



YOUR
PLAIN ENGLISH
GUIDE TO THE
LATEST INCOME TAX
CHANGES

SUMMARY

Year Book

ATR SUMMARY YEAR BOOK

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CHAPTER 1

NEW DEVELOPMENTS

2010/2011 FEDERAL BUDGET

The Government handed down the 2010 Federal Budget on 11 May.

This year's Budget was framed against a world economy slowly emerging from the global financial crisis which saw a world-wide economic contraction. The Australian economy however defied this downturn growing by 1.4% in 2009/2010, more than 4.5% above the advanced economy average. This growth is set to continue in the years to come with the Australian economy forecast to expand by 3.75% in 2010/2011 and 4% in 2011/2012. The big story however is that the Budget is set to return to surplus much earlier than expected. Although the Budget projects an underlying cash deficit of \$40.8 billion in 2010/2011 this is \$16.3 billion less than what was forecast one year ago. Treasury predicts a return to surplus in 2012/2013 three years earlier than anticipated and ahead of all major advanced economies.

Headline features of the Budget include:

Individuals

- Tax relief including a \$16 000 effective tax-free threshold in 2010/2011 as well as personal income tax cuts for middle income earners;
- An incentive to save in the form of a tax discount on your interest earnings;
- The ability to claim a standard \$500 tax deduction for work-related expenses without the need for substantiation
- An increase in the superannuation guarantee from 9% to 12% which will mean extra retirement savings for more than 8 million Australians;
- A Government superannuation contribution of up to \$500 for low income earners; and
- Provision for older workers to make extra contributions to superannuation.

Health

More than \$7 billion of new investment over the next five years and \$23 billion over the next decade on the National Health and Hospitals Network including an additional and immediate expenditure of:

- \$355 billion for GP Super Clinics;
- \$417 million to enhance after-hours services;
- \$523 million for training nurses; and
- \$467 million to introduce individual electronic health records.

Infrastructure

Over \$6 billion in funding for infrastructure projects including \$5.6 billion for a new infrastructure fund, and \$1 billion in funding for the renewal of rail networks.

Business

Measures announced include:

- Company tax cuts from 30% to 29%;
- Instant write-offs for small business assets costing less than \$5 000; and
- A mining resources rent tax from 1 July 2012.

ECONOMIC REPORT CARD

Following a sharp contraction in 2009, the world economy is in the early stages of recovery; a recovery which is expected to be slow and patchy. Growth is strongest amongst large emerging economies such as China which is continuing to expand rapidly, while the sovereign debt crisis in Greece threatens to spread to other countries and seriously impact world financial markets. Overall however, the world economy is expected to grow by 4% in 2010 and 2011 dragging Australia along with it which is forecast to grow

BUSINESS TAX CHANGES

There has been a raft of business tax changes, implemented or announced, over the last 12 months.

Company Tax Cuts

As recommended in the Henry Tax Review and confirmed in the Federal Budget, company tax will be reduced. Following the renegotiation of the mining tax, the company tax rate will be reduced from 30% to 29%.

For companies with an annual turnover of less than \$2 million, the 1% cut in company tax will apply from 2012/2013. For an eligible company with a taxable income of \$750 000 for example, this tax cut will result in a \$7 500 tax saving. Note however that this tax cut is only available to businesses that operate through a company structure. Businesses operating through a trust, partnership or sole trader structure are not eligible for this corporate tax cut.

For companies with an annual turnover of \$2 million or more, the cut to company tax (from 30% to 29%) will commence a year later in 2013/2014.

Depreciation

Currently small business taxpayers (those with an annual turnover of less than \$2 million, including the turnover of related entities) can write-off (depreciate) assets in the year of purchase if they cost less than \$1 000. From 1 July 2012, this threshold will be increased to \$5 000, making most small business purchases deductible in full in the year of purchase.

Secondly, also from 1 July 2012, small business taxpayers will be able to depreciate all business assets costing more than \$5 000 (other than buildings) using a single pool rate of 30%. This is a significant improvement on the current rules whereby small businesses must allocate assets costing \$1 000 or more into one of two pools which are then depreciated at either 30% or 5% depending on the life of the assets (half these rates in the year of purchase).

These two depreciation measures will not result in any bonus depreciation deductions, rather it is just that the deductions you would have already been entitled to will be accelerated and therefore result in a cash flow benefit to your business. As well as accelerating your deductions, the depreciation changes should also cut small business compliance costs. Under the changes, no longer will small businesses need to classify their assets into a number of different pools as they currently do. Rather, assets will either be immediately written off (if costing less than \$5 000) or depreciable at a single rate of 30%.

EXAMPLE

Barry's Bookkeeping is a small business taxpayer which purchases a \$1 200 bookcase for use in its business.

If the purchase was made before 1 July 2012, the business would be able to claim a deduction of \$180 (\$1 200 x 15%) in the year of purchase.

By contrast, under the new rules, if the purchase was made on or after 1 July 2012, it would receive an immediate deduction in the year of purchase of \$1 200 (a full write-off). This represents a massive \$1 020 acceleration of the depreciation deduction.

Division 7A

Essentially, Division 7A is an integrity measure designed to capture the tax-free distribution of profits that private companies could otherwise make to shareholders. There have been several recent developments which have expanded the application of Division 7A.

Firstly, in 2009, the government became concerned that some private companies were permitting shareholders (or their associates) to use company assets on a permanent loan. Such arrangements effectively provided these shareholders with tax-free benefits which were not taxed under the FBT rules if the shareholder was not also an employee of the company. To close this loophole, on Budget night 2009 it was announced that from 1 July 2009, these non-commercial loan rules in Division 7A were to be extended

to ensure the word ‘payment’ in Section 109C of the 1936 Income Tax Act, includes the use of any company assets.

EXAMPLE

A private company allows a shareholder (who is not an employee or an associate) to use a company car for private purposes over a four-month period at no charge. The car is then returned to the company.

Pre-1 July 2009

The use of the car would have been tax-free, as the shareholder was not an employee or associate (therefore FBT does not apply) and the amount was not a ‘payment’ as defined under Section 109E.

Post-1 July 2009

The new rules define this usage as a ‘payment’ under Division 7A. The value of the payment is the amount that the car would have been hired for if the parties were dealing with each other at arm’s length.

Accordingly, because Division 7A applies, either an unfranked dividend will need to be declared for the amount of the ‘payment’ or, alternatively, the shareholder will need to enter into a Division 7A loan agreement with the company and pay back the amount over a seven year period (making minimum repayments each year and with commercial interest rates applying).

Following a period of extensive public consultation, concerns were raised that the new rules could be unduly harsh in the case of a shareholder whose use of company property is minor or insignificant. In response to this concern, the Government decided to include a carve-out for situations where the use of assets is minor and infrequent. That is, if the benefit provided to the shareholder would be considered a ‘minor benefit’ under FBT laws, then it will be so considered under this new amendment and therefore not subject to Division 7A. A benefit will be considered minor if its value is less than \$300 and it is provided on an infrequent and irregular basis and it would therefore be unreasonable to treat it as taxable.

EXAMPLE

Following on from the example above, assume that the car was only made available to the shareholder for an emergency one afternoon during the year.

In this case, because the value of the benefit would fall below \$300, and the usage of the car was infrequent, the minor benefit rule would exempt this particular usage from the operation of Division 7A.

Under these new rules, the ability of companies to circumvent the tax system by allowing shareholders and their associates to use company assets (such as property and boats) for their own personal enjoyment at less than market value has been curtailed.

These rules apply from 1 July 2009.

The second Division 7A change concerns unpaid present entitlements (UPEs). Late in 2009, the Tax Office released Draft Ruling **TR 2009/D8**. This ruling contained the Tax Office’s preliminary views on the circumstances in which a private company with a present entitlement to an amount from an associated trust may be taken to have made a loan to that trust under Division 7A of the Income Tax Act.

This draft ruling was finalised on 2 June 2010 when the Tax Office released:

- Taxation Ruling **TR 2010/3**; and
- Practice Statement **PSLA 3362** (draft), which provides practical guidance on the administration of the above ruling.

These two documents conclude that where a private company has knowledge that the trustee has allocated an amount to the company but not paid the amount, the arrangement will be treated as a loan for Division 7A purposes unless the amount is held separately on sub-trust. In these circumstances, the private company is considered to be providing financial aid to the trust by:

- Not calling for the UPE to be paid out; and
- Not requiring the investment of the UPE for the sole benefit of the company.

CHAPTER 3

BUSINESS TAX ISSUES

UNIFORM CAPITAL ALLOWANCES SYSTEM

The Uniform Capital Allowances (UCA) system commenced on 1 July 2001 and essentially applies to all taxpayers, except to small business concession taxpayers (ie. those with an annual turnover of less than \$2 million), who have elected to use the depreciation rules contained in the small business system. The UCA regime is implemented by Division 40 of the Income Tax Assessment Act 1997 and replaces several former divisions. The UCA regime came complete with its own language set. For instance, depreciation is now referred to as a "decline in value", whilst an item of plant is now referred to as a "depreciating asset".

To assist readability of the following paragraphs, we will embrace the practical changes introduced by the UCA legislation, however we will continue to use terms familiar to our readership.

A taxpayer can write-off certain kinds of capital expenditure as deductions. Such a deduction is called a "capital allowance". The deduction may be claimed either immediately or over a number of years, depending on the nature and amount of the capital expenditure.

Probably the most easily recognisable capital allowance is the deduction for depreciation of plant and equipment, but be aware there are many more. Currently there are over 40 separate capital allowance deductions available in one form or another to taxpayers of various descriptions.

The New Business Tax System (Capital Allowances) Act 2001 and the New Business Tax System (Capital Allowances - Transitional and Consequential) Act 2001 received Royal Assent on 30 June 2001 and gave rise to "The Uniform Capital Allowances System". Generally the system applies to all taxpayers, except small business concession taxpayers, that choose to use the rules contained in the small business concession system.

The system has the following features:

- The term "depreciating asset" replaces the term "plant" and means "an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used";
- The deduction for the cost of a depreciating asset in a particular income year is based on its "decline in value";
- Creation of a pool for in-house software development expenditure;
- Creation of a low value pool for most assets costing less than \$1 000 (or that have declined in value to below \$1 000);
- The effective life regime already applying to plant and equipment is extended to depreciating assets;
- "Blackhole" expenses (formation costs and the like) can be written off over a 5-year period;
- An immediate deduction for various mining and prospecting type expenditures; and
- An immediate deduction for income-producing **non-business** depreciating assets costing \$300 or less.

There are a number of exclusions and transitional arrangements.

DEPRECIATION (DECLINE IN VALUE)

The cost of purchasing an asset used for gaining or producing assessable income is capital expenditure and is not an allowable deduction. However, the cost of the asset can be allocated over its useful life and allowed as a deduction each year. This allocation process is referred to as **depreciation**.

The value of assets generally reduces over time as they approach the end of their useful lives. Assets that lose value in this way are said to depreciate. In recognition of this ageing process, the Tax Office allows the cost of capital assets used in producing assessable income to be written off over a period of time as tax deductions.

Assets not only depreciate due to wear and tear. Technological obsolescence is a major factor in the high depreciation rates suggested by the Tax Office for computers and mobile phones.

EXAMPLE

A lawyer purchases a business machine for \$5 000 to help in the running of his business. The effective life of the machine is 5 years. The cost of the machine is not an allowable deduction, however, the cost can be divided by the asset's effective life to allow a depreciation deduction of \$1 000 per annum.

Depreciation for tax purposes is calculated by reference to the taxpayer's estimate of an item's effective life. The Tax Office has issued advisory depreciation rates, which taxpayers may use instead of their own estimates. These can be located in Taxation Ruling TR 2010/2 which applies from 1 July 2010.

CONDITIONS OF DEDUCTIBILITY

For an item to **qualify** for a depreciation deduction, certain criteria must be met:

- The item must be a depreciating asset (such as machinery, motor vehicles, office machines, fixtures and fittings); and
- The asset must be used or installed ready for use; and
- The asset must be owned or 'quasi'-owned. An example of quasi-ownership is where a taxpayer has a Crown lease and has attached plant to that land after acquiring the lease; and
- The asset is used for the purpose of gaining or producing assessable income or carrying on a business (however a proportionate depreciation allowance is available where plant is used only partly in the production of assessable income).

DEPRECIATION METHODS

There are 2 acceptable methods of depreciation:

- a) The prime cost or "straight line" method (PCM); and
- b) The diminishing value or "reducing balance" method (DVM).

A taxpayer may elect to use either method. Generally speaking, once you adopt a particular method of depreciation for a particular item, you cannot change to the other method for that item.

The Diminishing Value Method (DVM) may be preferable to the Prime Cost Method (PCM).

DVM claims are higher than PCM claims until about 70 percent of the way through the theoretical life of the asset, and lower in the later years of ownership. The advantage of one method over the other is cashflow. Tax saved in early years is money available for reinvestment into the business by way of working capital, or to the business owners by way of drawings.

For all assets (including motor vehicles) acquired after 21 September 1999, the depreciation deduction rate is determined solely by reference to effective life as determined by the taxpayer or by the Tax Office.

In the May 2006 Federal Budget, the government announced changes to the rate of the DVM. The rate that taxpayers use to work out the decline in value was increased from 150% to 200%. Put simply, you will be able to use this new rate for all eligible assets where:

- You use them for a taxable purpose;
- You first held those assets on or after 10 May 2006;
- Those assets are not in-house software, an item of intellectual property, a spectrum licence or a telecommunications site access right.

Therefore, for assets that meet the above criteria, the formula for working out the decline in value under the DVM is:

$$\text{Cost} \quad \times \quad \frac{\text{days held}}{365} \quad \times \quad \frac{200\%}{\text{asset's effective life (in years)}}$$

The formula for determining the amount of depreciation under the PCM is:

$$\text{Cost} \quad \times \quad \frac{\text{days owned}}{365} \quad \times \quad \frac{100\%}{\text{asset's effective life (in years)}}$$

EXAMPLE

Depreciation Calculations

The cost of an item of purchased plant is \$1 000. It has an effective life of 5 years and it is owned for the full year for producing assessable income. Depreciation calculated (in the first year) using each of the two methods is as follows:

DVM - The depreciation deduction will be \$400 calculated as follows:

$$\begin{array}{cccccc} \$ 1\ 000 & \times & \frac{365}{365} & \times & \frac{200\%}{5} & \\ & & & & & \end{array}$$

PCM - The depreciation deduction is \$200 calculated as follows:

$$\begin{array}{cccccc} \$ 1\ 000 & \times & \frac{365}{365} & \times & \frac{100\%}{5} & \\ & & & & & \end{array}$$

RATES OF DEPRECIATION

EFFECTIVE LIFE SCHEDULE

The effective life rates apply to plant and equipment acquired by:

- Non-small business concession taxpayers; and
- Non-business taxpayers (eg. employees and rental property owners).

You can either make your own estimate of the effective life of an item of plant, or adopt the effective life determined and published by the Commissioner. If you decide to make your own estimate of effective life, you need to take into account how long you expect the item of plant to be used (irrespective of who uses it), how you expect to use it and whether you would be likely to scrap it before the end of its useful life.

The Commissioner's published effective life schedule is published in Taxation Ruling TR 2010/2 - Income Tax: depreciation effective life. The ruling replaced TR 2009/4 - Income Tax: effective life of depreciating assets, with effect from 1 July 2010.

RE-ESTIMATION OF EFFECTIVE LIFE

Where plant or equipment is acquired on or before 21 September 1999 the effective life estimate, once applied, cannot be varied to reflect information gained in hindsight. However, for plant and equipment acquired on or after 21 September 1999, in recognition that the effective lives of assets can change because of technological or market developments or other factors connected with usage and consistent with the Ralph Review recommendations, taxpayers are able to reassess the effective lives of their assets.

This means that if an asset is expected to have a shorter effective life than originally anticipated, the rate of depreciation is able to be increased from the time of the reassessment. The adjustment can be made whether a taxpayer self-assessed effective life, or used the Commissioner's schedule.

This fresh calculation of effective life may be either up or down, but it must be based on market or technological developments or other changes in circumstances connected with usage.

CHAPTER 5

TAX PLANNING

Tax planning is a term we hear often but you might be tempted to ask exactly what does the term mean? Tax planning may be described as considering the tax implications of individual or business decisions throughout the year, so as to comply with the tax law (including the anti-avoidance provisions) and usually with the goal of minimising the resulting tax liability. It is the right of every Australian taxpayer, a right not lost on the late, Mr Kerry Packer.

When Kerry Packer was asked at the 1991 Senate Fairfax inquiry to state his full name and the capacity in which he appeared, he replied, “Kerry Francis Bullmore Packer. I appear here reluctantly.”

At the same inquiry when questioned about his contribution to tax, he responded, “Of course I am minimising my tax, and if anybody in this country doesn't minimise their tax they want their heads read, because as a government, I can tell you, you're not spending it that well that we should be donating extra.”

Many consider tax planning to be solely a year-end exercise, however tax planning is a year-round sport. The borrowing, spending and investment decisions you make from 1 July through to 30 June each year shape your tax bill for the year.

The Australian income tax system taxes not only income that individuals earn directly, but also income earned through entities such as partnerships, trusts and companies. Current income tax laws apply various approaches to taxing different kinds of entity income in different circumstances.

Some of the most important tax planning you might ever undertake can occur before you earn your first dollar from a business enterprise – that is, planning the choice of structure/entity you will operate through.

Tax planning is not the sole domain of big business or the wealthy. All taxpayers, ranging from the individual through to the huge corporate, can use tax planning techniques. In the following passages, we will look at some common tax planning techniques taxpayers can use and the trading structures through which they might operate.

CHOICE OF ENTITY - TRADING STRUCTURES

Business and investments are conducted through a number of different legal structures. The choice of structure can significantly affect the taxing of various transactions. The correct choice of structure can result in significant tax savings each year, as well as minimised legal and economic risks to the owner.

The most common types of trading structures are:

- Sole traders;
- Partnerships;
- Companies; and
- Trusts.

There is no single, superior operating structure. Rather, the most appropriate structure depends on your individual circumstances and needs. To inform your choice, you should consider the following factors:

- Asset protection
- Minimisation of tax, and
- Compliance costs.

Asset Protection

There is risk attached to every business venture. Therefore one of the goals of most business owners is to limit their personal exposure to creditors. In this regard, at one end of the spectrum are sole traders, who assume great personal risk as they are personally liable for all of the debts of their business. This exposure can put at risk their personal assets if the business goes bad. By contrast, at the other end of the spectrum are companies. Company directors are largely protected from creditors except where the director offers a personal guarantee.