become yours, so that you can be sure that you are paying only the tax required under the tax laws.

¶1-020 How to use this book

What this book will not do is tell you how to become one of the super-wealthy in Australia, or how to achieve a "million-dollar lifestyle" in "10 easy lessons".

The purpose of this book is to present, in plain and understandable language, what is required from you under Australian tax laws and rulings. The book provides relevant information for individual taxpayers, and taxpayers who are in business, whether it be as a sole trader, partnership, trust, company, or some combination of these.

Each chapter of the book presents in straightforward terms the details and knowledge you require for a particular area of taxation law. In addition to outlining the legal requirements in each area of taxation law, the book provides you with valuable tips to ensure you get the best advantage from the particular legal provisions. You are also provided with checklists to assist you to make sure that when applying the provisions to your own income tax, you have overlooked nothing.

¶1-030 Complexity of taxation laws

There is no doubt that Australian income tax law has become complex in its structure, and unwieldy in its application. In 1975, the Australian income tax legislation was contained in one volume. In 2012, the taxation legislation consisted of 4 volumes, and in total runs to around 10,000 pages. This is without the GST legislation which first came into play on 1 July 2000.

This amount of legislation appears overwhelming and mind-boggling in its complexity.

It is not only the sheer volume of the legislation that is daunting. Each year Parliament passes substantial amendments to taxation law, which makes keeping up to date an almost impossible task.

However, not every section in every part of the legislation will apply to you and your income tax. By distilling the relevant parts from the legislation, and structuring the information to bring all relevant details in a particular area of law together, this book provides you with an understanding of the basic concepts upon which the taxation regime is built.

As you work through the book and your understanding of the concepts grows, you can start applying the principles to your own circumstances and make tax laws work for you.

¶1-040 What the book will not do

It is worth giving a word of warning at this stage. While this book aims to arm you with an understanding and knowledge of the basics of taxation, this does not mean that you should undertake major tax planning tasks yourself. As already noted, a book such as this cannot and does not claim to be able to replace the advice from an accountant, tax agent or lawyer. The work of these professionals requires that they

keep up to date with all aspects of taxation, and knowledge gained from their experience cannot be learned from a book such as this.

What the book can do is to put you in a position where you will have an understanding of the basics, and thus can make better use of your tax adviser by seeking advice at a more advanced level, since you will have understood the basics.

This can be of benefit to you in two ways.

By using the knowledge you have gained you can do additional preparation for your own tax, thus reducing the time and therefore the cost of having your tax adviser do this work. The reduced cost is an immediate saving you have made. The preparation you will be able to do yourself will be in recording all items of income, and identifying those which you consider will be assessable; and in recording all expenses and identifying those which you consider will be tax deductible. The final decision as to what will be assessable and deductible should be left to your adviser, as they will be aware of recent changes in the law.

Secondly, by having this ground work prepared, you and your tax adviser will be able to use the time saved to engage in more advanced tax planning. This advanced tax planning may involve such issues as reviewing the structure of your business, and from the understanding gained from the information on business structures provided in the book you will be in a better position to contribute to this review.

¶1-050 Finally — it's up to you

Although everybody is in a different situation with regard to their income, expenses, and family circumstances, the book can arm you with the knowledge you need, and through easy to use tips and checklists covering a wide range of situations and occupations, show you how best to use it.

Finally, however, it is up to you to apply this knowledge to your own situation and circumstances, and by doing this you can be sure that while you will be paying your "fair share" of tax to meet your legal tax liability, you will not be paying more tax than you need to!

If you have read this far, then you are probably serious about making a difference to the income tax you are paying. From here on, as you read each new area, keep in mind how the factors explained may apply to your situation. Make note of the tips, and how you can use them to your advantage. Read the checklists to see what items in the lists relate to you, and note how these items are used in calculating your income tax liability. In this way, you will ensure that you are making the most of the essential information in minimising your next income tax bill.

¶1-060 Sources of tax law

For those who are technically minded and may wish to delve more deeply into the realms of tax law, this section introduces some of the sources of tax law in Australia.

As mentioned earlier, part of the complexity of tax law arises because of the number of different pieces of legislation dealing with tax, the number of cases decided which establish what is termed the common law rules for tax, and the number of documents published by the ATO to explain particular aspects of the operation of tax law.

Due to a constitutional requirement that tax legislation can deal only with one matter of tax, there is separate taxation legislation dealing with, among other areas:

- the calculation of income subject to income tax
- the imposition of income tax
- the imposition of goods and services tax (GST)
- the imposition of fringe benefits tax (FBT) which is paid by employers
- the operation and administration of the tax system, and
- the interaction of Australia's tax system with other countries' tax systems

to mention just a few.

Tax cases, being heard by administrative bodies or through the court system, arise when taxpayers and the ATO are in dispute as to the correct interpretation and operation of tax legislation. While many disputes may be settled by administrative bodies such as the Administrative Appeals Tribunal (AAT), some cases involving the interpretation and application of complex legislation to complex business transactions which may involve international business operation will reach the higher courts. Cases determined by the higher courts such as the Federal Court or the High Court will create precedent as to the interpretation and application of tax law, and this precedent must be followed by lower courts in subsequent matters which are similar in nature.

In addition to the large number of legislative provisions, and the large number of cases being determined by tribunals and courts, the ATO issues a number of publications designed to provide guidance on the ATO interpretation and application of law. The more common examples of these include:

- Public Rulings which, as the name suggests, are rulings on the ATO approach to a particular area of law, and the ATO is bound to follow a Public Ruling it has issued
- Private Rulings, which relate to the circumstances of a particular taxpayer, and provide the ATO approach to a particular transaction of that taxpayer; these provide guidance to taxpayers who may have similar circumstances but can be relied on only by the taxpayer who sought the ruling
- Product Rulings are a form of binding public ruling that relate to the availability of tax benefits from marketed tax products, such as vineyards or timber
- Tax Determinations are designed to quickly publish the ATO interpretation on a particular tax issue.

ATO publications are available on the ATO website www.ato.gov.au, and access to rulings and legislation is available from the ATO Legal Database at www.law.ato.gov.au.

¶1-070 Tax formula

This introductory chapter concludes by introducing some of the jargon used in tax law, in an outline of how income tax payable is calculated.

The formula to calculate tax payable is often termed the tax formula or income tax equation. While it is not necessary for you to be able to calculate your tax payable (the ATO is quite happy to do this for you!), an appreciation of the components of the

formula and the terminology used will help you to better understand what elements are significant in ensuring that you are paying the correct amount of tax, and no more.

It is important to appreciate that income tax is imposed on taxpayers for 12-month periods ending on 30 June. This period is the income year or financial year, and while it is an artificial concept, it is a convenience for the purpose of levying income tax. As we will see later in the book, this concept of a financial year as the basic period for levying tax may be used to your advantage in keeping your tax payments to the minimum amount required.

The basic equation for calculating tax payable for a financial year is:

Tax payable = (taxable income × tax rate) − tax offsets

While the terms used here are explained in greater detail in the following chapters, we will expand the formulas at this stage to show the calculation of taxable income.

Taxable income, which is the income figure on which income tax is paid, is calculated by the formula:

Taxable income = assessable income − allowable deductions

By combining these two equations, we can incorporate all of the components that are used in calculating income tax payable, the formula becoming:

Tax payable = ((assessable income − allowable deductions) × tax rate) − tax offsets

Taking this expansion and the introduction of new terms one last step, assessable income is the assessable part of gross income, after exempt income has been subtracted, or in terms of an equation:

Assessable income = gross income − exempt income

Depending on how well you handle equations, you may by now be scratching your head, or you may think there is nothing to this. If you are confused, hang in there as all will be revealed. If you are finding the equations straightforward, remember the well worn political phrase, "the devil is in the detail". It is the concepts underlying each of the terms in these equations that we will discuss throughout the remainder of this book.

There are some parts of tax law where there is uncertainty as to how the law works. If everyone was certain about all areas of the law, then why is it that there are so many objections lodged, tribunal appeals, and appeals to the courts, including the High Court? Given the expense involved in these court hearings, people would only go to court if they felt sure that they had a good chance of winning, but if both sides are willingly going to court then both sides feel certain of their case.

However, you should not let the uncertainty put you off. The parts of the law which are uncertain are generally at the "edges" of the law. In this book the advice keeps well clear of anything which may be uncertain or "dodgy". The factors discussed are well settled areas of law, and the advice is tried and proven, and accepted by the ATO. You can rest assured that following any advice in this book will not find you in court fighting the ATO.

Hopefully, by the end of this book you should have a better understanding of the effect of the application of the taxing formula, the operation of the tax system and the obligations it places on you, and how you can fully meet these obligations without having to part with more income tax payments than is totally necessary.

Example:

A dividend statement received by a shareholder shows the following:

Dividend rate	*No of shares*	*Franked amount*	*Unfranked amount*	*Imputation credit*
17 cents	9,000	$530.00	$1,000.00	$227.14

The amount that should be included in assessable income is:

Dividends:	
Franked amount	$ 530
Unfranked amount	$1,000
Net dividend	$1,530
Imputation credit	$ 227
Total dividend (in assessable income)	$ 1,757

TIP:

Keep your dividend statements, as the imputation credit shown on the dividend statement must be included as part of dividend income in your assessable income.

¶2-050 Statutory income

The other component of assessable income is statutory income. Statutory income consists of amounts which are not income as it is ordinarily understood, but there is a provision in the tax legislation or statute which declares amounts of this type to be income. The most common form of statutory income which taxpayers encounter is capital gains tax which can arise when there is a receipt of a capital nature from the disposal of a capital asset.

Capital gains and capital losses

The law in this area requires that you include in your assessable income the net capital gain you have made in the financial year. A net capital gain is the sum of capital gains less the sum of capital losses. If you have a net capital gain, this is added into assessable income. If you have a net capital loss in a financial year, this is carried forward to be set off against a capital gain in a later financial year.

There are a number of events which can give rise to a capital gain, the most common being the disposal of a "capital gains asset". A capital gains asset is an asset which was acquired after 19 September 1985. An asset is not only a physical asset such as land or buildings, but includes other property such as shares.

Not all assets acquired after 19 September 1985 will be capital gains assets. There are some assets exempt from capital gains, and these are outlined later in this chapter.

Elements in working out your capital gain

The formula for working out if you have a capital gain is:

Capital gain = capital proceeds on disposal – cost base of asset

The capital proceeds on disposal is the amount received, or the value of property received, as payment for the sale of the capital gains asset.

The cost base of a capital gains asset includes:

- the money paid, or value of property given, to acquire the asset
- incidental costs associated with buying or selling the asset
- certain expenditure for which you have not claimed a deduction.

Incidental costs are those costs incurred with the purchase or sale of the asset, and for which you have not claimed a deduction.

Checklist of incidental costs:

- surveyor's fees
- valuer's fees
- cost of an auctioneer
- accountant's fees
- brokerage
- agent's fees
- consultant's fees
- legal adviser's fees
- costs of transfer
- stamp duty or other duty
- borrowing expenses, eg application fees or mortgage discharge fees
- cost of advertising to find a buyer or seller.

Other items of expenditure which may be added to the cost base include:

- costs of ownership; eg water rates and council rates on a holiday home that is not rented out to earn income; as there is no deduction for these costs of ownership, they may be included in the cost base, thus reducing the capital gain and the tax payable on disposal
- capital expenditure you have incurred to increase the value of the asset; eg capital expenditure on an extension or improvement to the property, or legal and other expenses in fighting a proposed development which would adversely affect your property
- capital expenditure to defend title to your asset; eg an amount paid to a purchaser to terminate the sale contract and retain ownership of the asset.

Amounts excluded from the cost base include:

- amounts for which you receive a deduction
- expenditure which you will recoup
- outgoings on illegal activities, and
- bribes to public officials.

TIP:

Ensure that all allowable expenditure is included in the cost base, as this will reduce the capital gain, and thus the tax paid on the capital gain.

Calculating the capital gain

If the capital gains asset is purchased before 21 September 1999 and sold after 21 September 1999, then you have a choice as to how to calculate the amount of capital gain to include in assessable income.

If you have owned the capital asset for more than 12 months, then you can apply the formula above to work out the capital gain, and then include one-half of the capital gain in assessable income. This is the CGT discount method.

Alternatively, you can use the indexation method. If the capital gains asset has been held for more than 12 months, you can adjust the cost base to take account of inflation since you acquired the asset. This is termed indexation, and under this calculation the difference between the capital proceeds received and the indexed cost base will be the real growth in the value of the asset after inflation. If you use this calculation, the whole of the calculated gain is included in assessable income.

Each of the costs included in the cost base must be separately indexed to take account of inflation. The indexation formula is:

Indexed cost = cost × indexation factor

The indexation factor is determined by dividing the CPI for the quarter of disposal by the CPI for the quarter when the cost was incurred. The CPI is the consumer price index, which measures inflation. The formula is:

$$\text{Indexation factor} = \frac{\text{CPI index number for quarter of disposal}}{\text{CPI index number for quarter when cost incurred}}$$

With the introduction of the new system for calculating capital gains after 21 September 1999, indexation has been frozen at 30 September 1999, so if a capital gains asset is disposed of after this date, indexation is calculated using the September 1999 CPI index number.

The CPI index numbers are published each quarter by the government. The CPI index numbers from September 1985 until September 1999 are in the following table.

CPI index numbers

Year\Quarter	September	December	March	June
1985/86	71.3	72.7	74.4	75.6
1986/87	77.6	79.8	81.4	82.6
1987/88	84.0	85.5	87.0	88.5
1988/89	90.2	92.0	92.9	95.2
1989/90	97.4	99.2	100.9	102.5
1990/91	103.3	106.0	105.8	106.0
1991/92	106.6	107.6	107.6	107.3
1992/93	107.4	107.9	108.9	109.3
1993/94	109.8	110.0	110.4	111.2
1994/95	111.9	112.8	114.7	116.2
1995/96	117.6	118.5	119.0	119.8
1996/97	120.1	120.3	120.5	120.2
1997/98	119.7	120.0	120.3	121.0
1998/99	121.3	121.9	121.8	122.3
1999/2000	123.4			

CPI index numbers

Note that indexation is frozen from September 1999, so CPI numbers are not relevant for CGT calculations after that time.

For capital gains assets purchased after 21 September 1999, and which you have owned for more than 12 months, the CGT discount method must be used, that is calculate the gain as per the formula, and include one-half of the gain in assessable income.

How to work out if you have a capital loss

If the result from the capital gain formula is not a positive answer, then there is no capital gain, and you will need to calculate if there is a capital loss. The calculation for a capital loss is:

Capital loss = reduced cost base − capital proceeds on disposal

The cost base consists of the same elements as above, except for the costs of ownership which cannot be added into the reduced cost base. Also the reduced cost base cannot be indexed for inflation.

If the result of this formula is a positive answer, this is the amount of a capital loss, and you can subtract it from any capital gains amounts to give a net capital gain. If you have no capital gains amount to offset your capital loss against, then you record the capital loss information on your tax return, and carry forward the loss into future years until you have a capital gain to set it off against.

Example:

You purchase a unit for investment purposes in December 1995 for a cost of $140,000. Costs associated with the transfer are $4,000. In March 1997, you add an extension to the unit at a cost of $35,000. In February 2000, you obtain a valuation of the unit, the valuer's fee being $800. On 30 September 1999 you sell the unit for $210,000. Agent's commission on the sale is $1,500, and the agent charges $600 for advertising expenses incurred.

The unit is a capital gains asset as it was purchased after 19 September 1985. The sale of the unit is a capital gains event, so the capital gain on sale must be calculated.

As the capital gains asset was acquired before 19 September 1999 and held for more than 12 months, there is a choice of using the indexation method or the CGT discount method.

Example:

If you use a room in your residence as a home study, but also have other furniture in the room, such as a bed or wardrobe which you use for domestic purposes, then the Commissioner is more likely to deny a deduction for expenditure on your home study.

Landlords

Because rent received is assessable income for a landlord, expenses incurred in earning that rental income are allowable deductions.

Checklist of landlord expenses deductible:

- council and water rates, land tax
- insurance premiums for the property rented
- interest on money borrowed to purchase the property
- borrowing and mortgage discharge expenses on money borrowed to purchase the property
- management fees and agent's commission for collecting rent
- repairs and maintenance
- depreciation on furniture when the property is let furnished
- travel costs for property inspection
- financial charges on bank accounts specifically maintained to receive rental income
- cost of telephone expenses related to rental property
- rent paid, if landlord is subletting
- secretarial and bookkeeping expenses
- audit fees where necessary
- legal expenses to recover arrears of rent or eject tenant for non-payment
- advertising.

Note that when a deduction is claimed for an amount of expenditure, that amount may not be included in the cost base of the asset for capital gains purposes.

TIP:

Ensure that deductions are claimed for non-cash amounts, such as depreciation on furniture in a rental property. Often these deductions are overlooked since there was no cash expenditure.

Investment expenses

If you derive assessable income from investments, such as interest and dividends, then expenses incurred in deriving this income will be deductible.

Checklist of investment expenses deductible:

- management fees
- accounting and audit fees
- secretarial and bookkeeping fees
- retainers paid to an investment advisor

- a portion of periodicals for investment information, eg *Financial Review*
- interest on money borrowed to invest
- management and administration of income tax affairs.

Checklist of investment expenses not deductible:

- initial financial planning advice
- initial portfolio establishment
- upfront service fees or commission for entry into investment product.

TIP:

If technical newspapers, periodicals, and journals are used partly for investment information for use in earning assessable income, and partly for private purposes, you will be entitled to an allowable deduction for the portion of the cost that is related to earning assessable income.

Interest

The primary test in determining if you can claim a deduction for interest payments you have made on borrowed money is the purpose of the borrowing; that is, the use that has been made of the borrowed money.

If the borrowed funds are used to buy an income producing asset, such as a rental property or shares, then the connection with earning assessable income has been established and the interest on the borrowed money is deductible. If the borrowed money is used to purchase a non-income producing asset, such as a private residence, then there is no connection with earning income, and no deduction is allowed for the interest.

If the borrowed funds have been used partly to purchase an income producing asset such as a rental property or shares, and partly for some other non-income earning use, then there will be a deduction for a portion of the interest payment. The portion of the interest payment deductible will be calculated from the portion of the borrowed money that was used to buy the income producing asset.

Example:

You borrow $300,000 from the bank. You use $100,000 of the funds to purchase shares, and you use the remaining $200,000 to buy a new home. Interest payments in the first financial year are $21,000.

Since 1/3 of the money is used to buy an income producing asset, you will be allowed a deduction of 1/3 of the interest expense, that is $7,000.

Negative gearing

When money is borrowed to buy an income producing asset, and interest is paid on the loan, it may happen that the deduction for the interest paid, and other deductible amounts, is greater than the assessable income from the asset purchased. This situation is referred to as "negative gearing".

There will still be a deduction allowed for the interest paid on the loan for the income producing asset, and the loss made on this transaction for the financial year may be deducted from other assessable income in the financial year.

Example:

You borrow $250,000 to purchase a rental property, the interest on the loan in this financial year being $17,000. You incur other expenses on the property for which you can claim a deduction of $10,000. Rental income received from the property for the financial year is $22,000. The net loss for the rental property for the income year will be:

Assessable income:		
– rental income		$ 22,000
Less allowable deductions:		
– interest on loan	$17,000	
– other expenses	$10,000	
		$ 27,000
Taxable income (loss)		$ (5,000)

This form of financing has been, and remains, very popular, as the loss on the income producing asset can be offset against other income, thus reducing taxable income and tax payable. If you have salary income of $30,000, the loss from the rental property will be deducted from your other assessable income, leaving you with a taxable income of $25,000.

This means you will now be paying tax on $25,000 instead of $30,000.

At the same time, the rental property will be growing in value, and when it is sold, only 1/2 of the capital gain on disposal will be included in assessable income if the CGT discount method is used, the other 1/2 of the increase in value being tax free.

You will have paid less tax while owning the asset, and receive 1/2 of the increase in value while you owned the asset as a tax free amount.

TIP:

If buying an income producing asset and a private asset, use your own funds for the private asset and use borrowed funds for the purpose of purchasing the income producing asset, so that you can claim an allowable deduction for the interest on the borrowed funds.

Example:

Assume you have recently sold your home and are left with $200,000 cash. You wish to purchase a new private home for $200,000, and a rental unit for $150,000, making a total of $350,000, so you need to borrow $150,000.

Assume you borrow $150,000 at 10% interest per annum, so annual interest payments in the first year are $15,000.

Using these facts, we can compare three case situations.

Case 1

If you pay cash for your new home, and use the $150,000 borrowings for the purpose of buying the rental unit, you are entitled to an interest deduction of $15,000, as the borrowed funds are used for an income producing purpose, so your taxable income on which you pay tax is reduced by the $15,000 interest deduction.

Case 2

If you pay $150,000 cash for the rental unit, and use the $150,000 borrowed funds for the purpose of purchasing your private home, you are not entitled to any deduction for interest on the borrowed funds, as the borrowed money is used for a private purpose. Your taxable income is $15,000 higher than under Case 1, so you are paying tax on $15,000 more income than in Case 1.

Case 3

If you put $100,000 cash towards your home, and use $100,000 of the borrowed funds for the purpose of purchasing your home, and put $100,000 cash towards the rental unit, and use $50,000 of the borrowed funds for the purpose of purchasing the rental unit, you will be entitled to a part deduction on the interest paid on the borrowed money. Since 1/3 of the borrowed money ($50,000) is being used for the purpose of purchasing an income producing asset, you will be entitled to a deduction for 1/3 of the interest on the borrowed money, that is $5,000.

Your taxable income is $10,000 higher than in Case 1, which means that you will be paying tax on an extra $10,000 income than in Case 1.

This example illustrates the importance of using borrowed funds for the purpose of purchasing income producing assets, so you can claim a deduction for the interest paid on the borrowed money, and using our own funds for the purpose of purchasing a private asset, where you cannot claim a deduction for interest on borrowed money.

TIP:

A word of warning: If you purchase a negatively geared income producing asset, be sure that you have enough other income or funds to meet the loan payments and other expenses, as the income from the asset will not cover these expenses.

¶3-060 Specific (statutory) deductions

There are some deductions you can claim even though they may not be related to earning assessable income. This is because there is some specific part of the tax legislation which allows a deduction for these items. Some of these are related to carrying on a business, and these are discussed in the chapter on businesses. Others can be claimed by individuals.

Borrowing expenses

When you have borrowed money and the money is to be used for the purpose of earning assessable income, you can claim a deduction for the cost of borrowing the money, as distinct from the deduction for interest that you have paid.

Checklist of borrowing expenses you can claim:

- procuration fees
- legal costs
- search fees
- valuation fees
- survey fees
- registration fees

- if the betting or gambling is related to, or part of, some other businesslike activity. If the taxpayer is involved in other racing activities that are a business, eg bookmaking, training, or breeding racehorses, it is more likely, but not certain, that the betting will also be a business, and
- whether the person is gambling for entertainment or for profit. Indulging a passion for gambling does not constitute a business.

Checklist of factors to consider in deciding if betting and gambling is a business:

In favour of being a business	Against being a business
System or organisation to increase chance of success	Results rely solely on chance
Other racing related business	Love of horses and not just gambling
Profit making motive	Motive of pleasure element
Intention of making regular income	Intention restricted to entertainment and occasional profit
Systematic and organised method of gambling	No organised system of gambling
No other employment or business	Other employment or business
More regular betting	Less regular betting
Larger scale of activities	Smaller scale of activities
Use of office, staff and computer	No office or staff
Keeping extensive records	No extensive records kept

Checklist of factors not relevant in deciding if a business exists:

- period of time involved in the activity
- size of individual bets, and
- intention to win when placing bets.

Generally, none of these factors or considerations will alone decide if a business is being carried on. It is important to consider the overall picture as indicated by these considerations.

TIP:

Unless there is a large scale of activity with a systematic approach and an intention to earn an income, betting and gambling does not generally amount to a business. If it is not a business, winnings are not assessable income and losses are not allowable deductions.

Share trading

Buying and selling shares may amount to a business if there is enough activity to constitute share trading. The main factor to consider is whether you intend to buy or sell at a profit, or whether the main intention is to hold shares for an investment. The frequency and volume of buying and selling will be the most important factor in deciding on your intention.

If there is enough share trading to be a business, then profits from sales will be included in assessable income, and losses from sales will be an allowable deduction. If the activity is not a business, capital gains can still be subject to tax under capital gains tax, as there has been the disposal of a capital gains asset, namely shares.

However, the capital gain subject to tax may be reduced by indexation or by the CGT discount.

Sportsperson

If a sportsperson exploits their athletic talent to earn money, or commercially exploits their sporting prowess and associated celebrity status, then they may be carrying on a business, even if they are also an employee. This may be a question of fact and degree in each particular case as to whether the sportsperson is exploiting their sporting talent to the degree required to be carrying on a business.

If a sportsperson is carrying on a business, then nearly all receipts would be assessable income, including prizes, appearance fees, sponsorship, and government grants. Also additional amounts would be allowable deductions, such as management fees in connection with negotiating contracts.

Primary producers

Every year around tax time there are always a number of schemes being sold with the claim that you can get a big deduction in the current year, and thus reduce your tax. Many of these schemes involve primary production business, to take advantage of the concessions available to primary producers.

Whether primary production activities are sufficient to constitute a business, or whether they are merely a hobby, as with a hobby farm, has been a contentious issue in taxation law because of the favourable tax treatment for primary production businesses. There is no clear cut answer, and while there are several factors to take into account, no one factor alone can provide the answer.

Checklist of factors as to whether a business of primary production exists:

- whether the activity has a significant commercial purpose and character
- the size and scale of activities
- whether activities are profitable, or will become profitable
- the repetition and regularity of activities
- organisation of activities in a businesslike way
- use of a system in undertaking activities
- prior experience in related business activities
- whether activities are more properly described as a hobby or recreation rather than a business.

¶5-040 Business income

If we refer back to the assessable income component of the taxing formula in Chapter 2, assessable income consists of ordinary income and statutory income.

Taxable income = assessable income – allowable deductions

ordinary income   statutory income

This is true for a business as well as for an individual.

TIP:

Remember that if you value trading stock at cost, you should include all the costs associated with the item, and not just purchase price.

There is an alternative method available where none of the above methods is appropriate, for example with trading stock which is obsolete, or there is some other special reason. In these cases, you may value the trading stock at a value which is reasonable in the circumstance.

TIP:

If your business has trading stock which is obsolete, you may select a reasonable value for the items.

¶5-080 Business deductions

In Chapter 3 we saw that allowable deductions may be of two types, either general deductions or statutory deductions.

Assessable income – allowable deductions = taxable income

general deductions   specific (statutory) deductions

This is the case for business deductions as well as for deductions for individuals.

¶5-090 General deductions

We have seen in Chapter 3 that under the general deduction provisions you can claim a deduction for:

- expenditure incurred in earning your assessable income, and
- expenditure incurred in carrying on a business to earn assessable income,

but you cannot claim a deduction for:

- expenditure for capital items
- expenditure for private or domestic items
- expenditure to earn exempt income, and
- expenditure for which the legislation denies a deduction.

Generally, an individual will be allowed a tax deduction for an expense that is incurred to earn assessable income. For a business to claim a deduction for an expense, the expense must be incurred in carrying on the business to earn assessable income.

It is not necessary that the expenditure can be shown to have produced a certain amount of assessable income. Rather, the expenditure must have been incurred to carry on a business, with the business being carried on to produce assessable income.

Remuneration

Remuneration paid by employers to employees will be an allowable deduction when incurred in carrying on a business to produce assessable income.

Checklist of deductible remuneration payments:

- salaries
- wages
- bonuses
- allowances
- gratuities
- directors' fees
- recruitment costs, eg advertising, agency fees, travelling expenses
- cost of drawing up employment agreements
- payments to induce an employee to retire
- payments which promote efficiency or economy in operations, eg Christmas bonuses
- retiring allowance (lump sum or pensions)
- payment to widow or dependant of former employee.

Insurance premiums

Insurance premiums are an allowable deduction if incurred in carrying on a business to earn assessable income.

Checklist of deductible insurance premiums:

- workers compensation insurance
- accident insurance for employees
- fire
- burglary and theft
- public liability
- loss of profits
- motor vehicle insurance
- insurance against foreign exchange losses
- disability insurance against loss of income
- professional indemnity insurance
- "key-man" accident insurance to protect revenue
- sickness/accident insurance for self-employed.

Spare parts

Expenditure incurred on the cost of spare parts and other consumable stores in a business will be an allowable deduction. This is part of the expense incurred in carrying on a business to produce assessable income. The deduction can be claimed in the financial year in which the expense was incurred.

Advantages of the trust business structure:

- great flexibility in distributing income so as to minimise tax, ie allows income splitting
- permanency and stability of operation as the trust continues virtually indefinitely.

Disadvantages of the trust business structure:

- more complex and costly to establish than a partnership
- more complex and costly to administer
- need for ongoing legal/accounting advice
- loss of control of assets as trustee makes decisions on distribution, etc
- trust losses are not distributed to beneficiaries but carried forward to set-off against future income.

¶6-050 Company structure

Companies are of two broad types — public companies and private companies. Only private companies are considered here, as if you are planning a float of a public company on the stock exchange, you should be getting complex legal and accounting advice well before this.

However, even with a private company, this structure is probably the most complex and demanding in terms of requirements for establishment, and the ongoing obligations. That does not mean that this may not be the right structure for your business, as your business may be at the size where a company structure best suits, in which case the cost of meeting the obligations becomes another cost of carrying on business, and is tax deductible.

TIP:

Establishing a company of any size is a complex task with specific legal requirements, and should not be attempted without legal and tax advice.

The advantage of a company is that because a company is a separate legal entity and thus a separate taxpayer, there is generally no liability imposed on shareholders of the company to meet the debts or obligations of the company if the company cannot meet these debts or obligations itself. This protects the personal assets of shareholders.

In many ways, a company is an ideal structure as it allows for splitting of income, paid as dividends to shareholders. By having different types of shares being held by different shareholders, you can allow some shareholders to control the assets, while others receive income.

You may decide, for example, that you and your spouse will hold voting shares that may not receive a dividend, thus allowing you to keep control of the assets and operations of the company. Your children may hold shares that allow them to receive dividends, but give them no voting rights. This allows income splitting, and if the children have a low tax rate, reduces the overall tax paid.

Taxation of companies

Companies are separate legal entities, and as such companies pay tax themselves. The company works out its taxable income in the same way as for an individual:

Company taxable income = assessable income – allowable deductions

Tax is then paid at a flat rate on the taxable income, so no matter how high the company income, the tax rate does not increase as it does for individuals.

The company tax system is an "imputation" system, which means that tax paid by the company is then "imputed" or passed on to the shareholders when dividends are paid. The benefit of this is that shareholders get the benefit of company tax paid. If a shareholder has a tax rate which is less than or equal to the company tax rate, then the shareholder pays no more tax on the dividend received. If a shareholder has a tax rate greater than the company tax rate, then the shareholder pays the extra tax above the company rate, still getting the benefit of the tax paid by the company.

The downside of all this is that there are extra record keeping requirements for a company so that it can keep track of the tax paid, and how much of this company tax paid has been passed on to benefit shareholders.

Advantages of the company business structure:

- limited liability for shareholders
- because it is a separate entity, the company can last forever, allowing the business to be passed on to future generations
- control of assets can be separated from distribution of income
- different dividends can be paid on different types of shares
- company can claim a deduction for salaries paid to all employees including owners
- company can claim a deduction for superannuation contributions paid on behalf of all employees including owners
- flexible fund-raising options, eg borrow funds or sell more shares.

Disadvantages of the company business structure:

- legal obligations to meet to establish company
- ongoing legal obligations
- ongoing accounting and record keeping obligations greater than for other structures
- strong obligations on directors of companies, with severe penalties for breach
- relatively complex taxation and recording requirements.

¶6-060 Combinations of structures

Your business operations need not be limited to one entity or one structure. If there are separate parts of a business, it may make sense to have the separate parts as separate entities, eg subsidiary companies of a holding company. Different structures can be used in combination, for example having a trust as a partner in a partnership may be able to make the most of the advantages offered by each structure. A common

Superannuation funds can be either complying funds, which comply with regulatory requirements and receive concessional tax treatment, or non-complying funds, which do not satisfy regulatory requirements and suffer penalty tax treatment.

TIP:

You should ensure that your superannuation fund is a complying superannuation fund so it gets the benefits from tax concessions, rather than being subject to penalty tax.

¶8-030 Superannuation contributions

Contributions to a superannuation fund will generally be made either by an employer for the benefit of employees, or by the member if self-employed.

Under the superannuation guarantee system, employers are required to provide a minimum level of superannuation support in relation to employees. This minimum level is currently 9% of an employee's earnings, with the rate to gradually increase to 12% by July 2016.

Contributions may be classed as either:

- concessional contributions — contributions included in the assessable income of the superannuation fund, and the payer is allowed a deduction, or
- non-concessional contributions — contributions not included in the fund's assessable income and no deduction is allowed to the payer.

Generally contributions to a fund would be either in money or property.

Concessional contributions

For concessional contributions, the payer is allowed a tax deduction for the amount of the contribution to the fund, whether the payer is an employer or a self-employed person. The contribution will be assessable income of the superannuation fund, and will be taxed to the fund at the rate of 15%.

While there is no longer any limit on the amount of the tax deduction that can be claimed for a superannuation contribution, if you are a member of the superannuation fund, you may be penalised if "excess" contributions are made which exceed your concessional contributions cap. The concessional contributions cap has been significantly reduced from the level set when the rules were first introduced, and is currently $25,000 per annum.

If concessional contributions exceed the cap, the payer is still entitled to an allowable deduction, but the excess contribution is effectively taxed at the rate of 46.5% and you as the member are liable to pay the excess contributions tax. You may withdraw an amount from the superannuation fund to pay the excess contributions tax.

Non-concessional contributions

Non-concessional contributions are contributions which are not included in the assessable income of the superannuation fund, and for which there is no allowable deduction for the payer. An example of non-concessional contributions would be

additional personal contributions you made from your after after-tax income, as a member of the fund.

While no deduction is allowable to the payer of a non-concessional contribution, there is still a cap on the amount of non-concessional contributions that can be made in any one income year. The non-concessional contributions cap is currently set at six times the concessional contributions cap, being $150,000. Non-concessional contributions in excess of this cap are taxed at the rate of 46.5% of the excess.

If you are under 65, the non-concessional contributions cap can be averaged over three years, so you could make a non-concessional contribution of up to $450,000 each three years.

TIP:

It is important to keep a check on your concessional and non-concessional contributions, particularly if you are nearing a contributions cap, so you avoid paying the excess contributions penalty tax.

Deducting contributions made

An employer is allowed a tax deduction for a superannuation concessional contribution made for the purpose of providing superannuation benefits for employees.

As noted above, there is no limit on the amount of the allowable deduction, but the member will be subject to excess contributions tax if contributions exceed the concessional contributions cap.

The conditions to be able to claim an allowable deduction include the following:

- the deduction must be in the year that the contribution was made
- employees for whom contributions are made must be engaged in producing the employer's assessable income, or be Australian residents engaged in the employer's business
- the contribution must be made to a complying superannuation fund
- the contribution must be for the purpose of providing superannuation benefits for another person.

If the employee is turning age 75, the contribution must be made by the employer within 28 days after the end of the month when the employee turns 75 for an allowable deduction to be claimed for the contribution.

If your employer makes concessional contributions to a superannuation fund for your benefit, and claims an allowable deduction for that contribution, you cannot claim a deduction for any contributions you make to the fund.

However, if you are self-employed and make concessional contributions to a complying superannuation fund for the purpose of providing superannuation benefits for you, you are entitled to claim an allowable deduction for the amount of that contribution.

Chapter 8

To qualify as self-employed, generally less than 10% of your assessable income and reportable fringe benefits should come from employment activities where you would qualify as an employee.

As above, there is no limit on the amount that you may contribute and claim as an allowable deduction, but if the contribution exceeds the cap, then excess contributions tax may be imposed on the excess contributions.

TIP:

If you wish to claim a deduction for superannuation contributions made as a self-employed person, ensure you do not exceed the 10% limit on employment income.

You are able to make contributions to a complying superannuation fund for the purpose of providing superannuation benefits for a low-income or non-working spouse, subject to conditions.

While there is no deduction for the contribution, by making it a non-concessional contribution, there may be a tax offset available if:

- you made contributions on behalf of your spouse to a complying superannuation fund
- both you and your spouse are Australian residents
- the purpose of the contribution is to provide superannuation benefits for your spouse, or
- your spouse's assessable income and reportable fringe benefits total is less than $13,800.

The tax offset is 18% of the amount of the contribution made, up to a $3,000 limit, making the maximum tax offset available $540. If your spouse's income is more than $10,800, the maximum $3,000 contribution that attracts the 18% offset is reduced by $1 for each dollar of total income in excess of $10,800.

Example:

Buddy and Holly are married, and Buddy contributes $4,000 to a complying superannuation fund for Holly. Holly has total income for the year of $12,800.

The excess of income above the threshold is: $12,800 – $10,800 = $2,000

Reduce the maximum contribution of $3,000 by the excess: $3,000 – $2,000 = $1,000

The offset will be 18% of the reduced amount: 18% × $1,000 = $180

¶8-040 Taxation of superannuation funds

Superannuation funds are effectively trust structures, where the trustees have responsibility for running the fund for the benefit of members. In general terms, superannuation funds are taxed in a similar way to other entities, but there are a number of modifications to provide concessions to certain types of income.

If you look back to the taxing formula earlier in the book, the same principles apply here in that superannuation funds need to determine their assessable income and allowable deductions.

Complying superannuation funds are taxed at a concessional rate of 15% on the low tax component of their taxable income. Non-complying superannuation funds are taxed at a penalty rate of 45% on all of their taxable income.

In general terms, a complying superannuation fund is a resident fund which operates within the government regulatory framework and is subject to prudential supervision.

For a self-managed super fund (SMSF), the regulatory requirements are generally less onerous than for a managed fund.

Complying funds

Assessable income

Assessable income for a complying fund would commonly include classes of assessable income for:

- contributions
- ordinary earnings, and
- capital gains.

Contributions would generally be included in assessable income if they are:

- contributions by a contributor on behalf of someone else — eg by an employer on behalf of an employee — whether or not a deduction had been allowed
- contributions made on the contributor's own behalf, and the contributor received a tax deduction, and
- amounts transferred from a foreign super fund to an Australian super fund.

Certain contributions received by a complying fund are not assessable income, eg:

- contributions made on behalf of a spouse
- government co-contributions.

As with other taxpayers, ordinary earnings from carrying on a business would be included in assessable income. A penalty rate of 45% applies to non-arm's length income, which is income derived where the superannuation fund and another party were not dealing independently at arm's length.

The capital gains treatment for superannuation funds differs for complying and non-complying superannuation funds. Non-complying funds are taxed in the same way as other taxpayers, with the operation of the CGT rules being broadly outlined in Chapter 2.

For complying funds, there are some modifications to the general CGT rules.

The first modification is that all assets owned by a complying superannuation fund are deemed to be acquired on 30 June 1988, and the cost base of these assets is the market value on 30 June 1988, or the actual cost, whichever is the greater. You will remember that pre-CGT assets are those acquired prior to 19 September 1985, and these are generally not subject to CGT.

To calculate the deemed depreciation, the formula is:

$$\frac{ABC}{D}$$

where:

A is the depreciated value of the car, or its cost

B is the depreciation rate of 25% (using the diminishing value method)

C is the number of days in the income year that the benefit was provided

D is the number of days in the income year.

For calculating the imputed interest to be charged, the formula is:

$$\frac{ABC}{D}$$

where:

A is the cost of the car

B is the imputed interest rate of 7.4%

C is the number of days in the income year that the benefit was provided

D is the number of days in the income year.

Both interest and depreciation may need to be apportioned where the fringe benefit was given for only part of the year.

Example:

An employer purchases a new car costing $25,000 on 1 April 2013 and provides the car to an employee for business and private use. The employee travelled 20,000 km in the car up to the following 31 March, of which 5,000 km related to business travel. Operating costs for the year (other than deemed depreciation and interest) were $4,000, and the employee contributed $500 toward these operating costs.

Assume all costs are free of GST.

(i) Statutory formula basis:

The car was acquired after May 2011, so the statutory fraction is 0.2.

From the formula above, taxable value is:

$$0.2 \times \$25{,}000 \times \frac{365}{365} - \$500 = \$4{,}500$$

(ii) Operating cost basis:

Deemed depreciation = ABC/D = $25,000 × 0.25 × 365/365 = $6,250

Imputed interest = ABC/D = $25,000 × 0.074 × 365/365 = $1,850

Taxable value = C × (100% – BP) – R = ($4,000 + $6,250 + $1,850) × (100% – 25%) – $500 = ($12,100 × 75%) – $500 = $8,575

The statutory formula taxable value will be used as it is the lower value:

$$\begin{aligned}\text{Grossed up value} &= \text{Fringe benefit amount} \times \frac{1}{1 - \text{FBT rate}}\\ &= \$4{,}500 \times 1.8692\\ &= \$8{,}411\\ \text{Fringe benefits tax payable} &= \$8{,}411 \times 46.5\% = \$3{,}911\end{aligned}$$

TIP:

Remember that even if you choose the operating cost method, if the statutory formula method has a lower taxable value, you should use this amount as you will pay less fringe benefits tax.

Debt waiver fringe benefit

Example:

An employee owes an employer $500, and the employer releases the employee from the debt. There has been a fringe benefit to the employee with a taxable value of $500. The benefit is GST free.

The grossed-up taxable value of the fringe benefit is:

$$\$500 \times \frac{1}{1 - .465} = \$935$$

Fringe benefits tax payable = 46.5% × $935 = $435

Loan fringe benefit

Example:

An employer provides an employee with an interest free loan of $5,000. The normal commercial interest rate would be 7.4%, with interest payments of $370 for the year. Assume there is no GST.

There has been a fringe benefit to the employee with a taxable value of $370.

The grossed-up taxable value of the fringe benefit is:

$$\$370 \times \frac{1}{1 - .465} = \$692$$

Fringe benefits tax payable = 46.5% × $692 = $322

¶11-020 Tax rates and tax offsets

To work out tax payable, we saw in Chapter 1 that the formula is:

Tax payable = (taxable income × tax rate) – tax offsets

From this formula, to minimise tax payable, the relevant steps are to minimise taxable income, reduce the tax rate and to maximise tax offsets.

In Chapter 7, you have seen that if you earn income from certain occupations, then you can reduce your tax rate by averaging your income.

Just by keeping your taxable income lower, you are reducing your tax rate by staying in a lower marginal tax bracket, so minimising your taxable income serves a double purpose.

TIP:

If your occupation has special concessions, eg income averaging, make use of these concessions to reduce your tax payable.

There are other actions you can take to ensure that the rate at which you pay tax is no higher than it need be.

Checklist of steps to minimise tax rate:

- disclose your tax file number to investment bodies, superannuation funds, companies you hold shares in, and your employer, to avoid paying the top rate of tax
- salary repackaging — convert salary to fringe benefits
- take out private health insurance to avoid Medicare levy surcharge
- transfer income from high rate taxpayers to low rate taxpayers, eg by paying salaries to family members working in a business, and
- minimise or avoid any penalties.

The major tax offsets available have been outlined above (Chapter 4), and you should ensure that you enter details on your tax return to allow for these offsets to be claimed.

Checklist of steps to maximise tax offsets:

- for medical expenses, have one spouse incur all medical expenditure to maximise the chance of exceeding the threshold and gaining a rebate
- make superannuation contributions on behalf of low-income spouse
- if in receipt of franked dividends, show all imputation credits from dividend statements.

By taking some of the steps above in relation to assessable income, allowable deductions, tax rates, and tax offsets, you may be surprised at the difference that will result in your tax payments. Even small changes in each of these factors, if the changes are all in the right direction, could see you cutting out any unnecessary tax you may have been paying.

As stated before, there is no magic to this. By careful and methodical recording of income and expenses throughout the year, you can make a real difference in the final amount of tax that you pay, or in the amount of the refund you will receive. This is what happens when you make effective use of the tax laws, and this is how high income individuals and companies reduce the tax payments they make.

Even if your tax return is done by a tax agent or accountant or solicitor, the time you spend in preparing will make the task quicker and easier, and if you have the relevant records you may end up with more deductions than you had anticipated. By reducing the time your tax advisor spends on mundane matters, there will be more time to spend on longer term tax planning issues.

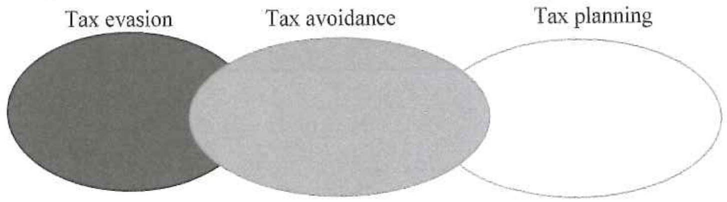
¶11-030 Avoiding the anti-avoidance trap

A word of warning at this stage. While you are entitled to claim all valid deductions, you should not start inventing expenses, or try to claim for deductions where you are not entitled to. Also while you do not need to include non-assessable income, you should not leave out income which is assessable. Such tactics amount to tax evasion, which attracts the most severe penalties from the ATO.

The steps outlined in this book are designed to allow you to make the most of the tax laws by undertaking legitimate tax planning, minimising your tax payments in a legal and acceptable manner.

Between tax planning and tax evasion lies the grey and murky area of tax avoidance. This basically involves minimising tax in ways that are within the letter of the law, but which attempt to exploit anomalies and inconsistencies in the law, or gain an advantage not intended by the law.

The relationship between tax evasion, tax avoidance, and tax planning may be illustrated diagrammatically below.



You can see that there is some overlap between these concepts, and that actions cannot always be clearly classified as being of one type or another.

Tax evasion is illegal and should be avoided at all times. The penalties for this are the most severe as the actions are a deliberate breach of the tax laws. Tax planning is a legitimate activity and is undertaken so as to minimise tax liability within the letter of the tax law and within the intent of the tax law, and tax planning techniques have been outlined in this book.

The area that can be difficult is tax avoidance, as while it may be strictly legal and within the letter of the law, it is taking advantage of some aspect not intended by the tax laws.

There are sections in the tax legislation which are designed to prevent tax avoidance, so whenever you are involved in tax planning, it is important to bear these provisions in mind. If you slip into the areas covered by these anti-avoidance provisions, then the ATO can issue an assessment based on what the circumstances would have been without the tax planning, not what the circumstances were.

The anti-avoidance provisions generally operate whenever you enter into a scheme with the dominant purpose being to gain a tax benefit, and as a result of the scheme you do gain a tax benefit, ie you pay less tax.

A scheme is generally any arrangement which may affect the amount of tax you pay. A tax benefit is a reduction in tax, either through reduced assessable income or through increased allowable deductions.

The thrust of the provisions is that if you enter into an arrangement, the arrangement cannot be only or mainly for the purpose of reducing your tax payable. There must be other main reasons for the arrangement, eg a commercial or business reason such as protecting assets of a business, or passing control of the business to your children.

If there is a tax avoidance scheme with the dominant purpose of reducing tax, the ATO can reverse the tax benefit gained and assess the tax that would have been paid before the scheme existed.

As noted when outlining the various business structures available (Chapter 6), you should not choose a structure, or enter into any arrangement, purely for tax purposes. There should always be some good business or family reason underlying these decisions.

TIP:

You should always have a sound business or commercial reason for any arrangement that reduces your tax, to avoid being caught by the anti-avoidance provisions.

¶11-040 Final note

Much of what has been said above may seem to be common sense to you, and in large measure much of tax planning is common sense. The difficult part is getting into the habit of doing the things you now know you should be doing such as:

- keeping receipts for all work-related expenses
- keeping records if receipts are not available
- identifying receipts which are assessable and non-assessable
- identifying all expenses for which a deduction may be allowed.

These are the common everyday things that in the end will go to reducing your tax payment.

As well as these everyday elements, the book has also sought to give you some insights into some of the longer range matters such as:

- distinguishing between a business and hobby
- deciding on an appropriate business structure
- being aware of other taxes which impact on business
- understanding your responsibilities and rights with self-assessment, and
- avoiding being caught by anti-avoidance legislation.

There is much material covered in this book, and it will not all be absorbed in one go. But by bearing the essentials in mind, and systematically and methodically working on the aspects of the book that are relevant to your situation, you should be able to see some reduction in the amount of tax you are paying.

While no one enjoys paying tax, we all realise the importance of our taxes to the community. By following the steps outlined throughout the book, you will know that while you are paying your "fair share" of taxes, you are no longer paying more than you need to because you are effectively minimising your tax payable.

Key points

- To ensure your taxable income is no more than it should be, you need to minimise your assessable income and maximise your allowable deductions.
- To identify all income and deductions, you need to methodically keep clear records of all income and expenditure.
- There should be sound business reasons for entering any arrangement that reduces your tax, and the dominant reason should not be tax minimisation.
- Effectively minimising your tax does not happen by magic; it is like running a business and requires meticulous, clear and accurate record keeping of all receipts and expenses, and careful and sound judgment and decisions in all matters relating to your tax affairs.