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Tax For Australians

FOR
DUMMIES®

by Jimmy B. Prince



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Dedication

This book is dedicated to my wife, Maria Rosa Prince.

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Jimmy Prince is a fellow of CPA Australia and a tax specialist. He is a former lecturer and tutor in income tax law at La Trobe University, Melbourne Institute of Technology and AMI Education, and teaches a number of investment courses for the CAE in Melbourne. He is the author of several investment books including *Shares & Taxation*, *Property & Taxation* and *Superannuation & Taxation*. In 2000, Jimmy was nominated for an Adult Learners Week 2000 outstanding tutor award.

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Introduction



Australian income tax law can be very complex and difficult to understand. You may need to thumb through two income tax assessment Acts equivalent in size to four telephone books, thousands of income tax rulings and a library full of legal books to find the right answer.

The dominant purpose of the income tax legislation is to raise revenue by levying a tax on taxable income. The tax Acts point out that assessable income minus deductions equals taxable income, and then tell you the rules you need to follow to calculate your assessable income and allowable deductions. The Acts also tell you who must pay income tax and how to work out how much income tax you must pay.

Generally, you have a choice of two ways to solve your tax liability problems: You can either pay a registered tax agent or solicitor who specialises in income tax law, or you can try to find out the answer yourself. If you pay someone, you quickly find that the meter starts ticking the moment you walk through the door. Although seeking professional advice is highly recommended and encouraged, you need never underestimate your own abilities. If you use basic research skills that you acquired during your student days plus the skills you use to do your job, you may be pleasantly surprised at how adept you are at taking on responsibility for your own tax journey.

So, if you have a winning edge — the skills to do basic research — why not have a go? If you can't solve your problem or you lack confidence, at least you tried. And if you do seek professional advice, you're in a position to have a meaningful conversation (especially if the fee is substantial!). As a student once said to me: 'I'll at least be in a position to verify and check the facts out myself and not feel like a fool!'

About This Book

Tax For Australians For Dummies caters for tax beginners and is useful as a quick reference for the more tax-savvy readers. As well as helping you come to terms with the basic principles of income tax law, it also appeals to students who plan to study tax law, because it closely follows the content of a standard course syllabus. The book explains in simple terms core taxation concepts that you need to be aware of when dealing with Australian issues. Throughout the book, case studies reinforce core taxation principles. Also, you have the option of checking out technical information such as references to major fact sheets and income tax rulings that tax professionals use and rely on to solve taxation issues. This level of information is useful to readers who are studying income tax law or who wish to understand how the Tax Office comes to certain tax conclusions in its own interpretation of the tax laws.

Conventions Used in This Book

To keep things consistent and easy to follow, here are a couple of the conventions this book uses:

- ✓ Tax terms appear in italics and are closely preceded or followed by an easy-to-understand definition.
- ✓ When I reference tax office publications or provide websites of interest, I include the address in a special typeface like this: `www.ato.gov.au`.

What You're Not to Read

Here and there throughout this book, you see sidebars — text boxes that are separate from the regular content and feature a grey background. Sidebars include information that's related to the content in the chapter but is also independent of it. You don't have to read them, and your understanding of the chapter's subject matter isn't going to suffer if you don't. While you're not going to miss critical information if you decide to skip them, many of the worked examples are great to come back to at a more relevant time — that is, when you're preparing your own tax return and the like.

Other things you can safely skip without worrying are the occasional paragraphs with a Technical Stuff icon beside them. Big surprise, this is stuff for tech-minded readers and represents information that's interesting (downright fascinating sometimes!), but not crucial to your general understanding of the subject matter.

Foolish Assumptions

I wrote this book with some assumptions in mind. I assume

- ✓ You're in one or more of the following categories — accountant or adviser on tax, employee, employer, investor, self-employed, retiree, taxation student, or worker in the tax industry.
- ✓ You want simple facts on the complex subject of tax in an easy-to-use format.
- ✓ You want to have on hand the many ways to minimise your tax while keeping the Tax Office happy.
- ✓ You're likely to be aged 18 years and upwards.

How This Book is Organised

This book has seven parts, divided as follows.

Part I: How You're Taxed in Australia

Part I shows that Australian income tax law uses a formula to tax income. Australian residents are taxed differently to non-residents, so it's important that you're aware of your residential status for the purposes of income tax legislation. This part also explains what happens if your tax affairs are audited.

Part II: Income from Personal Exertion

If you're an employee and you derive a salary or wage, your employer is required to deduct income tax from your pay and make a contribution to a superannuation fund on your behalf. At the end of the financial year, you need to lodge a tax return for

individuals disclosing your taxable income. This part shows that your main residence is exempt from tax and how your children are taxed on income they derive.

Part III: Tax-Effective Investments

In this part, I discuss the key taxation issues associated with investing and their impact on your investment's overall performance. You may be liable to pay tax on investment income and capital gains tax on gains. Further, you may qualify for certain tax deductions and some very handy tax offsets.

Part IV: Running a Business

If you plan on starting a business, you need to come to terms with the complex tax rules associated with operating a business. In this part of the book, you find out about the four ways you can structure your financial affairs and what you must do to comply with the tax Acts. You also discover the benefits you can gain from running a small business. This part also discusses fringe benefits tax and the goods and services tax provisions.

Part V: Thinking Long Term

Planning ahead and covering all your bases makes good financial sense. In this part, you find issues associated with preparing for retirement using superannuation and the taxation of pension options. You also find how your income and assets are taxed after you die and how to reduce the tax burden.

Part VI: The Part of Tens

In this part of the book, I look at ten different ways to help you reduce your tax bill and ten ways to help you live comfortably in retirement.

This part also contains an appendix (Appendix A) which discusses taxation issues for non-residents. I've also created an online appendix (Appendix B) which lists leading tax cases and Tax Office publications. (This online reference is a handy tool if you want to know whether a specific expense is tax deductible or you're studying tax law. You can find this appendix on our website: www.dummies.com/go/taxforaustraliansfd).

Icons Used in This Book

Some people are more visual than others. That's where icons come in handy. This book uses several icons and each has a little titbit of information associated with it. Here's what each icon means.



If you're keen and eager to learn more about tax, this icon points you to handy websites to help you quickly solve tax issues that may come your way.



This icon highlights a change in tax rules that the federal government is proposing for the future. Where possible, fixed commencement dates are given.



Everyone can use a friendly reminder. The Remember icon is a quick and easy way to identify some of the more important tax points that you may want to make note of throughout the book.



Sometimes I get carried away with technical stuff. Some of you are going to find this level of information really interesting; some of you may be bored to tears. Skip it if you wish or use it if you want a more complete understanding of your tax issue.



Tips include tax information that can help you save time or cut down on frustration.



Text flagged with the Warning icon can keep you out of trouble. Serious legal issues encourage you to watch your tax step.

Where to Go from Here

Tax For Australians For Dummies may not be the exciting novel that you read from cover to cover. Rather, you can dip in and out to suit the occasion (tax return time) or when your interest level is piqued (due to a change in personal circumstance or making plans for your retirement).

Each chapter is designed to give you a good overview of a specific tax topic you may be interested in, with case studies to reinforce the learning process.

While sitting in a comfortable chair or at your desk with a cup of coffee, within a matter of minutes you can come to terms with specific issues such as assessable income, deductions, superannuation and business structures. The book also provides a quick summary of the capital gains tax, fringe benefits tax and goods and services tax provisions.

By the way, if you're cramming for an exam or you're not sure about a particular issue, *Tax For Australians For Dummies* can quickly steer you in the right direction and save you much time and heartache! **Note:** Check out a number of leading tax cases and Tax Office publications in Appendix B, which is online at our website: www.dummies.com/go/taxforaustraliansfd. And, if you wish to brush up on a tax term, you can flip to the Glossary for a quick prompt.

Part I

How You're Taxed in Australia

Glenn Lumsden



*'We declare you a free man.
Now get back to the chain gang,
you're a taxpayer.'*

In this part ...

Australia uses two income tax assessment Acts to levy tax on taxable income. They're the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*. When you thumb through the 1936 Tax Act you would think it was written in a foreign language. Fortunately, the 1997 Tax Act is in plain English to help you to better understand your tax obligations.

In this part of the book, you find that Australian income tax law is made up of rules and regulations that you need to know and follow. I explain the rules for lodging your annual tax return, how self-assessment works and what happens if your tax affairs are audited.

Chapter 1

Understanding the Australian Tax System

.....

In This Chapter

- ▶ Breaking down the tax system
 - ▶ Progressing through the tax rates and rules
 - ▶ Determining sources of income
 - ▶ Paying tax if you're a company
-

If you find tax a — excuse the pun — taxing subject, you're not alone. Most people are confused by taxes and, of course, would rather not pay them. However, we all know the cliché: Death and taxes are the only sure things in life. So, put another way, you probably need to take some time to understand taxation. This chapter goes over some basic info that you need to understand in order to lodge your tax return in Australia. I explain the basics of the Australian tax system, tell you how to work out sources of income and examine what tax you need to pay if you're set up as a company.

Explaining the Australian Tax System

In Australia, two income tax assessment Acts are used by the federal government to levy tax on taxable income. They're equivalent in size to four telephone books and are the *Income Tax Assessment Act 1936* and *Income Tax Assessment Act 1997*. (The reason for two Acts is because the 1936 Tax Act is gradually being replaced with the more user-friendly 1997 Tax Act.)

Taxing matters: How it all began

In 1915, the Fisher Government introduced an Act to impose a tax on income from personal exertion, income from property and company profits. The major reason given was to help fund Australia's involvement in the Great War. However, after you let such a genie out of the bottle, stopping a politician from continually dipping a hand in your wallet or purse is nigh impossible. The federal government has since introduced

three additional taxes — capital gains tax (CGT, introduced in 1985), fringe benefits tax (FBT, 1986) and the goods and services tax (GST, 2000). When you come to think about it, the federal government has just about covered every conceivable way you can be taxed. The only thing it hasn't done is tax the air you breathe. But, wait on, hold your breath ... I'm quite sure some diligent bureaucrat in Canberra is currently examining this possibility!

Understanding Your Income Tax Rates

For resident individuals, tax is levied on worldwide income on a progressive basis, referred to as *marginal tax rates*. Your marginal tax rate can vary between 0 per cent and 45 per cent (marginal tax rates are shown in Chapter 5). This rating system means the more income you earn, the greater the amount of tax you're liable to pay.

Australia has numerous federal, state and territory, and local government taxes that you need to deal with.



The Australian Taxation Office (Tax Office) is the federal government authority responsible for administering Australia's tax laws. To help you meet your legal requirements, the Tax Office regularly issues free-of-charge fact sheets, income tax rulings, tax determinations and interpretative decisions to explain tax issues that need clarification. You can get copies of these fact sheets and tax rulings from your local tax office or you can visit the Tax Office's website (www.ato.gov.au).

Federal taxes

The most important federal taxes include the following:

- ✓ *Capital gains tax* (CGT) is paid on gains you make when you sell assets you own and on the occurrence of certain CGT events. Your main residence is exempt from tax and some other concessions may potentially be available (see Chapter 11 for more).
- ✓ *Customs duty* is paid on certain goods you import into Australia (for example, cameras, perfume, alcohol and cigarettes).
- ✓ *Excise duty* is levied on certain goods manufactured in Australia, such as alcohol and tobacco.
- ✓ *Fringe benefits tax* (FBT) applies to certain benefits you may receive (for example, your employer provides you with a car for private use). See Chapter 16.
- ✓ *Fuel tax* is levied on petrol.
- ✓ *Goods and services tax* (GST) is applied to most purchases and sales. See Chapter 15.
- ✓ *Income tax* is paid on income you derive from worldwide sources. See Chapters 5 to 7.
- ✓ The *Medicare levy* is used to help fund the Australian health system. The rate is 1.5 per cent of your taxable income.

In the 2010–11 tax year, if you earned below \$18,839 as an individual or \$31,789 as a couple/family, you were exempt from paying the 1.5 per cent Medicare levy. (**Note:** For each dependent child, the family threshold increases by \$2,919) Rates for the 2011–12 tax year are not available at the time of writing; check the Tax Office website (www.ato.gov.au) for this information.

If you don't have private health insurance, you may be liable to pay an extra 1 per cent Medicare levy surcharge. For the 2011–12 tax year, if your taxable income is above \$80,000 for individuals or \$160,000 for couples/families, the levy applies. (**Note:** The family threshold for the Medicare levy surcharge increases by \$1,500 for each dependent child after the first child.)





- ✓ *Withholding tax* is paid on certain income derived by a non-resident.
- ✓ From 1 July 2012, the federal government is to put a price (or tax) on *carbon emission*, to promote a 'clean energy future' and reduce Australia's carbon pollution.

For the financial year 2011–12 only, the federal government has set a flood levy, to assist with paying for the rebuilding of Queensland after the devastating floods that occurred there in 2011. You're levied 0.5 per cent of your taxable income if you earn between \$50,001 and \$100,000; above \$100,000 and you're charged 1 per cent of your taxable income. By the way — if you earn below \$50,000, or if you received a government emergency relief payment, the levy doesn't apply to you.

State taxes

Following are some of the taxes levied by states:

- ✓ *Gambling tax* is levied on certain gambling transactions (such as licence fees and poker machines).
- ✓ *Land tax* is paid on some property holdings.
- ✓ *Payroll tax* is levied on wages and fringe benefits an employer pays employees.
- ✓ *Stamp duty* applies to certain transactions, particularly when you buy a property.

Local taxes

Property valuation and *rates* charges fund local government services (such as rubbish collection).

Taxing Major Income Streams

Income is normally derived from three major sources:

- ✓ Income from personal exertion, such as salary and wages, bonuses and commissions you earn as an employee, and any allowances you receive (see Chapter 5)

- ✓ Income from property and investments, such as interest, dividends, rent, annuities and royalty payments (see Chapters 8 to 10)
- ✓ Income from carrying on (running) a business, such as profits you earn from your business activities (see Chapter 12)

Taxing your treasures: CGT assets

You may be liable to pay capital gains tax (CGT) on profits you make when you sell CGT assets such as shares, real estate and collectables. However, just 50 per cent of the capital gain you make is liable to tax if you own the CGT asset for more than 12 months. This concept is discussed in more detail in Chapter 11.



Under the CGT provisions, your main residence is exempt from tax. If you're temporarily absent from Australia, the good news is your main residence continues to be exempt for an indefinite period if the property isn't used to earn assessable income. Alternatively, if you lease the property while you're away, your main residence is exempt from tax for up to six years (for more details, see Chapter 6).

Bringing home the money: International sources of income

As an Australian resident, you're required to disclose income you earn from worldwide sources; non-residents are required to disclose income that has only an Australian source. Unfortunately, the tax Acts don't provide a statutory definition of source. Generally, three key tests are used to determine source of income:

- ✓ The place where you perform the services
- ✓ The place where you sign the contract to perform those services
- ✓ The place of the payment

Checking your residency status

Your residency status determines the amount of tax you're liable to pay — because different tax rules and tax rates apply to residents and non-residents.

A resident of Australia is a person who normally lives in Australia and has a permanent home and job in Australia (commonly known as the *residency test*). In most cases, determining residency is relatively straightforward. But this determination can become a little cloudy if you're absent from Australia for a long time.

Your personal circumstances can change from year to year, so a number of tests may be used to check whether you're a resident. The main tests are

- ✔ Do you intend to live in Australia?
- ✔ Are you physically present in Australia?
- ✔ How long do you stay in Australia each financial year?
- ✔ Do you have a family home in Australia?
- ✔ Do you have business and family ties in Australia?
- ✔ Are your personal assets located in Australia?

As a general rule, if you're out of the country for more than two years and you sever your economic and social ties with Australia (for example, you

quit your job and your family goes with you), you're most likely going to be treated as a non-resident for income tax purposes. Of course, after you leave Australia, you can still change your mind and come back in the future. On the other hand, if you migrate to Australia, you're generally considered a local for tax purposes from the date of your arrival, which means you're taxed as a resident from day one, and you gain all the tax concessions available to residents.

If you become a resident of Australia part way during the financial year, you can't claim the full *tax free threshold*. (The tax free threshold is the maximum amount of income you can receive that isn't taxed — see Chapter 5.) You need to pro rata the amount. You can claim one-twelfth of the amount for each month you're in Australia including the month you arrive. For example, if you arrive in Australia on 13 October 2012, at the time of writing your tax free threshold is \$13,650 ($\$18,200 \div 12 \times 9$ months).

The Tax Office has published Taxation Ruling 'TR 98/17' regarding the residency status of certain individuals entering Australia (such as migrants, academics, students studying in Australia, visitors on holiday and workers with prearranged employment contracts). You can download a copy from the Tax Office website (www.ato.gov.au).