statutory income (eg capital gains) is not, as a general rule, included as part of a taxpayer's instalment income. Further, exempt income is not included as part of instalment income.

Special rules apply for calculating the instalment income of a partner in a partnership (¶27-265) and a beneficiary of a trust estate (¶27-270).

If there is no instalment income for a period, the taxpayer must advise the Commissioner of that fact.

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Statutory income included for some taxpayers

Financial arrangements

The definition of "instalment income" includes net gains (to the extent the gains equal or exceed the losses) from Div 230 financial arrangements, applicable to the first quarter of an income year following a TOFA entity's first base assessment that applied the TOFA provisions to their Div 230 financial arrangements. It does not apply to individuals, and entities whose only gains and losses are from financial arrangements that are qualifying securities. To ensure that there is no double counting of an ordinary or statutory income amount in instalment income calculations for any instalment period, where an amount of ordinary or statutory income is taken into account in working out a net TOFA gain for an instalment period (including nil), it is not taken into account again in the instalment income calculations for any instalment period.

Other statutory income

The instalment income of the following taxpayers for a period also includes statutory income that is reasonably attributable to the period and is assessable income of the income year that is, or includes, that period:

- complying and non-complying superannuation funds
- complying and non-complying ADFs
- PSTs (s 45-120(2)).

The instalment income of a life insurance company for a period also includes: (a) its statutory income to the extent that the statutory income is reasonably attributable to that period and is included in the complying superannuation class of its taxable income (¶3-490) for the income year that is, or includes, that period; and (b) any part of its statutory income (other than net capital gains) that is included in the ordinary class of its taxable income for that income year (s 45-120(2A)). These rules apply, not only to an entity that is itself a life insurance company, but also to a head company of a consolidated group or provisional head company of a MEC group that is taken to be a life insurance company because a subsidiary member of the group is a life insurance company.

PAYG withholding payments

Generally, a taxpayer's instalment income does not include: (a) amounts that have been, or should have been, subject to PAYG withholding (¶26-120); or (b) personal services amounts required to be included in a taxpayer's assessable income and for which amounts are required to be paid under TAA Sch 1 Div 13 (¶26-280) (s 45-120(3)).

However, amounts that have been subject to PAYG withholding because the taxpayer failed to quote a TFN or an ABN (¶26-200) will be included in instalment income.

Farm management deposits

If a taxpayer makes a farm management deposit (FMD) (¶18-290) during a period, the taxpayer's instalment income for that period is reduced (but not below nil) by the amount of that deposit to the extent that the taxpayer reasonably expects to be able to claim a deduction for it for the income year that is, or includes, the period (s 45-120(4)). Conversely, where a taxpayer makes an FMD withdrawal during a period, the taxpayer's instalment income for that period includes that withdrawal to the extent that it is assessable income for the income year that is, or includes, that period (s 45-120(5)).

Clean energy initiatives

Instalment income for a period also includes an amount that is included in a taxpayer's assessable income under ITAA97 s 420-25 for the income year that is or includes that period because the taxpayer ceases to hold a registered emissions unit during that period (s 45-120(5A)).

[FTR ¶977-145]

¶27-265 Instalment income for partners in a partnership

The instalment income of a taxpayer who is a partner in a partnership at any time during a period includes an amount calculated in accordance with the following formula for each such partnership (TAA s 45-260):

$$\frac{\text{taxpayer's assessable income from the partnership for the last income year}}{\text{partnership's instalment income for that income year}} \times \text{partnership's instalment income for the current period}$$

The "taxpayer's assessable income from the partnership for the last income year" is so much of the taxpayer's individual interest in the partnership's net profit as was included in the taxpayer's assessable income for the most recent income year that ended before the start of the current period and for which the taxpayer has been assessed or has been advised by the Commissioner that no tax is payable. This will usually be the amount of the partnership distribution included in the taxpayer's assessable income for the income year that has most recently been assessed.

The "partnership's instalment income for that income year" is the instalment income for the partnership (calculated using all of the rules involving calculation of instalment income, including this one) for the most recent income year that ended before the start of the current period and for which the taxpayer has been assessed or has been advised by the Commissioner that no tax is payable.

The "partnership's instalment income for the current period" is the instalment income for the partnership for the current period. Therefore, the partnership will be required to calculate its instalment income on a monthly, quarterly and annual basis. Further, the partnership will need to notify each partner of the amount calculated in accordance with the above formula (or each of the components so that the partners can calculate the amount) on a monthly, quarterly and annual basis.

The amount included in a taxpayer's instalment income from a partnership is in addition to any other amounts already included in instalment income (eg other business income, interest and dividends). However, no deduction is made if the partnership is expected to make a loss.

The general rule in s 45-260 does not apply to a partner in a corporate limited partnership. Instead, the general rule in TAA s 45-120 (¶27-260) applies, and the partner includes in instalment income any distribution from the corporate limited partnership for the instalment period in which the distribution is made.

Instalment income may include a "fair and reasonable" amount

If the taxpayer's share from the partnership for the last income year or the partnership's instalment income for that year is nil or did not exist, the taxpayer's instalment income for the current period includes an amount that is fair and reasonable having regard to the following factors:

- the extent of the taxpayer's interest in the partnership during the current period
- the partnership's instalment income for the current period
- any other relevant circumstances (s 45-260(3)).

This could occur where the partnership is new or incurred a loss in the last year, or the taxpayer has only recently become a partner in the partnership. There is no guidance as to what may constitute "other relevant circumstances". This qualification has no application where the partnership's instalment income for the current period is nil.

See ¶27-270 for an example showing the calculation of instalment income for a taxpayer who is a partner in a partnership and also a beneficiary of a trust.

[FTR ¶977-195]

¶27-270 Instalment income for beneficiaries of a trust estate

If a taxpayer is a beneficiary of a trust estate at any time during the period, the general rule is that the taxpayer's instalment income, in relation to each trust of which the taxpayer is a beneficiary during the period, includes an amount calculated in accordance with the following formula (TAA s 45-280):

$$\frac{\text{taxpayer's assessable income from the trust for the last income year}}{\text{trust's instalment income for that income year}} \times \text{trust's instalment income for the current period}$$

The "taxpayer's assessable income from the trust for the last income year" is so much of the taxpayer's share of the net income of the trust as was included in the taxpayer's assessable income for the most recent income year that ended before the start of the current period and for which the taxpayer has been assessed or advised by the Commissioner that no tax is payable. This will usually be the amount of the trust distribution included in the taxpayer's assessable income for the income year that has most recently been assessed.

In general, a taxpayer's assessable income does not include a share of the trust net income that is attributable to a capital gain made by the trust. There are, however, two circumstances in which a capital gain is included: (a) if the beneficiary is an eligible ADF, an eligible superannuation fund or a PST; or (b) to the extent that the share of the trust's net income is included in the complying superannuation class of a life insurance company's taxable income (TAA s 45-290).

In determining the taxpayer's assessable income from the trust, only amounts assessed under ITAA36 Pt III Div 6 (¶6-080) are taken into account. Amounts assessed under other provisions (eg a distribution from a superannuation fund) are not included. Effectively, this means that only the flow-through distributions are included for this purpose. The PAYG instalment system applies separately to certain trustees where such trustees are taxable on some or all of the net income of the trust estate (¶27-500).

The "trust's instalment income for that income year" is the instalment income for the trust for the most recent income year that ended before the start of the current period and for which the taxpayer has been assessed or has been advised by the Commissioner that no tax is payable.

The "trust's instalment income for the current period" is the instalment income for the trust for the current period. Therefore, a trust will be required to calculate the trust's instalment income on a monthly, quarterly and annual basis. Also, on a monthly, quarterly and annual basis, the trustee will need to notify each beneficiary of the amount calculated in accordance with the above formula (or each of the components so that the beneficiaries can calculate the amount).

The amount included in a taxpayer's instalment income as a beneficiary is in addition to any other amounts already included in the instalment income.

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Instalment income may include a "fair and reasonable" amount

If the taxpayer's share of the net income of the trust estate for the last income year or the trust's instalment income for that year is nil or did not exist, the taxpayer's instalment income for the current period includes an amount that is fair and reasonable having regard to the following factors:

- the extent of the taxpayer's interest in the trust, or in the income of the trust, during the current period
- the trust's instalment income for the current period
- any other relevant circumstances.

This could occur where the trust is new or incurred a loss in the last year, or the taxpayer has only recently become a beneficiary of the trust. There is no guidance as to what may constitute "other relevant circumstances". This qualification has no application where the trust's instalment income for the current period is nil.

▶ Example

Calculation of instalment income for partner/beneficiary

During a particular instalment quarter (the current period), Marcia derived the following assessable income:

Gross sales	$45,000
Interest	$10,000
Unfranked dividends	$2,000
Net capital gain	$4,500

During the previous income year, Marcia was a beneficiary of the Jan Fan Trust. For that year, Marcia derived assessable income from the trust of $2,300 and the trust had total instalment income of $67,094. The Jan Fan Trust has informed Marcia that it has derived $23,000 instalment income for the current period.

Marcia has also gone into partnership with Greg and Peter during the current period. This partnership did not exist during the last income year. Under the partnership agreement with Greg and Peter, profits are to be divided equally. During the current period, the partnership derived instalment income of $3,300.

Marcia's instalment income for the current period is calculated as follows:

Instalment income = $45,000 + $10,000 + $2,000 + $788.45 (from the trust) + $1,100 (from the partnership)
= $58,888.45

The trust amount of $788.45 was calculated as follows:

Trust amount = $\frac{\$2,300}{\$67,094} \times \$23,000$
= $788.45

The partnership amount of $1,100 is a fair and reasonable amount given that the partnership did not exist last year and given Marcia's interest in the partnership and the instalment income derived by the partnership during the period.

The net capital gain of $4,500 is not included as it is not ordinary income and Marcia is not a superannuation fund, ADF, PST or life insurance company.

Exceptions to general rule in s 45-280

There are four exceptions to the general rule for calculating the instalment income of the beneficiary of a trust.

(1) The instalment income of a *beneficiary of a corporate unit trust or public trading trust* is calculated under the general rule in TAA s 45-120 (¶27-260). Such a beneficiary includes any distribution from the trust in its instalment income for the period in which the distribution is made (s 45-280(4)).

(2) *Beneficiaries who are absolutely entitled* to the assets of a trust include in their instalment income for an instalment period their proportionate share of the instalment income earned by the trust in that period (s 45-280(6)). This applies to a beneficiary where:

(a) the trustee's only active duties in managing the trust are to deal with trust income and trust capital according to the requests or directions of the beneficiaries

(b) the beneficiary is absolutely entitled to the trust assets, and

(c) the beneficiary has a vested and indefeasible interest in all of the trust income or, if there is more than one beneficiary, each beneficiary has a vested and indefeasible interest in a proportion of the trust income that corresponds with the beneficiary's proportional interest in the trust capital.

The beneficiary is treated as having received its share of the trust income as soon as that income is earned in the trust.

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(3) Certain *beneficiaries of broadly held resident investment unit trusts* calculate their instalment income by applying the rules in TAA s 45-285(1). The beneficiary's instalment income for an instalment period includes any trust income or trust capital that the trust distributes to them, or applies for their benefit. In working out the instalment income on this "receipts basis", it does not matter whether the trust income or trust capital is included in the beneficiary's assessable income for the income year in which the distribution or application occurs.

A *unit trust* is required to satisfy four conditions before the beneficiaries are entitled to determine their instalment income on this basis:

(a) the unit trust is resident

(b) the unit trust is broadly held, ie throughout the relevant instalment period the units in the unit trust are listed on a stock exchange in Australia or elsewhere, are offered to the public, or are held by at least 50 persons

(c) ownership of the trust is not concentrated in 20 or fewer individuals (tests about "ownership" of the trust are contained in TAA s 45-287)

(d) the trust's activities are limited to investment activities listed in the ITAA36 s 102M definition of "eligible investment business" throughout the relevant instalment period (these activities include investing in land to earn rent and investing or trading in various securities) (¶6-320).

(4) *Beneficiaries of certain other resident investment unit trusts* (ie certain "narrowly held" trusts) can determine their instalment income from the trust on a receipts basis if the unit trust and the beneficiary satisfy certain conditions (s 45-285(2)). The tests that the *unit trust* must satisfy are that:

(a) the unit trust is a resident trust

(b) the trust's activities consist only of activities listed in the s 102M definition of "eligible investment business".

The *beneficiary* must satisfy two conditions:

(a) the beneficiary is not required to include in instalment income the trust income or trust capital distributed to, or applied for, it under s 45-285(1) (ie under the exception in (3) above)

(b) the beneficiary must, throughout the instalment period, be one of the following: (i) the trustee of a broadly held resident investment unit trust that satisfies the four conditions in (3) above; (ii) exempt from tax; (iii) a complying superannuation fund, complying ADF or PST; (iv) a statutory fund of a life insurance company; or (v) the trustee of one or more trusts that meets specified requirements (TAA s 45-288), including that the beneficiaries are absolutely entitled to the assets of the trust.

A taxpayer's instalment income for a period also includes trust income or trust capital that a trust distributes to the taxpayer, or applies for the taxpayer's benefit, during that period in certain situations (s 45-286). This applies where:

(a) the income or capital is not included in the taxpayer's instalment income under s 45-280 or 45-285

(b) the trust satisfies the condition in s 12-400(1)(a) (¶26-267) in relation to the income year that is or includes that period

(c) the trust is a managed investment trust or is treated as a managed investment trust for that income year, and

(d) the trust meets the requirement in ITAA97 s 275-110 throughout the income year (ie it is not a corporate unit trust or trading trust).

The liability to PAYG instalments of *trustees* in respect of a beneficiary's share of the trust's net income, or the income to which no beneficiary is entitled, is discussed at ¶27-500.

[FTR ¶977-200]

Variation of Instalments

¶27-280 Variation of instalments based on instalment income

All monthly PAYG instalment payers and some quarterly PAYG instalment payers are ineligible to pay quarterly PAYG instalments based on GDP-adjusted notional tax. Further some quarterly payers, being eligible, have declined to use this method. Such taxpayers may wish to use an instalment rate other than that which has been advised by the Commissioner. Note that annual payers can use the instalment rate method but are not eligible to use a varied rate. (Variation of instalments by taxpayers who use the GDP-adjusted notional tax basis is discussed at ¶27-300.)

Some situations in which it may be appropriate to vary an instalment include:

- reducing or expanding investment activity (or receiving significantly lower or higher dividends from a share portfolio)
- changes in the level of business activity and, therefore, business income
- having much higher or lower than expected tax deductions for about the same level of investment and business income
- having repaid all amounts owed under HELP or Student Financial Supplement Scheme (SFSS)
- changes in business structure, eg mergers, takeovers or internal restructuring.

Once a taxpayer has decided to use a different instalment rate to that notified by the Commissioner, the varied instalment rate must be notified to the Commissioner in order to be effective (TAA s 45-210). This notification forms part of the Business Activity Statement or the Instalment Activity Statement (¶24-200, ¶24-220) and must be notified on or before the due date for payment of the instalment.

Once the Commissioner has been notified, the taxpayer must use that instalment rate for that instalment month or quarter, even if the Commissioner notifies the taxpayer of a different instalment rate after that time (TAA s 45-205). In fact, this rate must continue to be used by the taxpayer for the remaining months or quarters in the income year, unless the taxpayer chooses to use a different instalment rate and notifies the Commissioner accordingly. Therefore, a taxpayer can effectively vary the instalment rate up to four times (for quarterly payers) or 12 times (for monthly payers) in any given income year, once for each instalment period.

However, the varied instalment rate is only applicable for the income year for which it was notified to the Commissioner. For the subsequent income year, the taxpayer must either revert to using the rate most recently notified by the Commissioner, or again vary the instalment rate and notify the Commissioner accordingly.

A taxpayer may be liable for a penalty if the varied instalment rate is too low (¶27-320).

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Claiming a variation credit for previous overpaid instalments

If a taxpayer has already paid a monthly or quarterly PAYG instalment before choosing to use a varied instalment rate, the taxpayer may be entitled to claim a variation credit (TAA s 45-215). To claim such a credit, the instalment rate chosen for the calculation of the current monthly or quarterly instalment must be less than the instalment rate used to calculate the instalment for the previous instalment month or quarter (if any) in the same income year.

Further, the amount calculated in accordance with the following method statement must be positive.

Step 1: Add up all the instalments the taxpayer has paid, or is liable to pay, for the instalment periods in the current income year prior to the current instalment period (even if they have not yet been paid).

Step 2: Subtract from the step 1 amount each earlier variation credit that the taxpayer has claimed in respect of the current income year.

Step 3: Multiply the total of the taxpayer's instalment income for the earlier periods by the instalment rate to be used for the current period.

Step 4: Subtract the step 3 amount from the step 2 amount.

Step 5: If the result at step 4 is positive, this is the amount of the variation credit.

The variation credit claim must be made in the approved form on or before the day on which the instalment for the current quarter is due. Further, an entitlement to a variation credit does not affect the taxpayer's liability to pay an instalment. The variation credit claimed by the taxpayer will be credited to the taxpayer's running balance account (¶24-300).

▶ Example

The Merry Widow Axe Co Pty Ltd ("the taxpayer") is a quarterly payer and has been notified by the Commissioner of an instalment rate of 15%. The taxpayer uses that rate to calculate its first quarterly instalment for the income year. Its instalment income for that quarter is $80,000 and, therefore, its first instalment is $12,000.

The taxpayer's instalment income for the second quarter is $100,000. For the second instalment, the taxpayer notified the Commissioner that it wished to vary its instalment rate to 10%. The taxpayer's variation credit is determined as follows.

Step 1: The taxpayer's earlier instalments add up to $12,000.

Step 2: There were no previous variation credits, therefore no reduction is required.

Step 3: Multiply $80,000 by the varied rate of 10% = $8,000.

Step 4: $12,000 – $8,000 = $4,000.

Step 5: The amount at step 4 is positive, therefore, the variation credit is $4,000.

Thus, the taxpayer's second instalment is $10,000 ($100,000 × 10%) and the taxpayer may claim a variation credit of $4,000.

In the third instalment quarter, the taxpayer's instalment income was $70,000 and again the taxpayer chose to vary its instalment rate, this time to 8%. The taxpayer's variation credit for the third instalment quarter is determined as follows.

Step 1: The taxpayer's earlier instalments add up to $22,000.

Step 2: The taxpayer has previously claimed a variation credit of $4,000, therefore $22,000 – $4,000 = $18,000.

Step 3: Multiply $180,000 ($80,000 + $100,000) by the varied rate of 8% (ie $14,400).

Step 4: $18,000 – $14,400 = $3,600.

Step 5: The amount at step 4 is positive, therefore the variation credit is $3,600.

Thus, the taxpayer's third instalment is $5,600 ($70,000 × 8%) and the taxpayer may claim a variation credit of $3,600.

Where a taxpayer varies the instalment rate upwards, there is no need to make additional payments. However, the taxpayer may make voluntary payments if desired.

When a taxpayer makes a claim for a variation credit, the instalment income for all previous quarters is required. This information will also need to be advised to the Commissioner in order for the Commissioner to determine if the taxpayer is liable to a penalty where the varied instalment rate is too low.

[FTR ¶977-175]

¶27-300 Variation of instalments based on GDP-adjusted notional tax

A quarterly PAYG instalment payer who uses the GDP-adjusted notional tax basis can vary the amount of a quarterly instalment by making an estimate of benchmark tax (¶27-490) (TAA s 45-112). For situations in which such a variation may be appropriate, see ¶27-280.

The taxpayer must notify the Commissioner, in the approved form, of the estimated benchmark tax amount on or before the due date of the instalment (see ¶27-200 for when the instalment is due). In subsequent quarters, unless the taxpayer chooses to vary the estimated benchmark tax amount, the Commissioner will advise the taxpayer of the amount of the instalment and the taxpayer will have at least 21 days from the date of the notice in which to pay the instalment.

Once the Commissioner has been notified, the taxpayer must use that amount as the basis for calculating the instalment for that instalment quarter. This amount must be used by the taxpayer for the remaining quarters in the income year unless the taxpayer chooses to estimate a different benchmark tax amount for later instalment quarters and notifies the Commissioner accordingly. Therefore, a taxpayer can effectively vary the benchmark tax amount up to four times in any given income year, once for each instalment quarter.

However, the estimated benchmark tax amount calculated by the taxpayer is only applicable for the income year for which it was notified to the Commissioner. It does not carry over to subsequent income years.

Amount of instalments once a taxpayer has chosen to use benchmark tax

Taxpayers who pay four quarterly instalments

The amount of the instalment for an instalment quarter depends upon the number of the quarter (TAA s 45-410). That is, the first instalment quarter refers to the first instalment quarter for the current income year for which the taxpayer is liable to pay an instalment. This will usually be the first instalment quarter of the income year, but may be a later quarter if the taxpayer was not required to pay instalments for those previous quarters (eg because the Commissioner had not previously advised the taxpayer of an instalment rate).

The following table sets out the amount payable for a particular instalment where the taxpayer has chosen to pay instalments based on GDP-adjusted notional tax and has subsequently decided to work out instalments on the basis of an estimate of benchmark tax for that income year.

If the instalment quarter is:	The amount of the instalment is:
The first in that income year for which the taxpayer is liable to pay a PAYG instalment	25% of the estimated benchmark tax amount
The second in that income year for which the taxpayer is liable to pay a PAYG instalment	50% of the estimated benchmark tax amount, less the amount of any previous instalment in that income year
The third in that income year for which the taxpayer is liable to pay a PAYG instalment	75% of the estimated benchmark tax amount, less the amount of any previous instalments in that income year, plus any variation credit claimed in respect of the second instalment
The fourth in that income year for which the taxpayer is liable to pay a PAYG instalment	100% of the estimated benchmark tax amount, less the amount of any previous instalments in that income year, plus any variation credit claimed in respect of the second and third instalments

An instalment calculated in accordance with this table is only payable where the amount is positive. If the amount is negative, no amount is payable and the taxpayer may be entitled to a variation credit.

▶ Example

Rupert is eligible to pay his quarterly PAYG instalments on the basis of GDP-adjusted notional tax and has chosen to do so. Rupert did not choose to work out his first instalment on his estimate of benchmark tax. At the time Rupert's first instalment was payable, his GDP-adjusted notional tax was $26,000. Accordingly, the Commissioner notified Rupert of an instalment of $6,500.

During the second quarter of the income year, Rupert decided to estimate his benchmark tax amount at $14,000 and notified the Commissioner accordingly. Therefore, Rupert's second quarterly PAYG instalment is:

(50% × $14,000) – $6,500 = $500

For the third and fourth quarterly PAYG instalments, the Commissioner will notify Rupert of the amount payable. On the basis that Rupert does not wish to vary his estimate of benchmark tax, these instalments will each be $3,500.

Taxpayers who pay two quarterly instalments

The amount of the varied instalment depends on when the taxpayer is first provided with an instalment rate, as follows:

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Instalment quarter in which instalment rate is first notified	Instalment quarter for which the instalment is payable	Amount of instalment
Before the end of the first	Third	75% of the taxpayer's estimate of benchmark tax
	Fourth	100% of the taxpayer's estimate of benchmark tax, less the third instalment
During the second	Third	50% of the taxpayer's estimate of benchmark tax
	Fourth	75% of the taxpayer's estimate of benchmark tax, less the third instalment
During the third	Third	25% of the taxpayer's estimate of benchmark tax
	Fourth	50% of the taxpayer's estimate of benchmark tax, less the third instalment
During the fourth	Third	Not applicable
	Fourth	25% of the taxpayer's estimate of benchmark tax

Claiming a variation credit for prior overpaid instalments

Where an instalment calculated in accordance with either of the above tables is a negative amount, the taxpayer is entitled to a variation credit (TAA s 45-420). The amount of the variation credit is the negative amount expressed as a positive.

The variation credit claim must be made in the approved form on or before the day on which the instalment for the current quarter is due. Further, an entitlement to a variation credit does not affect the taxpayer's liability to pay an instalment. The variation credit claimed by the taxpayer will be credited to the taxpayer's running balance account (¶24-300).

[FTR ¶977-145, ¶977-240]

¶27-320 Penalties where the varied instalment rate is too low

A taxpayer is liable to GIC for each instalment month or quarter in which the taxpayer chooses to use an instalment rate that is less than 85% of the benchmark instalment rate (¶27-490) for that income year (¶27-280). GIC is payable on the following amount (TAA s 45-225; 45-230):

rate discrepancy × taxpayer's instalment income for the variation month or quarter + credit adjustment

The "rate discrepancy" is the difference between the varied instalment rate chosen by the taxpayer and the lesser of the following:

- the benchmark instalment rate
- the most recent instalment rate notified to the taxpayer by the Commissioner prior to the end of the instalment month or quarter.

The "credit adjustment" is only relevant where the taxpayer has claimed a variation credit in relation to the instalment month or quarter (¶27-280, ¶27-300). Where this has occurred, the credit adjustment is the lesser of:

- the amount of the credit actually claimed

- the amount calculated by multiplying the instalment income of the previous instalment months or quarters by the rate discrepancy.

▶ Example

Continuing the example of The Merry Widow Axe Co Pty Ltd from ¶27-280, the taxpayer's instalment income for the fourth instalment quarter was $50,000 and therefore the fourth PAYG instalment was $4,000. There was no variation credit for this quarter. After lodgment of the taxpayer's income tax return, the Commissioner determines that the taxpayer's benchmark instalment rate is 10%.

There will be no amount on which to impose GIC for the first instalment quarter as the taxpayer did not use a varied instalment rate for that quarter. Further, there will be no amount on which to impose GIC for the second instalment quarter as the taxpayer had chosen to use 10% for that quarter which is not less than 85% of the benchmark instalment rate.

The amount on which GIC will be imposed for the third instalment quarter is calculated as follows:

rate discrepancy × taxpayer's instalment income for the variation quarter + credit adjustment

= [(10% – 8%) × $70,000] + [lesser of $3,600 or (10% – 8%) × $180,000]
= $1,400 + $3,600
= $5,000

The amount on which GIC will be imposed for the fourth instalment quarter is calculated as follows:

[(10% – 8%) × $50,000] + [lesser of $0 or (10% – 8%) × $250,000]
= $1,000 + $0
= $1,000

[FTR ¶977-185]

¶27-330 Penalties where the estimated benchmark tax is too low

A taxpayer is liable to GIC for each instalment quarter in which the taxpayer chooses to use an estimate of benchmark tax (¶27-490) that is less than 85% of the benchmark tax amount for that income year as calculated by the Commissioner (¶27-300) (TAA s 45-232).

For a particular instalment quarter, GIC is imposed on the amount worked out as follows (if it is a positive amount):

acceptable amount of the instalment – actual amount

The "actual amount" is the amount of the instalment for the particular quarter as worked out in accordance with the applicable table at ¶27-300. However, where the taxpayer claimed a variation credit, the actual amount is the amount of that credit expressed as a negative.

The "acceptable amount of the instalment" is whichever of the following is applicable:

- if the taxpayer has not varied the particular instalment, or any earlier instalments in that income year — the amount notified by the Commissioner (which will be based on the GDP-adjusted notional tax of the taxpayer), or
- if the taxpayer has varied an instalment — the amount calculated using the applicable table below.

If the amount on which GIC is payable is negative, there is no GIC penalty for that instalment quarter.

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Instalment quarter in which instalment rate is first notified	Instalment quarter for which the instalment is payable	Acceptable amount of instalment
		(b) 50% of the benchmark tax amount for that income year
	Fourth	the lower of: (a) the amount the Commissioner would have notified the taxpayer as the amount of the instalment for that instalment quarter if the taxpayer had not chosen to vary the instalments (this will be based on GDP-adjusted notional tax), and (b) 75% of the benchmark tax amount for that income year less the sum of the acceptable amount for the earlier instalment quarter in that income year
During the third	Third	the lower of: (a) the amount the Commissioner notified the taxpayer as the amount of the instalment for that instalment quarter (this will be based on GDP-adjusted notional tax), and (b) 25% of the benchmark tax amount for that income year
	Fourth	the lower of: (a) the amount the Commissioner would have notified the taxpayer as the amount of the instalment for that instalment quarter if the taxpayer had not chosen to vary the instalments (this will be based on GDP-adjusted notional tax), and (b) 50% of the benchmark tax amount for that income year less the sum of the acceptable amount for the earlier instalment quarter in that income year
During the fourth	Third	Not applicable
	Fourth	the lower of: (a) the amount the Commissioner notified the taxpayer as the amount of the instalment for that instalment quarter (this will be based on GDP-adjusted notional tax), and (b) 25% of the benchmark tax amount for that income year

Reduction of amount on which GIC is imposed

The amount on which GIC is imposed can, in certain circumstances, be too high. This will occur where a taxpayer has estimated the benchmark tax for a quarter and that estimate was too low and, in a later instalment quarter in that income year, the taxpayer estimates the benchmark tax at a higher level. This upwards estimation has the effect of "catching-up" some of the previous underpayment.

The amount on which GIC is imposed for a particular instalment quarter is reduced if, in a later instalment quarter in the same income year, the amount worked out using the following formula is a negative amount (TAA s 45-233):

acceptable amount of the instalment for the later instalment quarter − actual amount of that instalment

The above amount, expressed as a positive, is called the "top up".

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The "actual amount of that instalment" is the amount of the instalment for the particular quarter as worked out in accordance with the applicable table in ¶27-300. However, where the taxpayer claims a variation credit, the actual amount is the amount of that credit expressed as a negative.

The "acceptable amount of the instalment for the later instalment quarter" is the amount calculated using the applicable table above.

A top up has the effect of reducing the amount on which GIC is imposed by that amount (but not below nil). Where the top up exceeds the amount on which GIC is imposed, any amount not applied can be carried forward to offset the amount on which GIC is imposed for a later instalment quarter in the same income year.

▶ Example 2

Continuing the example of Tony — assume that Tony made another estimate of his benchmark tax in the fourth quarter. This time he estimated that his benchmark tax would be $32,000. Accordingly, his instalment for the fourth quarter will be $11,000 (100% × $32,000 – $21,000).

Tony is still liable to the GIC penalty in respect of the second, third and fourth quarters as both of his estimates of benchmark tax are less than 85% of the amount of benchmark tax calculated by the Commissioner. However, the amount on which GIC is imposed for the fourth quarter is calculated as follows:

acceptable amount of the instalment – actual amount

= [$10,500 or (100% × $40,000 – ($10,500 + $9,500 + $10,000)), whichever is lower] – $11,000

= [$10,500 or ($40,000 – $30,000)] – $11,000

= $10,000 – $11,000

= ($1,000)

As this amount is negative, no GIC penalty will be imposed for the fourth quarter. Further, this means that there is a top up of $1,000. This amount will reduce the amount on which GIC will be imposed for the second quarter from $6,000 to $5,000.

Therefore, for the second quarter, GIC will be imposed on $6,000 for the period from 28 February to 28 July and on $5,000 for the period from 28 July to the due date for payment of Tony's assessed tax (or the date the assessed tax is paid if this is earlier).

Imposition of GIC

GIC is payable for each day in the period that:

- starts on the due date by which the instalment for the variation quarter is due to be paid, and
- finishes at the end of the day on which the taxpayer's assessed tax for the income year is due to be paid.

The Commissioner must give written notice of the liability to GIC, and the charge must be paid within 14 days of the notice being given. If GIC is unpaid at the end of those 14 days, additional GIC is payable on the unpaid GIC.

Payment of GIC is considered at ¶29-510; remission of GIC is considered at ¶29-530.

[FTR ¶977-185]

¶27-340 How an annual instalment payer varies an instalment

An annual instalment payer normally has three choices as to the amount of the annual instalment (TAA s 45-115; 45-175):

(1) the amount worked out by multiplying the Commissioner's instalment rate by the taxpayer's instalment income for the income year

(2) the most recently notified notional tax, or

(3) the taxpayer's estimate of benchmark tax.

Annual PAYG instalment payers cannot estimate an instalment rate as quarterly PAYG instalment payers can (¶27-280). If an annual taxpayer believes that the instalment rate is too high and the notional tax amount is also not appropriate, the taxpayer can pay a different amount by estimating benchmark tax. For situations in which such a variation may be appropriate, see ¶27-280. In this case, the taxpayer must notify the Commissioner in the approved form of the estimated benchmark tax amount on or before the due date of the instalment. The amount of the annual instalment is then the benchmark tax amount as estimated by the taxpayer.

Penalty where the estimated benchmark tax is too low

A taxpayer is liable to GIC if the taxpayer chooses to use an estimate of benchmark tax that is less than 85% of the benchmark tax amount for that income year as calculated by the Commissioner (TAA s 45-235).

The amount on which GIC is imposed is calculated as follows:

acceptable amount of the instalment – actual amount

The "actual amount" is the amount of the estimated benchmark tax advised by the taxpayer to the Commissioner (ie it is the amount of the instalment as estimated by the taxpayer).

The "acceptable amount of the instalment" is the lowest of the following:

- the most recent instalment rate given to the taxpayer by the Commissioner before the end of the income year multiplied by the taxpayer's instalment income for the income year
- the most recent notional tax amount notified to the taxpayer by the Commissioner before the end of the income year
- the taxpayer's benchmark tax amount for the income year as calculated by the Commissioner (¶27-490).

Calculation of GIC

GIC is payable for each day in the period that:

- starts on the due date of the instalment that is subject to the penalty, and
- finishes at the end of the date on which the taxpayer's assessed tax for the income year is due to be paid.

Payment and remission of GIC are considered at ¶29-510 and ¶29-530.

[FTR ¶977-165, ¶977-185]

Changing Instalment Frequency

¶27-380 Change from an annual instalment payer

Ceasing to be annual instalment payer immediately

A taxpayer ceases to be an annual instalment payer at the start of an instalment quarter if the taxpayer becomes the head company of a consolidated group or the provisional head company of a MEC group during that quarter. In this case, the taxpayer must pay an instalment for that instalment quarter and later instalment quarters. Such a taxpayer may again become an annual instalment payer if it ceases to be the head company of a consolidated group or provisional head company of a MEC group, satisfies the other conditions to be an annual instalment payer (¶27-170) and elects to do so (TAA s 45-160).

Ceasing to be an annual instalment payer at the end of the income year

A taxpayer ceases to be an annual PAYG instalment payer *at the end of an income year* if, during that year:

- the Commissioner notifies the taxpayer of a notional tax amount of $8,000 or more
- on the taxpayer's MPR test day, the taxpayer's base assessment instalment income is greater than the threshold (¶27-170), or
- the taxpayer chooses to pay PAYG instalments quarterly instead of annually (TAA s 45-155).

A taxpayer also ceases to be an annual PAYG instalment payer if, *during an instalment quarter*:

- the taxpayer becomes required to be registered for GST
- the taxpayer becomes a partner in a partnership that is required to be registered for GST
- a partnership in which the taxpayer is a partner becomes required to be registered for GST
- a taxpayer company becomes part of an instalment group or a participant in a GST joint venture, or
- an annual GST election for the taxpayer, or a partnership in which the taxpayer is a partner, ceases to have effect (TAA s 45-150).

Where these rules are satisfied, the taxpayer will commence paying monthly or quarterly instalments from the first instalment period of the following income year for which the taxpayer is required to pay an instalment. A taxpayer required to pay four instalments annually will commence paying quarterly PAYG instalments from the first instalment quarter of the following income year. A taxpayer eligible to pay two quarterly instalments annually will commence paying quarterly PAYG instalments from the third instalment quarter of the following income year. A taxpayer required to pay monthly instalments will commence from the first month of the following income year (although the legislation has "current year" which cannot be the intention — s 45-136(2)(b)). In all cases, taxpayers are still required to pay an annual instalment for the year in which they become ineligible to be annual PAYG instalment payers. Monthly or quarterly instalments continue to be payable after that time, unless and until the taxpayer again satisfies the requirements for being an annual PAYG instalment payer (¶27-170) and chooses to pay on that basis or the Commissioner withdraws the taxpayer's instalment rate.

[FTR ¶977-165]

¶27-420 Change from a quarterly instalment payer

Becoming an annual instalment payer

An eligible taxpayer can only choose to be an annual PAYG instalment payer before the due date of the first quarterly PAYG instalment that the taxpayer would otherwise be required to pay for the income year (TAA s 45-140(2)).

Becoming a monthly instalment payer

A taxpayer becomes a monthly payer if, on the taxpayer's MPR test day, its base assessment instalment income is greater than the threshold (¶27-170). Where this occurs, the taxpayer will commence paying monthly instalments from the first instalment month of the following income year. Such a taxpayer is still required to pay any remaining quarterly instalments for the year in which the taxpayer became a monthly payer.

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Monthly instalments continue to be payable after that time unless and until the taxpayer ceases to be a monthly instalment payer (¶27-430) or the Commissioner withdraws the taxpayer's instalment rate.

¶27-430 Change from a monthly instalment payer

A monthly instalment payer ceases to be a monthly payer for a later tax year where (TAA s 45-136(4)):

- on the taxpayer's MPR test day for that year (ie the first day of the third last month of the previous income year), the taxpayer's base assessment instalment income is less than the threshold (¶27-170), and
- the taxpayer gives the Commissioner a notice (an MP stop notice) in the approved form for that year before the start of that later income year.

Such a taxpayer is still required to pay any remaining monthly instalments for the year in which the taxpayer ceased to be a monthly payer.

The taxpayer will become a quarterly payer for the first instalment quarter of the later income year unless the taxpayer is eligible to pay an annual instalment and chooses to be an annual PAYG instalment payer before the due date of the first quarterly PAYG instalment that the taxpayer would otherwise be required to pay for the income year (TAA s 45-140(2)).

Calculations by the Commissioner

¶27-450 PAYG instalment rate

The Commissioner calculates a taxpayer's instalment rate (to two decimal places) using the following formula (TAA s 45-320):

$$\frac{\text{notional tax}}{\text{base assessment instalment income}} \times 100$$

If either the notional tax (¶27-460) or the base assessment instalment income is nil, the instalment rate is also nil.

Base assessment instalment income

The first step in determining the meaning of base assessment instalment income is to determine the taxpayer's "base year". This is the latest income year for which an assessment has been made. However, if the Commissioner is satisfied that there is a later income year for which the taxpayer does not have a taxable income and therefore no assessment has been made, the base year will be that income year. This could occur where the taxpayer is in a loss position in that year.

▶ Example 1

At the time the Commissioner is determining the instalment rate for Enterprises Ltd, the company has lodged its 2016/17 return and has been assessed. The company has also lodged its 2017/18 return which disclosed an overall loss for that year. The Commissioner will determine that Enterprises Ltd's base year is the 2017/18 income year.

The "base assessment" is the assessment for the base year. If the base year is one in which an assessment has not been made (eg because the taxpayer was in a loss position), then the base assessment is the return or other information from which an assessment for that year would have been made.

The "base assessment instalment income" is so much of the taxpayer's assessable income taken into account for the base assessment as the Commissioner determines is instalment income. For the definition of "instalment income", see ¶27-260.

▶ Example 2

In the assessment for her base year, Joan Smith derived $25,000 salary, $30,000 business income, $2,000 interest and incurred $10,000 in business expenses. Joan's base assessment instalment income is $32,000 (ie $30,000 + $2,000).

High instalment rates

There are situations where the instalment rate calculated using TAA Sch 1 s 45-320 can produce a very high rate. This is usually caused by amounts that are included in the calculation of notional tax but are not included in base assessment instalment income. Examples include employee share scheme income from deferral schemes, excess superannuation contributions, and the second to fifth years after a primary producer has received an amount on the forced disposal of livestock. In these situations, it is not uncommon for the instalment rate to be greater than 100%.

The Commissioner limits the instalment rate calculated using TAA Sch 1 s 45-320 to a "more reasonable rate" (see the ATO website at www.ato.gov.au/general/payg-instalments/calculating-the-amount-you-pay/high-instalment-rates-and-amounts). The reasonable rates are set out below:

Entity type	Reasonable rate
Individuals	55%
Trusts	55%
Superannuation funds and self managed superannuation funds	45%
Companies (including entities taxed as companies)	30%

[FTR ¶977-210]

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¶27-460 PAYG notional tax

A taxpayer's "notional tax" for the base year is calculated as follows (TAA s 45-325):

$$\text{adjusted tax on adjusted taxable income} - \text{adjusted tax on adjusted withholding income}$$

Where a taxpayer's adjusted tax on adjusted withholding income is greater than the adjusted tax on adjusted taxable income for the base year, the notional tax is nil.

In working out a taxpayer's notional tax, the Commissioner may take account of:

- changes in the law that may reasonably be expected to apply to the year for which the Commissioner is calculating the instalment rate and which did not apply in the base year
- proposed changes in the law that, in the Commissioner's opinion, are likely to be enacted and have the effect of lowering the taxpayer's instalment rate.

The calculation of a superannuation or RSA provider's notional tax is modified to ensure that no-TFN contributions income and the tax offset for no-TFN contributions income are not taken into account. However the contributions are still assessable contributions that are taken into account when working out the provider's notional tax and base assessment instalment income.

Adjusted taxable income

A taxpayer's "adjusted taxable income" for the base year is the taxpayer's total assessable income for the base year, reduced by (TAA s 45-330):

- any net capital gains included in assessable income (except if the taxpayer is a superannuation fund, an ADF or a PST)

- all deductions allowed for the base year, except tax losses
- if the taxpayer is a company or it is a head company that had tax losses transferred to it under ITAA97 Subdiv 707-A, the lesser of:
  - any tax loss to the extent that it can be carried forward to the next income year, and
  - the deduction for tax losses claimed in the base year, and
- if the taxpayer is neither a company nor a head company that had tax losses transferred to it under Subdiv 707-A, any tax loss to the extent that it can be carried forward to the next income year.

The adjusted taxable income of a life insurance company is calculated using the formula in s 45-330(3).

Adjusted withholding income

A taxpayer's "adjusted withholding income" for the base year is the amount of assessable income from which PAYG withholding has been, or should have been, made for the base year (¶26-120) (except for amounts that have been subject to PAYG withholding because the taxpayer did not quote a TFN or an ABN), reduced by the deductions allowed for the base year to the extent that they reasonably relate to those amounts (TAA s 45-335).

There is no legislative guidance as to what deductions reasonably relate to the amounts from which PAYG withholding has been, or should have been, made. There is also no mention of how such deductions are to be allocated where they do not fully relate to PAYG withholding income.

Adjusted tax

Calculation of the adjusted tax on either the adjusted taxable income or the adjusted withholding income is a four-step process (TAA s 45-340).

Step 1: Calculate the income tax payable on the adjusted taxable income or the adjusted withholding income (as relevant). The following tax offsets are disregarded:

- private health insurance offset (¶15-330)
- tax offset arising from franking deficit tax liabilities (¶4-780)
- low income rebate/tax offset (¶15-300)
- offset for superannuation contributions made on behalf of the taxpayer's spouse (¶13-770)
- offset for Medicare levy surcharge (lump sum payments in arrears) (¶15-350)
- offset for early stage investors in innovation companies (¶20-700), and
- the junior minerals exploration incentive tax offset (¶19-010).

Step 2: Calculate the Medicare levy payable on the adjusted taxable income or the adjusted withholding income (as the case may be), disregarding the Medicare levy surcharge.

Step 3: Calculate the amount of any HELP or SSL debt and/or FS or TSL assessment debt that would have been repayable for the base year on the assumption that the taxpayer's taxable income was equal to the adjusted taxable income or the adjusted withholding income (as the case may be).

Step 4: Add up the amounts determined for steps 1, 2 and 3.

▶ Example 1: Corporate taxpayer

Happy Toys Ltd derived the following assessable income during the base year:

Gross sales	$120,000
Interest	$10,000
Royalties	$25,000

It incurred the following deductions during the base year:

Cost of sales	$50,000
Tax agent's fees	$2,000

Happy Toys Ltd did not quote its TFN in relation to the interest income and, consequently, tax was withheld. On the assumption that Happy Toys is a small business taxpayer and the tax rate of 27.5% applies for the year for which the instalment rate is calculated, Happy Toys Ltd's instalment rate is calculated as follows:

Happy Toys Ltd's adjusted taxable income = assessable income of base year − net capital gains of base year − allowable deductions (except tax losses) of base year − tax losses carried forward from base year

= $155,000 − $0 − $52,000 − $0

= $103,000

Happy Toys Ltd's adjusted withholding income = nil, since amounts subject to PAYG withholding due to the non-quotation of either the taxpayer's TFN or ABN do not count

Adjusted tax on adjusted taxable income

Step 1:	=	Income tax payable on $103,000
	=	27.5% × $103,000
	=	$28,325
Step 2:		Not applicable
Step 3:		Not applicable
Step 4:		Add Steps 1 to 3
	=	$28,325 + $0 + $0
	=	$28,325

Happy Toys Ltd's notional tax is therefore $28,325.

Happy Toys Ltd's base assessment instalment income equals so much of its assessable income for the base year that is instalment income. This would be $155,000 (ie $120,000 + $10,000 + $25,000).

$$\text{Happy Toys Ltd's instalment rate} = \frac{\text{Happy Toys Ltd's notional tax}}{\text{Happy Toys Ltd's base assessment instalment income}} \times 100$$

$$= \frac{\$28,325}{\$155,000} \times 100$$

= 18.27% (rounded to two decimal places)

▶ Example 2: Individual taxpayer

Hilary derived the following assessable income during the year ended 30 June 2017 (the base year):

Salary	$30,000
Net capital gain	$12,000
Interest	$8,000
Dividends (fully franked from a large public company)	$2,000
Dividend gross-up amount ($2,000 × 30/70)	$857

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She incurred the following deductions during the base year:

Work-related expenses	$800
Interest and dividend deductions	$200

Hilary did not quote her TFN in relation to the interest income and, consequently, tax was withheld. Further, on her assessment for the year ended 30 June 2018, Hilary was allowed an offset for a superannuation contribution she made on behalf of her spouse, Herbert. Hilary does not have an HELP or SSL debt or an FS or TSL assessment debt. Using the personal tax rates for the year ending 30 June 2019 (as at the time of publication), Hilary's instalment rate is calculated as follows:

Hilary's adjusted taxable income	=	assessable income of base year	–	net capital gains of base year	–	allowable deductions (except tax losses) of base year	–	tax losses carried forward from base year
	=	$52,857 – $12,000 – $1,000 – $0						
	=	$39,857						

Hilary's adjusted withholding income = $30,000 – $800
= $29,200

The interest subject to PAYG withholding due to the fact that Hilary did not quote her TFN does not count as adjusted withholding income.

Adjusted tax on adjusted taxable income

Step 1:	=	Income tax payable on $39,857
	=	Tax on $39,857 using 2018/19 rates (¶42-000) – franking credit of $857
	=	$4,500.52 – $857
	=	$3,643.52
Step 2:	=	Medicare levy on $39,857
	=	$39,857 × 2%
	=	$797.14
Step 3:		Not applicable
Step 4:		Add steps 1 to 3
	=	$3,643.52 + $797.14 + $0
	=	$4,440.66

Adjusted tax on adjusted withholding income

Step 1:	=	Income tax payable on $29,200
	=	Tax on $29,200 using 2018/19 rates (¶42-000)
	=	$2,090
Step 2:	=	Medicare levy on $29,200
	=	$29,200 × 2%
	=	$584
Step 3:		Not applicable
Step 4:		Add steps 1 to 3
	=	$2,090 + $584 + $0
	=	$2,674

Hilary's notional tax is therefore $1,766.66 (ie $4,440.66 – $2,674).

Hilary's base assessment instalment income equals so much of her assessable income for the base year that is instalment income. This would be $10,000 (ie $8,000 + $2,000). The dividend gross-up amount is not instalment income as it is statutory income.

$$\text{Hilary's instalment rate} = \frac{\text{Hilary's notional tax}}{\text{Hilary's base assessment instalment income}} \times 100$$

$$= \frac{\$1,766.66}{\$10,000} \times 100$$

= 17.67% (rounded to two decimal places)

Special rules provide a methodology for the Commissioner to work out one or more instalment rates for a trustee who has more than one PAYG instalment liability in respect of:

- a beneficiary under a legal disability
- a beneficiary that has a vested and indefeasible interest in the trust income but cannot require the trustee to pay that amount to them, and
- income to which no beneficiary is entitled (¶27-500).

[FTR ¶977-210]

¶27-470 GDP-adjusted notional tax

The Commissioner calculates GDP-adjusted notional tax in much the same way as notional tax is calculated (¶27-460). However, the adjusted taxable income for the base year is increased by the GDP adjustment and the adjusted tax is calculated based on this increased adjusted taxable income. Further, the adjusted withholding income for the base year is also increased by the GDP adjustment and the adjusted tax is calculated based on this increased adjusted withholding income.

The GDP adjustment was 4% for 2017/18 and 6% for 2018/19.

[FTR ¶977-235]

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¶27-490 Benchmark tax and benchmark instalment rate

The calculations of benchmark tax and the benchmark instalment rate are used to determine a taxpayer's liability to penalties where the taxpayer has varied the PAYG instalment rate (¶27-280 – ¶27-380).

Benchmark tax

Benchmark tax is calculated as follows (TAA s 45-365):

adjusted assessed tax on adjusted assessed taxable income	–	PAYG withholding credits

If the amount of PAYG withholding credits is greater than the adjusted gross tax on adjusted assessed taxable income, then the benchmark tax is nil (ie the above formula cannot produce a negative amount). PAYG withholding credits cover: (a) credits for amounts withheld from withholding payments to the taxpayer during the variation year (¶26-660); and (b) credits for amounts of personal services income included in the taxpayer's assessable income for amounts paid under TAA Sch 1 Div 13 (¶26-280).

A taxpayer's "adjusted assessed taxable income" for a particular income year is the taxpayer's taxable income for that year, reduced by any net capital gains (except if the taxpayer is a superannuation fund, an ADF or a PST) (TAA s 45-370). Special rules apply if the taxpayer is a life insurance company.

Calculation of the "adjusted assessed tax" on adjusted assessed taxable income for a particular year is a four-step process (TAA s 45-375).

Step 1: Calculate the income tax payable on the adjusted assessed taxable income. The following tax offsets are disregarded:

- private health insurance offset (¶15-330)