Chapter 1

INCOME TAX

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Rulings

Returns, assessments and review

Penalties

¶1-000 Income tax

The big picture

This chapter provides an introduction to key concepts of Australia's income tax system. It should assist with understanding the more detailed discussion of specific areas of the income tax law in other chapters.

Calculation of tax ....¶1-050

- Income tax is payable for each financial year by individuals and companies and by some other entities, such as corporate limited partnerships, superannuation funds and trustees of trusts (in respect of certain trust income). The income of partnerships and trusts is generally taxed in the hands of the partners and beneficiaries. Individuals who are Australian residents, and some trustees, are also liable to pay the Medicare levy each year.
- Under Australia's self-assessment system, assessments of taxable income and tax payable are initially based on the information shown in the taxpayer's income tax return, with the Australian Taxation Office (ATO) having wide powers to amend assessments in the light of subsequent audits. Taxable income is calculated by subtracting deductions from assessable income. A tax loss arises if deductions exceed the assessable income and any net exempt income. The tax loss may be a deduction in a later year.
- Assessable income consists of income according to ordinary concepts (eg salary or wages) and statutory income, being amounts that are made assessable income by specific provisions of the law, such as the capital gains tax (CGT) provisions. Exempt income and non-assessable non-exempt income are not included in assessable income (eg income that is a fringe benefit).
- Deductions include losses or outgoings incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for that purpose. Losses or outgoings of a capital, private or domestic nature are not deductible. Deductions are also allowed under specific provisions of the law, such as the depreciation and gift provisions.
- Tax payable is the amount remaining after subtracting tax offsets from gross tax. The gross tax of an individual is calculated by applying progressively greater marginal rates to successive slices of taxable income, the bottom slice for residents being tax-free. The gross tax of a company is calculated by applying a single rate to the whole of the taxable income. Examples of tax offsets are the concessional rebates and foreign tax credits. Excess tax offsets (apart from imputation credits) are generally not refundable and cannot be offset against later years' tax.

Collection of tax ....¶1-105

- Income tax is usually collected in instalments before a person's actual tax liability for the year can be calculated. Amounts are paid, usually at regular intervals, under the Pay As You Go (PAYG) system as income is earned during the year, and these amounts are credited in payment of the tax assessed. PAYG withholding applies to salary and wage earners and the PAYG instalments system applies to taxpayers, including companies, with business and/or investment income that is not subject to PAYG withholding. Individuals who have an Australian Business Number (ABN) can enter into a voluntary agreement with a payer to have PAYG withholding apply to payments for the performance of work or services.

● Non-residents who derive dividends (other than most franked dividends), interest or royalties from Australia generally pay the tax on that income as a flat rate final withholding tax, collected by the payer under the PAYG withholding system. Non-final CGT withholding applies to the disposal of certain taxable assets by a non-resident.

Companies ....¶1-400

● Companies are taxed as separate legal entities. The tax paid by Australian resident companies is then imputed, or credited, to resident individual shareholders when they are assessed on franked dividends. Franked dividends paid to non-residents are not included in assessable income and are generally exempt from withholding tax.

● Companies are not entitled to a deduction for prior years' losses unless the company satisfies either a continuity of ownership or same business test. Wholly-owned groups of companies, trusts and partnerships can choose to be taxed as a single consolidated entity.

Partnerships and trusts ....¶1-450, ¶1-500

● Partnership and trust income is taxed to the partners and to the trust beneficiaries who are presently entitled to the income, which retains its character in their hands (eg franked dividends). Trustees may be taxed on some trust income (eg income to which no beneficiary is presently entitled). Some provisions of the law (eg the CGT provisions) apply directly to partners and not to the partnership. Partnership losses are allocated to the partners but trust losses are carried forward in the trust as deductions from future trust income, subject to conditions. Limited partnerships and some public unit trusts are taxed as companies.

Cross-border issues ....¶1-550

● A person's country of residence and the source of income are fundamental determinants of liability for Australian income tax. Australian residents are taxed on income from all sources, while non-residents are taxed only on income from Australian sources. Agreements between Australia and other countries for the avoidance of double taxation override domestic law and allocate taxing rights on certain income to Australia or the other country. An agreement may, for example, include rules for determining whether a person is a resident of Australia or the other country.

● An Australian resident with foreign investments is taxed on investment income actually derived, and can also be taxed on an accruals basis on certain income derived by non-resident entities or accumulated through certain offshore investments. A credit for foreign tax paid is allowed against Australian tax on foreign income. Foreign losses may be deducted against both Australian-sourced and foreign-sourced income.

Tax avoidance ....¶1-600

● Specific anti-avoidance provisions deal with particular tax avoidance practices and a general anti-avoidance provision can apply to arrangements as a last resort after the application of all other provisions of the law have been considered. A determination can be made under the general provision to cancel a tax benefit of a kind to which the provision applies. Specific measures deal with distribution washing arrangements. Another anti-avoidance provision deals with transfer pricing arrangements to shift profits out of Australia.

Other processes, obligations, rights and penalties ....¶1-650

- Taxpayers are obliged to keep records, provide information and lodge returns. Failure to meet obligations under the income tax law may give rise to penalties. The Commissioner makes private, public and oral rulings, binding on the Commissioner, on the way in which, in the Commissioner's opinion, particular provisions of the law apply. Taxpayers can apply to the Administrative Appeals Tribunal (AAT) for a review of certain decisions of the Commissioner, or appeal to the Federal Court.

CALCULATION OF INCOME TAX AND MEDICARE LEVY, INCLUDING TAXATION OF MINORS

¶1-050 Taxable income

Income tax is worked out by reference to the taxable income of a taxpayer for an income year. The formula for working out the taxable income of an individual or a company (¶1-400) is:

Taxable income = assessable income (¶1-250) – deductions (¶1-300)

Partnerships (¶1-450) and trusts (¶1-500) generally are not treated as taxpayers and do not have a taxable income. There are, however, exceptions to the general rule. A partnership is taxed as a company if the liability of any partner is limited. Some public unit trusts are also taxed as companies. Trustees of superannuation funds, approved deposit funds (ADFs) and pooled superannuation trusts (PSTs) are liable to pay tax on the taxable income of the fund or trust.

¶1-055 Tax payable

The formula for working out tax payable on taxable income is:

Tax payable on taxable income = gross tax – tax offsets (¶1-350)

Examples of tax offsets are the low income tax offset (''LITO''), the private health insurance offset, the franking credit offset, the foreign income tax offset and the tax offset for investments in early stage innovation companies. If total tax offsets exceed the gross tax, no tax is payable but the taxpayer is generally not entitled to a refund of the excess. However, some taxpayers, primarily individuals and superannuation funds, who receive franking credits are entitled to a refund if their franking credits exceed tax payable. The private health insurance offset is also a refundable offset.

Gross tax of individuals

The gross tax of an individual for 2018/19 is calculated according to the following scale of rates (excluding Medicare levy*):

Slice of taxable income ($)	Marginal rate of tax (%)	
	Resident	Non-resident
1–18,200	Nil	32.5
18,201–37,000	19	32.5
37,001–90,000	32.5	32.5
90,001–180,000	37	37
180,001+	45	45

* Non-residents are not liable for the Medicare levy.

For 2018/19, residents are entitled to a LITO of $445 for taxable income less than $37,000. The rebate reduces by 1.5 cents for every dollar by which the taxable income exceeds $37,000 with no rebate applying on taxable incomes of $66,667 or more. The rebate is not available for ''unearned'' income of minors (¶1-070).

In addition, for the period 2018/19 – 2021/22 a low and middle income tax offset (''LMITO'') is available to individuals with relevant income that does not exceed $125,333. The amount of the LMITO is:

- for taxpayers with income not exceeding $37,000 — $200
- for taxpayers with income exceeding $37,000 but not exceeding $48,000 — $200 plus 3% of the amount of the income that exceeds $37,000
- for taxpayers with income exceeding $48,000 but not exceeding $90,000 — $530, and
- for taxpayers with income exceeding $90,000 — $530 less 1.5% of the amount of the income that exceeds $90,000.

The effect of the LITO and LMITO means no income tax (excluding Medicare levy) is payable in 2018/19 until the resident's taxable income exceeds $21,594.

Example

Carol is a teacher whose salary for the year ended 30 June 2019 is $41,000. Carol earned interest income of $200. During the year she incurred $800 of work-related expenses (union fees, reference books and depreciation on library), made tax-deductible gifts totalling $300 and paid $100 to have her tax return prepared.

Carol's tax liability for 2018/19 is calculated as follows:

	$
Salary	41,000
Interest	200
ASSESSABLE INCOME	$41,200

Less:		
	$	
Work-related expenses	800	
Gifts	300	
Tax return preparation	100	1,200
TAXABLE INCOME		$40,000
Gross tax payable (excluding Medicare) at 2018/19 rates on a taxable income of $40,000 (see the table at ¶20-010)		4,547
Less:		
LITO ($445 – ([40,000 – 37,000] × 1.5%))		400
LMITO ($200 + (40,000 – 37,000) x 3%):		290
Ordinary tax payable		3,857
Plus:		
Medicare levy (2% × $40,000)		800
TAX PAYABLE (including Medicare levy)		$4,657

Individuals deriving income from an unincorporated small business are entitled to the ''small business tax offset'' which effectively provides a discount of 8% on the income tax payable on that business income subject to a maximum cap of $1,000 per year (see ¶1-283).

For more information about the calculation of income tax, see ¶20-010 to ¶20-030.

Special rules modify the calculation of gross tax on certain income. Examples are unearned income of minors (¶1-070) and the taxable income of primary producers.

Gross tax of companies

The gross tax of a company is calculated by applying a single rate to the whole of the company's taxable income. The applicable company tax rate will depend upon the classification of the company. The general company tax rate is 30%. However, where a company that is a base rate entity (which requires an aggregated annual turnover of less than $50 million) a lower tax rate of 27.5% applies. The threshold for 2017/18 was $25 million.

For more information about tax rates for companies and life assurance companies, see ¶20-070.

¶1-060 Self-assessment

The Commissioner makes an assessment of an *individual's* taxable income and tax payable on the basis of the information contained in the person's income tax return (¶1-700) without examining the return in detail. This process is known as ''self-assessment''. The Commissioner issues a notice of assessment (¶1-705) to an individual taxpayer requiring payment of any balance of tax payable but not collected under the Pay As You Go (PAYG) system (¶1-105) or refunding any excess amount collected. In the case of a *company*, the Commissioner is deemed to have made an assessment of the taxable income and tax payable specified in the tax return. The tax return is deemed to be a notice of assessment. This process is known as ''full self-assessment''.

¶1-065 Tax losses

If the deductions of a company, trust or individual exceed the assessable income and any net exempt income (¶1-260) for an income year, the resulting tax loss can be a deduction in calculating taxable income (net income in the case of a trust) in later years. There is no ability to carry back losses. A partnership can also make a loss for an income year, but the loss is allocated to the partners rather than being carried forward in the partnership. The tax treatment of losses of companies, partnerships and trusts is discussed at ¶1-400, ¶1-455 and ¶1-525 respectively.

¶1-070 Taxation of minors

A person who is under 18 years of age at the end of the income year (a minor) is effectively taxed on *unearned income*, whether derived directly or through a trust, is taxed at the marginal rate of 45% for 2018/19 unless the minor was engaged in a full-time occupation at the end of the year or for at least three months during the year. Income derived by a minor from property received from a deceased estate is excluded. Certain disabled children and double orphans are also exempt from the rules. If the unearned income is $416 or less, the tax payable is nil. The LITO and the LMITO is not available for minors to offset unearned income (though it can offset income from ordinary employment). For more details of the tax calculation for minors, see ¶20-040.

Unearned income

The types of income that constitute unearned income are not spelled out in the law. Unearned income is assessable income *other than*:

- employment income
- reasonable business income (having regard to the minor's participation in the business)
- income from a deceased estate or the investment of a range of property, including inherited property, property transferred to the minor as a result of a family breakdown, death benefits from life assurance or superannuation and certain compensation payments.

A family breakdown occurs when a marriage or de facto relationship (including same sex) breaks down or where a child support order is made for the benefit of a child whose parents were not living together as spouses when the child was born. The taxation of minors in relation to family breakdown is covered in Chapter 18.

Unearned income therefore includes income, such as dividends, interest and rents, from the investment of property acquired by the minor in ways other than those mentioned.

As beneficiary of a trust

If a minor is a beneficiary of a trust, the portion of the minor's share of the net income of the trust that is attributable to unearned income is also subject to these rules. The income is taxed to the trustee at the rates that would have applied if the minor had derived the income. Business income of a trust is unearned income, as is employment income unless the minor does the work. A deceased estate's income is not unearned income.

¶1-075 Medicare levy and surcharge

A Medicare levy is payable by an individual who is a resident at any time during an income year. The levy is a fixed percentage of taxable income. The rate for 2018/19 is 2%. The proposed increase to 2.5% from 2019/20 has been abandoned. Low income individuals may pay no levy or a reduced one (¶20-020).

A Medicare levy surcharge is imposed on high income taxpayers who do not have adequate private patient hospital insurance. These taxpayers are required to pay a levy surcharge on the whole of their taxable income, reportable fringe benefits and the net amount on which the family trust distribution tax has been paid. The Medicare levy surcharge applies on a tiered system. The relevant tiers for 2018/19 are as follows:

Tier	Single Income Threshold	Families Income Threshold	Rate of Levy Surcharge
Nil	Up to $90,000	Up to $180,000	Nil
1	$90,001–$105,000	$180,001–$210,000	1%
2	$105,001–$140,000	$210,001–$280,000	1.25%
3	$140,001 and over	$280,001 and over	1.5%

''Families'' includes couples and single parent families. The relevant families income thresholds increase by $1,500 for each independent child after the first. While the income thresholds are generally indexed annually, the above thresholds are frozen until 2020/21.

The income for surcharge purposes is the total of the following amounts:

- taxable income for the income year
- reportable fringe benefits total
- reportable superannuation contributions, and
- total net investment loss.

Example

For 2018/19, Neil has taxable income of $135,000, reportable superannuation contributions of $10,000 and no reportable fringe benefits or investment loss. Neil is married to Nancy who has taxable income of $80,000 and no reportable fringe benefits, reportable superannuation contributions or investment loss. Neither of them has adequate private patient hospital cover, nor do they have dependent children or receive trust distributions. They will both have to pay the additional 1.25% levy surcharge on their taxable income because their combined income for surcharge purposes is $225,000, being over $210,000 but below $280,000, even though Nancy earned less than $90,000.

Consider if instead, Neil had taxable income of $135,000 and reportable superannuation contributions of $10,000 but Nancy's taxable income was only $42,000. As their combined income is $177,000, being under the $180,000 threshold, neither of them would be required to pay the levy surcharge, notwithstanding that Neil's income for surcharge purposes exceeds the single threshold of $90,000.

A trustee is generally liable to pay the Medicare levy in respect of a share of the net income of a trust (¶1-505) to which a resident beneficiary, under a legal disability, is presently entitled, or to which no beneficiary is presently entitled. In the latter case special shade-in rules may apply.

For more information about the calculation of the Medicare levy and Medicare levy surcharge, see ¶20-020.

¶1-090 Interaction between income tax and FBT

Income tax is not payable by employees on certain benefits which are dealt with under fringe benefits tax (FBT), such as car benefits and loan benefits. The value of such a benefit does not have to be included in the employee's assessable income. FBT contains rules for working out the taxable values of benefits but FBT does not apply to certain specified benefits, such as salary or wages and contributions by employers to complying superannuation funds. For more details on the operation of FBT, see ¶3-000 and following.

Reporting of benefits on payment summaries

The value of certain fringe benefits is taken into account for the purpose of applying certain income tests, eg in determining liability to the Medicare levy surcharge, Higher Education Loan Programme (HELP) and Higher Education Contribution Scheme (HECS) debt repayments, the entitlement to concessions for personal and spouse superannuation contributions and the imposition of Div 293 tax on concessional superannuation contributions. For this purpose, employers are required to record on payment summaries the grossed-up taxable value of the benefits provided to the employee during the FBT year where the value of the benefits exceeds $2,000. Some fringe benefits do not have to be reported, including car parking fringe benefits, remote area benefits and meal entertainment fringe benefits.

Salary sacrifice

An employee's after-tax position may be improved by replacing salary with certain benefits that are subject to concessional FBT treatment or are specifically exempt from FBT. Improvement will be evident where the FBT taxable value is such that the employer can meet the costs of both the benefit and the FBT out of the forgone salary and the employee's benefit is greater than could have been acquired with the after-tax salary. A common example is a car benefit. Unless the benefit provided is concessionally taxed (for example, superannuation, a laptop, portable electronic equipment or a car benefit), there is generally little advantage to salary sacrificing benefits unless the employee is on the top marginal tax rate or works for a non-profit organisation. Further, care needs to be taken in salary sacrificing certain benefits as the usual concessional treatment for such benefits may be lost (eg in-house benefits). For more detailed information, see ¶10-010.

PAYMENT OF INCOME TAX AND COLLECTION SYSTEMS

¶1-100 Financial year and income year

Income tax is payable *for a financial year* but is calculated by reference to taxable income *for an income year*. The income year of an individual is also the financial year for which tax is payable. In contrast, a company's income year is the year before the financial year for which tax is payable.

Most taxpayers (including companies) are required to pay most of their tax during the income year through the PAYG instalment system (¶1-105).

¶1-105 Collection of tax

Taxpayers are required to pay all or most of their annual tax liability before the actual tax payable on their taxable income can be worked out on assessment. Amounts are paid at regular intervals as income is earned during the year, and these amounts are credited in payment of the tax assessed. The system for collecting these advance payments of tax is called Pay As You Go (PAYG) and has two components:

- PAYG withholding
- PAYG instalments.

PAYG withholding

Payments subject to PAYG withholding are called ''withholding payments''. The entity making the withholding payment is obliged to withhold an amount from the payment and pay the amount withheld to the Commissioner. The amount required to be withheld is worked out under withholding schedules that are available from the Australian Taxation Office (ATO). Withholding payments include the following:

- payments of salary or wages, directors' fees, superannuation pensions, annuities, taxable social security pensions and benefits, payments on retirement in lieu of unused annual leave or long service leave and ETPs (¶1-285)

- payments for a supply (including supplies of goods, services and advice) where the payee does not quote its Australian Business Number (ABN) (¶1-120)
- payments arising from an investment where the payee does not quote its tax file number (TFN) or ABN to the investment body (¶1-115)
- dividends, interest or royalties paid to non-residents. The amount withheld is not to exceed the withholding tax (if any) payable in respect of the relevant dividend, interest or royalty (¶1-150)
- a payment covered by a voluntary agreement between the payer and payee under an arrangement for the performance of work or services, where the payee is an individual and has an ABN. Agreements do not have to be lodged with the Commissioner, but must be in the approved form and must quote the payee's ABN. A copy of the agreement must be kept by both parties for five years after the last payment covered by the agreement. Either party may terminate the agreement, in writing, at any time
- the disposal of taxable Australian property (including indirect interests and options or rights to acquire such property) by a foreign resident is subject to limited exclusions (¶1-295).

Variation of PAYG withholding amounts

The Commissioner of Taxation has discretion to vary prescribed PAYG withholding rates if total amounts withheld for the income year are likely to significantly exceed the tax payable. Application forms are available from the ATO. Reasons for applying for a variation of withholding amounts could include:

- an expected loss on another income-earning activity such as a negatively geared investment
- expected significant work-related expenses
- the receipt of an allowance from an employer for a tax-deductible purpose, eg travel
- prior year losses
- known or expected entitlement to offsets on franked dividends to offset tax payable on salary or wages.

The Commissioner will not approve a variation if any of the taxpayer's tax returns are outstanding. The Commissioner cannot vary a withholding amount in relation to an investment where the investor does not quote a TFN or ABN.

Other special cases

PAYG withholding amounts may be lower in a range of circumstances:

- the amount withheld can be reduced if a superannuation pension or annuity qualifies for a rebate or has a tax free component

- the rates of withholding from payments in respect of accrued leave on termination of employment generally match the rates of tax, some of which are concessional, that apply to such payments. Those rates of tax are set out at ¶1-265
- where the disposal of the taxable Australian property by a foreign resident taxpayer would give rise to a tax loss and the taxpayer obtains a variation of the withholding.

Employers may also be required by the Department of Human Services to make deductions of child maintenance from an employee's salary or wages.

PAYG instalments

The PAYG instalment system applies to taxpayers who have business and/or investment income that is not subject to PAYG withholding. The system applies to individuals, companies and superannuation funds, corporate unit trusts, public trading trusts and, generally, to trustees who are assessable on trust income.

PAYG instalments are payable only if the Commissioner gives the taxpayer an ''instalment rate''. The instalment rate is, broadly, the taxpayer's notional tax (ie a modified tax on taxable income) for the latest year for which an assessment has been made, expressed as a percentage of the taxpayer's ''instalment income'' for that year. Individual taxpayers are liable for instalments where they have gross business or investment income of $4,000 or more ($1 or more for non-residents) in their most recent tax return unless one of the following applies:

- the adjusted balance of the taxpayer's last assessment was less than $1,000
- the taxpayer's notional tax was less than $500
- the taxpayer is entitled to the seniors and pensioners tax offset.

Companies, superannuation funds and self managed superannuation funds (SMSFs), including those registered for GST, are not required to pay PAYG instalments if their notional tax is less than $500, even if their instalment rate is greater than 0%, unless:

- their business and/or investment income (excluding capital gains) in their most recent income tax return is $2m or more, or
- the taxpayer is the head of a consolidated group.

Instalment income for a period (eg an income year or a quarter of an income year) is the taxpayer's ordinary assessable income (eg business income) derived during the period, excluding amounts that are subject to PAYG withholding. Deductions for expenditure in the period are not taken into account. Nor, generally, is statutory income, such as capital gains and imputation credits. Complying and non-complying superannuation funds, ADFs and PSTs have to include statutory income in their instalment.

Partnerships do not have to pay PAYG instalments, but they need to calculate instalment income so that the partners can include their share in their individual instalment incomes.

Quarterly instalments

The general rule is that taxpayers are required to pay their PAYG instalments quarterly unless the taxpayer has base instalment income of $20 million or more and monthly instalments are required (see below). For taxpayers who pay their GST monthly, the due dates for PAYG instalments are 21 October, 21 January, 21 April and 21 July. For other taxpayers, the due dates are 28 October, 28 February, 28 April and 28 July. Quarterly instalments are not payable if the taxpayer is eligible to pay a single annual instalment and chooses to do so (see below). Certain primary producers, sportspersons, authors and artists are required to pay only two PAYG instalments, for the third and fourth quarters.

The amount of a quarterly instalment for an individual, or for a company or superannuation fund whose previous year's instalment income is $2 million or less, is calculated by the Commissioner on the basis of the taxpayer's latest assessed tax, with an adjustment for movements in Gross Domestic Product (GDP), and notified to the taxpayer. Alternatively, the instalment may be based on the taxpayer's estimate of the current year's tax liability net of PAYG withholding credits. These rules also apply to a company or fund whose previous year's instalment income is over $2 million if it is eligible to pay a single annual instalment but does not choose to do so.

A taxpayer not eligible to pay its quarterly instalments on the above basis, or one that is eligible but chooses not to pay on the above basis, must calculate its quarterly instalment by multiplying its instalment rate by its instalment income for the quarter. The instalment rate is either the one given by the Commissioner or one chosen by the taxpayer, although the general interest charge may be payable if an instalment based on the taxpayer's instalment rate is too low.

Monthly instalments

A taxpayer will generally be required to make monthly PAYG instalments if they have a base assessment instalment income of $20 million or more and they are one of the following:

- corporate tax entity (eg companies)
- superannuation fund
- trust
- sole trader
- large investor.

However, such entities that lodge their GST quarterly or on an annual basis will only be required to pay monthly if its threshold is at least $100 million and it is not a head company to a consolidated group or a provisional head company of a multiple entry consolidated group. A head company of a consolidated group or a provisional head company of an MEC group will be a monthly payer if their threshold amount is equal to or greater than the $20 million threshold, regardless of the GST reporting requirements.

An entity cannot object to being required to make instalments on a monthly basis.

The amount of the instalment is generally calculated as the instalment income for the month multiplied by the instalment rate. However, there is an additional simplified method for calculating the instalments that may be applied unless the entity is notified by the ATO that it cannot use that method. This simplified method allows for the taxpayer to make a reasonable estimate of the instalment income for the first two months of a quarter to which it can apply the instalment rate. In the third month of each quarter the taxpayer calculates the total instalment income for the quarter and subtracts the estimates used in the first two months. The payment in the third month will be the balance remaining for the quarter, multiplied by the applicable instalment rate.

A monthly instalment is due on or before the 21st day of the following month, or, if the entity is a deferred business activity statement (BAS) payer, by the 28th of the following month. All monthly PAYG instalments must be lodged and paid electronically.

Annual instalment

A taxpayer who is otherwise liable to pay quarterly instalments and meets certain requirements at the end of the first quarter for which an instalment would otherwise be payable can choose instead to pay one annual PAYG instalment. Two of those requirements are that the taxpayer is neither registered, nor required to be registered, for GST, and that the notional tax most recently advised to the taxpayer by the Commissioner (ie a modified latest assessed tax) is less than $8,000. The taxpayer must notify the Commissioner of this choice, in the approved form, on or before the due date for the first quarterly instalment.

The amount of an annual instalment is generally calculated by multiplying the Commissioner's instalment rate by the taxpayer's instalment income for the income year. Unlike the calculation of quarterly instalments, the taxpayer cannot choose an instalment rate.

Alternatively, the taxpayer can choose to pay as its PAYG annual instalment either the notional tax amount most recently notified by the Commissioner (ie a modified tax on the most recently assessed taxable income) at least 30 days before the instalment due date, or the taxpayer's estimate of the current year's tax liability net of PAYG withholding credits (benchmark tax).

If the taxpayer's estimate of annual or quarterly tax payable is inaccurate, penalties may apply.

Example

In 2017/18, Miguel derived $25,000 salary, $20,000 business income and $2,000 interest. He incurred $5,000 in business expenses. On 31 August 2018, the Commissioner gives Miguel an instalment rate of 29.07%. Miguel is therefore liable to pay PAYG instalments for 2018/19.

At 30 September 2018, Miguel is not registered, nor required to be registered, for GST, and the notional tax amount most recently notified to him by the Commissioner is $5,000 (in relation to 2018/19). Miguel is therefore eligible to pay an annual PAYG instalment and notifies the Commissioner on 30 September 2018 that he chooses to pay an annual instalment.

On 1 April 2019, the Commissioner notifies Miguel that his notional tax amount in relation to 2018/19 is $5,100. While Miguel considers the Commissioner's instalment rate too high he does not choose to estimate his benchmark tax for 2018/19. Miguel's annual PAYG instalment for 2018/19 is therefore $5,100. Upon lodgement of his 2018/19 tax return he will be entitled to refund for any tax overpaid.

¶1-115 Failure to quote TFN to investment body

Every taxpayer can apply to the ATO for a TFN. The TFN system enables the ATO to match income disclosed in tax returns with information obtained from other sources. Investors who make certain types of investments should quote their TFN (or, in the case of a business investment, their ABN — ¶1-120) to the investment body, otherwise the investment body must generally withhold an amount on account of tax from any income payable on the investment. The amount withheld is 47% of the payment being the top marginal rate plus the Medicare levy. A credit for the amount withheld is allowed on assessment.

The TFN quotation rules apply to, for example:

- interest-bearing accounts and other deposits with banks and other financial institutions
- loans to government bodies and companies
- units in unit trusts
- shares in public companies
- notionally accrued interest on deferred interest investments (but the investment body can recover the withheld amount from the investor).

Exemptions from TFN rules

Exemptions from the TFN rules apply in regard to:

- accounts or deposits with financial institutions where the annual interest is less than $120 (although exploitation of the threshold may be an offence). This annual limit may be increased to $420 in some situations where the investor is under 16 years of age
- people receiving age or other specified social security pensions
- dividends or interest received by non-residents that are subject to withholding tax
- fully franked dividends on shares in public companies.

¶1-120 Australian Business Number

The Australian Business Number (ABN) is a business identifier which facilitates businesses' dealings with the government. To get an ABN, an entity must apply to be registered on the Australian Business Register. The Commissioner is the Registrar. An ABN is available to companies, government entities, other entities carrying on an enterprise in Australia, and other entities required to register for the GST. Activities as an employee do not constitute an enterprise. The following examples illustrate the significance of ABNs under the tax laws:

- an entity required to register for the GST must have an ABN
- quoting an ABN can ensure that certain payments are not subjected to PAYG withholding (¶1-105)
- ABNs are used by businesses in business activity statements notifying the ATO of their obligations to make periodic tax payments, such as GST, PAYG withholding, PAYG instalments and fringe benefits tax (FBT) instalments (¶1-090)
- charities seeking tax exemption and entities seeking deductible gift recipient status must obtain an ABN.

WITHHOLDING TAX ON DIVIDENDS, INTEREST AND ROYALTIES

¶1-150 Dividend, interest and royalty withholding tax

Non-residents who derive dividends, interest or royalties from residents are generally liable to pay income tax as a withholding tax on the gross amount of that income at specified flat rates. The withholding tax provisions extend to interest and royalties derived by residents in carrying on business through a permanent establishment overseas which is paid by:

- another resident and it is not wholly incurred by the payer in carrying on a business in a foreign country through a branch in that country, or
- a non-resident and it is wholly or partly incurred in carrying on business in Australia through a branch.

Withholding tax is a final tax liability on the income and is collected by way of PAYG withholding by the payer. Income on which withholding tax is payable is not included in the recipient's assessable income.

Exclusions from withholding tax

There are significant exclusions from the withholding tax provisions. For example, franked dividends are generally not subject to withholding tax. Nor are interest payments on borrowings raised outside Australia by means of publicly offered debentures. Interest and royalties are not liable to withholding tax if the interest is derived by a non-resident carrying on a business in Australia at or through a permanent establishment in Australia.

Rates of withholding tax

Where dividends (generally unfranked dividends), interest or royalties are subject to withholding tax, the rates are generally as shown in the following table:

	No DTA*	DTA*
Dividends	30%	15% (generally)
Interest	10%	10%
Royalties	30%	10% (generally)

* A double taxation agreement between Australia and the non-resident's country of residence.

ASSESSABLE INCOME AND EXEMPT INCOME

¶1-250 Annual basis of taxation

Taxable income for an income year is calculated by subtracting from assessable income all deductions. Assessable income includes income according to ordinary concepts *derived during the income year*. The calculation of tax payable for a year therefore depends not only on whether certain income is derived but also on *when* the income is derived. In addition, progressive marginal tax rates for individuals mean that the timing of income derivation can have a significant effect on the total amount of tax payable over two or more years.

When is income derived?

The time at which income is derived can vary according to the nature of the income and the income-earning activities of the taxpayer. For example:

- salary or wages, directors' fees, interest derived by an individual and rent are generally derived when received. Income that is not actually received can be constructively received, and therefore be deemed to be derived. An example is where interest is credited on a savings bank deposit
- trading income is generally derived when the right to receive it arises as a debt due and owing
- a professional person assessed on an accruals basis is taken to have derived fees when a recoverable debt is created by, for example, sending an account to the client
- the yield from discounted or other deferred interest securities with terms exceeding 12 months is assessed as the income accrues over the term rather than when received on maturity
- dividends are included in the assessable income of a shareholder when they are paid, credited or distributed to the shareholder. A dividend is therefore taxable in the year the dividend cheque is posted to the shareholder even though the cheque is not received until the following

year. A dividend in the form of fully-paid bonus shares is included in assessable income when the bonus shares are issued.

Example

On 30 June 2019 Magnus received a wages payment of $2,000 (one week in advance, one week in arrears), and rental income of $1,000 from his rental property (payment is required on the last day of the month for the following month). He has a term deposit for which the term expires on 30 June 2019. However, the bank does not credit his cheque account with the interest until 2 July 2019. On 2 July 2019 he also receives a dividend cheque of $500 which was posted by the company on 30 June 2019.

Magnus' assessable income for 2018/19 includes the:

- full $2,000 of the wages payment
- rental income of $1,000
- dividend of $500.

The interest will form part of Magnus' assessable income for 2019/20.

¶1-255 Assessable income

Assessable income consists of *ordinary income* and *statutory income*, although some ordinary income and some statutory income can be *exempt income*. Exempt income is not assessable income. The assessable income of an Australian resident (¶1-550) includes ordinary income and statutory income from all sources (¶1-555), whether in or out of Australia, during the income year. The assessable income of a non-resident includes ordinary income and statutory income from Australian sources only.

The GST payable on a taxable supply is excluded from the supplier's assessable income and exempt income. It falls into another category called non-assessable non-exempt income.

Ordinary income

Ordinary income is income according to ordinary concepts. The characteristics of income according to ordinary concepts, such as regularity of receipt, have been identified in decided cases over many years. Earnings from personal services, business receipts, interest and rents are examples of ordinary income. Special provisions of the law sometimes modify the way in which ordinary income is included in assessable income. For example:

- annuities are included in assessable income under a provision that excludes from assessable income the part of the annuity that represents the return of a portion of the purchase price of the annuity. The excluded amount is calculated in accordance with a formula contained in the provision
- a non-cash business benefit may be treated as ordinary income even if it is not convertible into money (convertibility into money being a usual condition of an amount being ordinary income), provided the benefit is

otherwise of an income nature. A non-cash business benefit arises when property or services are provided to a business taxpayer in connection with a business relationship.

Income versus capital

Receipts of capital, such as a gain on disposal of an asset, are not ordinary income, and are therefore not assessable income unless included as statutory income as, say, a component of a net capital gain under the capital gains tax (CGT) provisions (see Chapter 2). A lump sum received on commutation of a superannuation pension or annuity, for example, would not be ordinary income, although the special provisions dealing with ETPs may treat some part of the lump sum as statutory income. In characterising a receipt as capital or income, it is the character of the amount in the hands of the recipient that matters. A payment that is income in the hands of the recipient may nevertheless be a capital payment, and therefore not a tax deduction, for the payer.

Statutory income

An amount is statutory income if it is not ordinary income but is included in assessable income by a specific provision of the income tax law. For example, a special provision includes in assessable income an amount that is a royalty in the ordinary sense of the word but is a capital receipt rather than income according to ordinary concepts. Such an amount is statutory income.

¶1-260 Exempt income

If an amount is exempt income, it is not assessable income and therefore not taxable. Net exempt income (see below) can reduce the amount of a tax loss incurred in an income year and also reduce the extent to which a tax loss is available for set off against assessable income of a later income year. Exempt income is made up of:

- ordinary income or statutory income that is made exempt by a provision of the law
- ordinary income that the law excludes, expressly or by implication, from being assessable income (and is not non-assessable non-exempt income).

Some examples of exempt income are:

- some pensions paid under foreign laws that are, broadly, related to enemy persecution during the Second World War or to disability arising from participation in a resistance movement during that war
- periodic maintenance payments to a spouse or former spouse
- earnings of a resident taxpayer from at least 91 days' continuous employment in a foreign country, including in some cases earnings that are also exempt from income tax in the foreign country, provided the income is earned as:
  - an aid or charitable worker employed by a recognised non-government organisation

  - a government aid worker, or
  - a government employee deployed as a member of a disciplined force.
- some scholarships and bursaries received by full-time students.

Net exempt income

A person's net exempt income for an income year is the excess of total exempt income for the year over the sum of the losses and outgoings (other than capital ones) incurred in deriving the exempt income and any foreign taxes payable on that exempt income. Net exempt income may reduce the amount of current year or carry forward losses available to a taxpayer.

Non-assessable non-exempt income

Non-assessable non-exempt income is a third category of income recognised by the income tax law. Non-assessable non-exempt income is ordinary or statutory income that is expressly made neither assessable income nor exempt income.

As non-assessable non-exempt income is not assessable income, it is not taken into account in working out a taxpayer's taxable income for an income year. As the amount is also not exempt income, it is not taken into account in working out a taxpayer's tax loss for an income year or in working out how much of a prior year tax loss is deductible in an income year.

Some examples of non-assessable non-exempt income are:

- the GST payable on a taxable supply
- amounts subject to family trust distributions tax
- foreign sourced ordinary income derived by a temporary resident
- dividends, interest and royalties that are subject to withholding tax when derived by non-residents
- exempt payments made by mining companies for the benefit of Aborigines or Aboriginal representative bodies.

¶1-265 Income from personal services and pensions

Earnings from providing personal services, whether under a contract of employment or some other contract for services, are assessable income. Assessable amounts include salary and wages, long service leave pay, directors' fees and commissions. The earnings are assessable in the year of receipt, not necessarily in the year in which the services are provided.

The following benefits are *not* assessable income:

- an employer's contributions to a complying superannuation fund for an employee's benefit. The contributions are deductions for the employer and taxable in the hands of the fund (although taxpayers with combined income and concessional superannuation contributions in a year exceeding $250,000 are personally taxed an additional 15% on those concessional contributions — see ¶4-225)

- benefits received by employees for frequent flyer points accumulated as a result of travel paid for by the employer. The reason is that the benefit does not arise from the employment relationship (where a non-cash benefit does arise from an employment relationship, the value of the benefit is generally subject to the FBT provisions (¶1-090) and is not included in the employee's assessable income)
- amounts received from pastimes, hobbies or windfall gains, including general gambling and lotto wins
- gifts that are not related to personal services.

Alienation of personal services income

Individuals are prevented from reducing or deferring their income tax by diverting their personal services income through a company, partnership or trust. Any diverted personal services income is included in the assessable income of the individual who performs the services, after allowing for certain costs incurred by the interposed entity. This rule does not apply where the interposed entity derives the income from conducting a personal services business or the income is promptly paid to the individual as salary or wages.

Employee share acquisition schemes

Benefits in the form of discounts on shares or rights acquired under an employee share acquisition scheme are taxed under special provisions. The rules have changed over time depending upon the date of acquisition of the shares or rights. The following applies to shares or rights acquired from 1 July 2015.

The general rule is that a discount (being the market value less consideration paid) received on a share or right is included in assessable income in the year of acquisition. This general rule does not apply and the tax will be deferred until a later time where:

- the shares are acquired under a capped salary sacrifice scheme under which an employee can obtain no more than $5,000 worth of shares and there is no real risk of the forfeiture of those shares
- the shares or rights are acquired under a scheme for which there is a real risk of forfeiture of the shares or rights
- the rights are acquired under a scheme that does not contain a real risk of forfeiture provided the scheme rules state that tax deferred treatment applies and the scheme genuinely restricts an employee from immediately disposing of the rights.

The deferral is only available where the scheme meets certain qualifying conditions.

Where the deferral applies, the discount is included in the recipient's assessable income at the earliest of the following times:

- in the case of a share, there is both no longer a real risk of losing the share and no restriction preventing the taxpayer from disposing of the share

- in the case of a right, when there are no longer any genuine restrictions on the disposal of the right and there is no real risk of the taxpayer forfeiting the right, or the time when the right is exercised and there is neither a real risk of the taxpayer forfeiting the resulting share or a genuine restriction on the disposal of the resulting share
- cessation of employment, and
- the end of 15 years after the acquisition of the share or right.

In addition, an exemption of $1,000 is available to be claimed by a taxpayer that is required to include the discount in their assessable income in the year of acquisition, if certain conditions are met and the individual has an adjusted taxable income (see ¶1-355) of less than $180,000.

Further, in relation to interests received in certain small start-up companies, the taxpayer may be eligible for:

- in relation to certain shares — an income tax exemption for the discount received. The shares will be subject to CGT provisions with a cost base reset at market value, and
- in relation to certain rights — the deferral of income tax on the discount. The rights will be taxed under the CGT provisions with the rights having a cost base equal to the taxpayer's cost of acquisition. Any shares acquired pursuant to the exercise of such rights are treated as having been acquired at the time the rights were acquired for determining whether the shares have been held for at least 12 months to apply the CGT discount.

For further information on employee share schemes, see ¶10-470.

Pensions

Most social security and veterans' entitlement pensions paid to people of pensionable age are assessable income, but a tax offset is available. For details of the Senior Australians and pensioner tax offset (SAPTO), see ¶1-355. Certain war-time persecution pensions are exempt from tax (¶1-260). The tax treatment of annuities and superannuation pensions is outlined at ¶1-290 and covered in detail at ¶16-700.

Termination of employment

If an employee is paid an amount in consequence of the termination of employment, the amount is generally taxable under special rules applicable to ETPs. Termination payments that are excluded from ETP treatment are dealt with at ¶1-285, eg the tax-free amount of a genuine redundancy payment or an early retirement scheme payment. The special rules that apply to payments in lieu of unused annual leave and payments in lieu of unused long service leave are outlined below.

Payments in lieu of unused annual leave

A payment that is in respect of unused annual leave and made in consequence of retirement from, or the termination of, employment is assessable in full and taxed at normal marginal rates. If, however, the payment is for leave accrued in respect of service before 18 August 1993 or the payment is made under an approved early retirement scheme, or as a consequence of bona fide redundancy or invalidity, a tax offset ensures that the rate of tax payable on the payment does not exceed 30% plus Medicare levy.

Payments in lieu of unused long service leave

Amounts paid in respect of accrued long service leave in consequence of retirement from, or the termination of, employment are included in assessable income and taxed in accordance with the following table:

	Amount included in assessable income	Rate of tax
(a)	5% of amount paid in respect of long service leave that accrued before 16 August 1978	Normal marginal rates
(b)	Whole amount paid in respect of long service leave that accrued after 15 August 1978 and also paid in respect of a bona fide redundancy or invalidity or an approved early retirement scheme	Not greater than 30% plus Medicare levy*
(c)	Whole amount paid in respect of long service leave that accrued between 16 August 1978 and 17 August 1993 inclusive and not covered by (b)	Not greater than 30% plus Medicare levy*
(d)	Whole amount paid in respect of long service leave that accrued after 17 August 1993 and not covered by (b)	Normal marginal rates

* A rebate of tax applies to limit the rate.

Payments made in respect of unused long service leave on the death of a person are exempt from tax if paid directly to the person's beneficiaries or to the trustee of the deceased's estate.

Example

Johan voluntarily retired on 16 August 2018 from the company he had worked for since 16 August 1977 (41 years). He was paid $100,000 in respect of his unused long service leave accrued over the employment. This payment will be taxed as follows (for simplicity, years have been used to allocate the payments, rather than days):

Amount before 16 August 1978

1/41 × $100,000 = $2,439

$122 (ie 5% × $2,439) included in taxable income and taxed at marginal rates (plus Medicare levy)

Amount between 16 August 1978 and 17 August 1993

15/41 × $100,000 = $36,585

$36,585 to be included in taxable income and taxed at marginal rates but not more than 30% (plus Medicare levy)

Amount after 17 August 1993

25/41 × $100,000= $60,976

$60,976 to be included in taxable income and taxed at marginal rates (plus Medicare levy).

¶1-270 Income from investments

Assessable income of resident individuals generally includes amounts derived as dividends, interest or rents and most returns from holding other investments such as units in unit trusts. The various kinds of investments and the returns on those investments are discussed in detail in Chapter 9. The gearing of investments is discussed in Chapter 11. Deductions for expenditure incurred in connection with the derivation of investment income are discussed at ¶1-325.

Dividends

Resident shareholders are assessable on dividends paid out of any company profits, including capital profits and profits that are exempt from tax. Dividends include any distributions made by a company to its shareholders, including certain distributions made in a return of capital. A reversionary bonus on a life assurance policy is not a dividend. Nor, generally, are bonus shares issued on or after 1 July 1998.

Dividends are included in the assessable income of a shareholder when they are paid, credited or distributed to the shareholder. Therefore, a dividend is taxable in the year the dividend cheque is posted to the shareholder even though the cheque is not received until the following year.

Payments or loans by private companies to shareholders or associates may be deemed to be payments of dividends, as may excessive remuneration for the services of past or present shareholders or associates. The taxation of companies and the operation of the company imputation system is covered at ¶1-400 and ¶1-405.

Franked dividends

Where a franked dividend is paid to a *resident* individual shareholder, the consequences are:

- both the dividend and the amount of the attached franking credit (reflecting tax paid by the company) are included in the shareholder's assessable income
- the shareholder is entitled to a franking offset equal to the franking credit
- the offset can be set off against tax on any income, but not against the Medicare levy. Any excess credits are refundable.

Where franked dividends are received through trusts and partnerships, the franking credits and corresponding franking rebates are generally apportioned between the beneficiaries or partners according to their share in the net income or loss of the partnership or the net income of the trust. Where permitted by the trust deed, franked distributions can be streamed for tax purposes if beneficiaries are made ''specifically entitled'' to those amounts. The concept of ''specifically entitled'' is discussed further at ¶1-505. Note that where the trust is a discretionary trust a family trust election may be required to allow the benefit of the franking credits to flow through to the relevant beneficiaries.

The law contains a rule to deter companies from the practice of ''streaming'' dividends in a way that ensures that franking credits are received by shareholders who benefit most. See also the discussion of the Pt IVA general anti-avoidance provisions at ¶1-610.

Franked dividends paid to *non-residents* are not included in the non-resident's assessable income and are generally exempt from withholding tax. Unfranked dividends paid to non-residents are not generally included in assessable income but are liable to withholding tax.

Example

Frank received a $3,000 dividend that was fully franked dividend at the 30% rate on 1 October 2018 with attached imputation credits of $1,286. Aside from the dividends, he made a loss during the year due to a negatively geared investment.

In respect of the dividend, Frank includes $4,286 in his taxable income (dividend amount and imputation credit). After including the negatively geared investment, Frank has a taxable income of $1,000. The tax payable on Frank's taxable income is nil. He is therefore entitled to a refund of the whole of the imputation credit of $1,286.

Interest

For most taxpayers interest from any source is generally assessable income when it is received, although that rule is modified in detailed guidelines issued by the Commissioner about when interest is derived by financial institutions. An amount of interest that is made available to the lender — such as interest on a fixed deposit that is added to the capital — is regarded as received, and therefore assessable, even though it has not actually been received.

Special rules

There are many specific rules (both interpretative and legislative) that either exclude interest from assessable income or declare when it is derived and by whom. For example:

- interest is not generally assessable where a person is not entitled to interest on a savings account that is set off against the person's mortgage account under an ''interest offset'' arrangement
- interest on joint bank accounts is assessable according to the beneficial interests of the account holders. The beneficial interests will be assumed to be equal unless there is evidence to the contrary
- interest on a child's savings account is assessable to the parent if the parent provided the money and controls the use of the interest. If the

money in the account really belongs to the child, the child is taxed on the interest

- special rules apply to the interest and other unearned income of minors (¶1-070)
- income in the form of the deferred yield on certain discounted and deferred interest securities is taxed as the deferred yield (the excess of the redemption price over the issue price) accrues rather than when it is received on redemption of the security. The security must have an expected term of more than a year and a deferred yield greater than an amount equivalent to 1.5% of the redemption price for each year of the term of the security
- interest derived from Australia by a non-resident is generally subject to a final withholding tax at a flat rate of 10%. If the interest is paid as an outgoing of an overseas business, withholding tax is not payable. If withholding tax is payable, the interest is not included in the non-resident's assessable income
- deemed interest on cash holdings or low interest bank accounts that is taken into account for social security purposes is not assessable income.

Rents

Rental income is generally assessable when received. Co-owners of property are generally assessable according to their legal interests in the property.

Unit trusts and other investment funds

Distributions out of income of a unit trust are assessable income of the unitholder, generally in the year in which the income is derived by the trust rather than the year in which the distribution is made. A distribution out of capital would not be assessed to the unitholder unless the amount was included in assessable income of the trust, eg as a net capital gain under the CGT provisions, or it gave rise to a taxable capital gain pursuant to CGT event E4 in the hands of the beneficiary. The taxation of trust income is discussed at ¶1-500 and following.

The taxation of capital gains is discussed at ¶1-295 and in Chapter 2.

Any ongoing commission paid by an investment fund to an investment adviser in relation to an investor's investment in the fund is considered to be assessable income of the investor if the adviser is under an obligation to pass the commission on to the investor.

The income earned on amounts contributed by a taxpayer or an employer of a taxpayer to a superannuation or roll-over fund or to a retirement savings account (RSA) is assessable income of the fund or RSA provider and not the taxpayer. The taxation of this income is discussed in Chapter 4.

¶1-275 Transactions in property and securities, other financial dealings and life assurance

Property

The proceeds of the sale of an asset do not give rise to assessable income if the taxpayer is merely realising the asset, even in the most advantageous way. If, however, the activities surrounding the sale constitute a business venture or profit-making undertaking, eg an extensive program of developing land for sale, the profit on sale is assessable income. In both situations the CGT provisions (¶1-295) may apply if the asset was acquired after 19 September 1985, but only to the extent that the gain is not assessable under other parts of the law. The gain may be smaller under the CGT provisions for an individual, trust or complying superannuation fund because the gain is discounted. Property investments are discussed at ¶9-310.

Securities

Any gain on the disposal or redemption of a security that is:

- not indexed, does not bear deferred interest
- issued at no, or a low, discount,

is assessable in the year of disposal or redemption. Examples of such securities are debentures, bills of exchange, bank accounts, fixed deposits and other debt instruments (¶9-110 and following). The gain is not subject to the CGT provisions. A loss on disposal or redemption of such a security is generally a deduction in the year of disposal or redemption. For securities issued after 7.30 pm 14 May 2002 that convert or exchange into ordinary shares, no gain or loss arises from the disposal or redemption of the security in two specified circumstances. This means an investor who holds a relevant financial instrument through conversion or exchange will not be subject to tax until it is ultimately sold.

Gains from the mere realisation of other securities or of shares are not assessable as ordinary income, although the CGT provisions may apply to all or part of the gain. If shares are sold cum dividend, the purchaser is assessable on the dividend when paid.

Foreign exchange gains and futures profits

A *foreign exchange gain* is assessable as ordinary income where, for example, a liability incurred in a foreign currency is discharged and the liability was for the purchase of trading stock or where a profit is made from speculating in currency variations.

Foreign currency gains and losses are brought to account when realised, regardless of whether there is an actual conversion of foreign currency amounts in Australian dollars. Financial institutions are exempt from the application of these rules. Foreign currency gains and losses are treated as having a revenue character, subject to limited exceptions where the foreign currency gain or loss is closely linked to a capital asset. Foreign exchange gains of a private or domestic nature are only assessable in limited circumstances.

Profits from speculative dealings on the *futures* market are also generally assessable as ordinary income. Futures are discussed at ¶9-335.

Life assurance

Life assurance or endowment policies are assessed as follows:

- the lump sum proceeds of life assurance or endowment policies are not assessable income, whether received on maturity, forfeiture or surrender of the policy
- amounts received as bonuses, other than reversionary bonuses, on life assurance policies are assessable income
- if the risk under a policy commenced after 7 December 1983, *reversionary bonuses* are assessable in full if received within eight years of the commencement of the risk. Two-thirds of any reversionary bonus received in the ninth year is assessable as is one-third of any such bonus received in the 10th year. Amounts assessable under these attract a tax rebate of 30% which can be set off against the tax otherwise payable on income from any source.

Insurance bonds are discussed at ¶9-600.

¶1-280 Partnership and trust income

Partners in *partnerships* are assessable in their individual capacities on their shares of the net income of the partnership. Similarly, beneficiaries of *trusts* who are presently entitled to a share of the income of a trust are assessable in their individual capacities on their share of the net income of the trust. The income is included in the individuals' assessable incomes of the income year in which the partnership or trust derives the income, whether or not the amounts have been distributed. Partnerships and trusts are discussed at ¶1-450 and ¶1-500 respectively.

The gross proceeds of a *business* are assessable income. For example, where the sales and purchases of shares are sufficient to constitute the carrying on of a business, the shares would then be trading stock (¶1-300) and, if unsold, would have to be brought to account at the beginning and end of each income year in working out taxable income. Proceeds of the sale of such shares would be included in assessable income and not subject to CGT.

¶1-283 Small business entities

Small business entities (ie entities that are carrying on a business during the year of income that satisfy the relevant ''aggregated turnover'' test) are entitled to tax advantages of special income tax concessions and CGT concessions. The aggregated turnover threshold for the concessions is generally $10 million. However, different thresholds apply for the following:

- the CGT small business concessions to which a $2 million threshold applies (see ¶2-333), and

- the small business tax offset to which a $5 million threshold applies (see below).

Small business tax offset

Individuals deriving income from an unincorporated small business are entitled to the ‘‘small business tax offset’’ which effectively provides a discount on the income tax payable on that business income subject to a maximum cap of $1,000 per year (see ¶1-283; ITAA97 Subdiv 328-F). The discount is 8% for unincorporated small business entities with an aggregated annual turnover of less than $5 million.

An individual is entitled to the small business tax offset for an income year where either:

- the individual is a small business tax entity for the income year (eg sole trader), or
- has assessable income for the income year that includes a share of the net income of a small business entity that is not a corporate tax entity (eg a trust or partnership).

The amount of the offset is equal to 8% of the following:

$$\frac{\text{The individual's total net small business income for the income year}}{\text{The individual's taxable income for the income year}} \times \text{The individual's basic income tax liability for the income year}$$

For these purposes, the individual’s total net small business income for the income year means so much of the sum of the following that does not exceed the individual’s taxable income for the income year:

- where the individual is a small business entity — the individual’s net small business income for the income year, and
- the individual’s share of a small business entity’s net small business income for the income year that is included in assessable income (excluding that of a corporate tax entity) less relevant attributable deductions to that share.

An entity’s net small business income is the result of:

- the entity’s assessable income for the income year that relates to the entity carrying on a business disregarding any net capital gain and any personal services income not produced from conducting a personal services business
- LESS: the entity’s relevant attributable deductions attributable to that share of assessable income.

If the result is less than zero, the net small business income is nil.

Relevant attributable deductions are deductions attributable to the assessable income other than tax-related expenses, gift and contributions or personal superannuation contributions under Subdiv 290-C.

Other income tax concessions

Small business entities may elect to take advantage of various income tax concessions including:

- small business restructure roll-over — an optional income tax and CGT roll-over available for the transfer of assets as part of a restructure which involves a change of legal structure without a change in the ultimate legal ownership of the assets.
- special depreciation provisions — depreciating assets acquired and first used or installed in the period from 7.30 pm on 12 May 2015 to 30 June 2018, but there is a proposal to extend to 30 June 2019 but at time of writing this had not passed into law with a cost less than $20,000 each are written off immediately. Assets acquired for a cost of $20,000 or more are included in a single depreciating pool with a diminishing rate of 30% (15% for the first year).
- trading stock concessions — the entity is not required to undertake a stocktake or account for changes in the value of trading stock at the end of an income year where the change in value from the start to the end of the year is $5,000 or less.
- prepayments — an entitlement to an immediate deduction for certain prepaid expenditure.
- start-up costs — an immediate deduction for professional expenses that are associated with starting a new business.
- FBT exemption for multiple work-related portable devices.

¶1-285 Employment termination payments (ETPs) and superannuation lump sums

The taxation of termination payments differs depending upon whether the payment is an employment termination payment (ETP) or a superannuation lump sum.

ETPs	Superannuation lump sums
• **"life benefit termination payments"** received in consequence of termination of employment, eg on resignation, retirement, redundancy or invalidity, including "golden handshakes" (¶14-250)	• payments from superannuation funds or RSAs, excluding payments such as pensions (¶4-420)
• **"death benefit termination payments"** received in consequence of termination caused by death (¶14-250)	• payments from ADFs (¶4-420)

Payments that are not ETPs

Payments that are *not* ETPs include payments in lieu of unused annual leave or unused long service leave (¶1-265). Genuine redundancy payments and early retirement scheme payments paid after 30 June 1994 up to certain limits are tax-free and not ETPs. The limit for 2018/19 is $10,399 plus $5,200 for each completed year of service. Any amount over this limit is taxed as an ordinary ETP.

The taxation of life benefit termination payments

Life benefit termination payments may be subject to concessional rates of tax if:

- the amount is taken in cash, and
- it is received within 12 months of the termination (unless it is a genuine redundancy payment or the Commissioner allows a longer time).

ETPs are not able to be paid into superannuation.

Life benefit termination payments from employers are comprised of the following two components:

- a tax free component, and
- a taxable component.

The **tax free component** comprises any invalidity amount and the pre-July 1983 amount. This component is non-assessable, non-exempt income and therefore not subject to tax.

The *invalidity segment* is calculated as the portion of the payment that represents the period between termination and the person's last retirement day. An ETP contains an ''invalidity segment'' if:

- the payment was made to the person because they can no longer work because of ill health
- the person stopped working before they reached their last retirement day, and
- two medical practitioners have certified that it is unlikely the person can ever work again in a role for which they are qualified.

The pre-July 1983 segment is calculated as the portion of the payment that represents the individuals' service period prior to 1 July 1983.

The **taxable component** is the whole of the termination payment amount reduced by the tax free component. Where there is no invalidity component, this will be the post-June 1983 component. The taxable component is included in assessable income. However, a tax offset may be available to limit the effective tax payable as detailed below plus the Medicare levy.

The calculation of the tax offset depends on the type of ETP paid.

The ETP cap applies to a:

- payment pursuant to an early retirement scheme or bona fide redundancy (part exceeding the tax free component)
- compensation payment for personal injury, unfair dismissal, harassment or discrimination
- payment because of an employee's permanent disability, and

- lump sum payment paid on the death of an employee.

In 2018/19 the taxable component of an ETP subject to the ETP cap are as follows:

Amount of benefit (column 1) ($)	If recipient is aged 55 and over		If recipient is aged under 55	
	Tax on column 1	% on excess (max marginal rate)**	Tax on column 1	% on excess (max marginal rate)
Nil	Nil	15	Nil	30
205,000*	30,750	45	61,500	45

* Note that this cap is indexed for future years. This amount is available each time an employee receives an ETP from an employer, unless an ETP has already been received by the employee in that same year or in respect of the same termination.

** The rates set out in the table are the maximum marginal tax rates that apply. The Medicare levy may also be payable on the life benefit termination payments.

However, for all other ETPs (eg a golden handshake, gratuities, payment in lieu of notice or unused sick leave) the offset is the lesser of the ETP cap and the amount worked out under the whole-of-income cap. The whole-of-income cap limits the tax offset to that part of the ETP takes the person's total annual taxable income (including the ETP) to no more than $180,000. The balance is taxed at the top marginal rate of tax.

Example

Dennis is made redundant from his position at Panache Power in August 2018 after working there for 16 years. He is 63 years old. He receives a payment of $300,000 in relation to his bona fide redundancy. There is neither a pre-June 1983 nor an invalidity segment included in the payment. Since Dennis' other income for the year is $200,000 (and he is therefore in the top marginal tax bracket), concessional rates will apply to the whole of the payment as the ETP relates to a genuine redundancy and only the ETP cap will apply. The tax he will pay on the ETP, excluding the Medicare levy is:

	Amount	Maximum tax rate	Tax payable
Exempt component	$93,599	Nil	Nil
The ETP cap	$205,000	15%	$30,750
Excess (balance of payment)	$1,401	45%	$630
Total tax payable			**$31,380**

Note that if the facts were different such that Dennis was merely terminated from employment, as opposed to receiving a bona fide redundancy, the payment would be subject to the whole-of-income offset. In such a case the whole of the payment would be subject to the top marginal tax rate of 45% (excluding Medicare levy) due to the whole-of-income cap of $180,000 being exceeded by the other income Dennis derived in the year.

The taxation of death benefit termination payments

The taxation of death benefit termination payments is discussed at ¶4-420.

Superannuation lump sums

The taxation of superannuation lump sums depends upon whether the payment is from a taxed source or an untaxed source. A taxed source refers to payments made from complying superannuation funds and RSAs. An untaxed source refers to payments from an untaxed superannuation fund such as a state superannuation fund or a non-resident superannuation fund and also to payments directly from an employer.

Taxation of superannuation lump sum benefit payments from a taxed source

Lump sum benefits paid from a taxed source to an individual aged 60 or over are tax-free.

Lump sum benefits paid from a taxed source to an individual who is below age 60 have two components:

- a tax free component, and
- a taxable component.

The **tax free component** comprises the following components:

- the ''contributions segment'', which includes all contributions made since 1 July 2007 that have not been included in the assessable income of the superannuation provider, for example, the person's non-concessional contributions, and
- the ''crystallised segment'', which is calculated by assuming that an ETP representing the full value of the superannuation interest is paid just before 1 July 2007. The crystallised segment contains the following previous elements:
  - the *pre-July 1983 component*: the proportion of a payment, excluding the above components, that relates to service before 1 July 1983. The method of apportioning a payment between service up to 30 June 1983 and service from 1 July 1983 is on a time basis, according to the eligible service period. Where a payment is from an employer-sponsored superannuation fund, the eligible service period is the combined periods of employment and fund membership. Where a payment is from a fund for the self-employed, the eligible service period is the period of fund membership.

    The pre-July 1983 component is calculated as the lesser of:

(Total ETP – concessional – post-June 1994 invalidity component – excessive component – CGT-exempt)	×	pre-July 1983 service period total service period
OR		
(Total ETP – concessional – post-June 1994 invalidity component – excessive component – CGT-exempt)	–	Undeducted contributions

- *the CGT exempt component*: this amount arose out of the disposal of the assets of a small business (¶15-200)
- *the post-June 1994* invalidity component: this component was paid when disability caused employment to cease and resulted in the recipient being unlikely to be able to be employed in any capacity for which he/she was reasonably qualified
- *the concessional component*: this component was paid from employer-sponsored superannuation funds up to 30 June 1994 and represented payments in relation to redundancy, approved early retirement schemes and invalidity, and
- *undeducted contributions up to 1 July 2007*: the part of the ETP represented by superannuation contributions made after 30 June 1983 (other than by an employer) that were not income tax deductions of the contributor.

The **taxable component** is tax-free up to the low-rate threshold of $205,000 for 2018/19 and taxed at a maximum rate of 15% above the threshold. For those under the age of 55, this component is taxed at a maximum rate of 20%. The taxed component currently comprises the following components:

- the post-June 1983 component: which represents the total ETP reduced by all the other components, and
- the non-qualifying component.

Note that the Medicare levy may also be payable upon any superannuation benefit where a tax rate greater than zero per cent applies.

Example

Delores retired from her job at age 58 on 31 May 2019 and, having already a substantial private income, has decided to spend her accumulated retirement funds on a house in the country. She had a salary in 2018/19 of $150,000, private income consisting of interest of $50,000 and her superannuation payout is $290,000 (with an exempt component of $50,000 and a taxable component of $240,000).

Her employer paid her a ''golden handshake'' of $5,000 with no exempt component. The taxation of Delores' superannuation payout and ''golden handshake'' (excluding Medicare levy), and the amount she will be able to apply towards the cost of her house, are illustrated below.

ETP component	Component amount $	Assessable amount $	Tax rate applied	Tax payable* $	ETP after tax $
Superannuation lump sum					
– tax free component	50,000	Nil	Nil	Nil	50,000
– taxable component	240,000	205,000	up to low rate cap (max rate): 0%	Nil	205,000
		35,000	above low cap rate (max rate): 15%	5,250	29,750
Golden handshake					
– taxable component	5,000	5,000	marginal rate: 45%	2,250	2,750
	$295,000			**$7,500**	**$287,500**

*As Delores' taxable income exceeds the whole-of-income cap of $180,000, the golden handshake is subject to marginal rates, not the concessional ETP rates.

Taxation of superannuation lump sum benefit payments from an untaxed source

Lump sum benefits paid from an untaxed source to an individual *aged 60 or over* are taxed at the maximum rates shown in the following table for 2018/19:

Amount of benefit (column 1) ($)	Tax on column 1	% on excess (max marginal rate)*
Nil	Nil	15
1,480,000**	222,000	45

* The rates set out in the table are the maximum rates excluding any applicable Medicare levy. The amount is included in the person's assessable income for the year and an offset against tax payable is calculated to effectively reduce the marginal tax rate to the maximum applicable.

** The untaxed plan cap amount is indexed annually.

Lump sum benefits paid from an untaxed source to an individual *aged 55 to 59* are taxed at the maximum rates shown in the following table for 2018/19:

Amount of benefit (column 1) ($)	Tax on column 1	% on excess (max marginal rate)*
Nil	Nil	15
205,000**	30,750	30
1,480,000***	413,250	45

* The rates set out in the table are maximum rates excluding Medicare levy. The amount is included in the person's assessable income for the year and an offset against tax payable is calculated to effectively reduce the marginal tax rate to the maximum applicable.

** The low rate cap amount is indexed annually. It is $205,000 for 2018/19 ($200,000 for 2017/18).

*** The untaxed plan cap amount is indexed annually. It is $1,480,000 for 2018/19 ($1,445,000 for 2017/18).

Lump sum benefits paid from an untaxed source to an individual *younger than 55* are taxed at the maximum rates shown in the following table for 2018/19:

Amount of benefit (column 1) ($)	Tax on column 1	% on excess (max marginal rate)*
Nil	Nil	30
1,480,000	666,000	45

* The rates set out in the table are maximum rates excluding Medicare levy. The amount is included in the person's assessable income for the year and an offset against tax payable is calculated to effectively reduce the marginal tax rate to the maximum applicable.

Note

The $1,480,000 threshold in the above tables applies on a lifetime basis to each member of the fund. It is also indexed to AWOTE and increases in amounts of $5,000.

Note also that the Medicare levy is also payable upon any superannuation benefit where a tax rate greater than zero percent applies.

Roll-over of superannuation benefits

ETPs cannot be rolled into superannuation funds. Superannuation benefits, however, may be able to be rolled over and are not assessable to the extent they are rolled over into a complying superannuation fund or ADF, into an RSA or used to purchase certain annuities (including allocated annuities that comply with relevant standards) from a life office, friendly society, trade union or employee association.

When funds are rolled over from an untaxed fund to a taxed scheme, the transferring untaxed fund must withhold tax at the top marginal tax rate for amounts above $1,480,000. The first $1,480,000 of the benefit transferred will be treated as a taxable contribution by the receiving fund, and the remainder will form part of the exempt component in the receiving fund and not be taxed further.

Certain forms and documentation need to be maintained for a roll-over of superannuation monies. These are discussed at ¶4-430.

¶1-290 Superannuation income streams

The following table shows the maximum tax rates that apply to superannuation income streams. The Medicare levy is also payable upon any superannuation benefit where a tax rate greater than zero per cent applies.

Age	Superannuation income stream — element taxed in the fund	Superannuation income stream — element untaxed in the fund
Aged 60 and above	– Tax-free	– Tax free component is tax-free – Marginal tax rates and 10% tax offset
Preservation age to age 59	– Tax free component is tax-free – Taxable component taxed at marginal tax rates with 15% tax offset	– Tax free component is tax-free – Taxable component is taxed at marginal tax rates with no tax offset
Below preservation age	– Tax free component is tax-free – Taxable component taxed at marginal tax rates (no tax offset) – A disability superannuation income stream receives a 15% tax offset	– Tax free component is tax-free – Taxable component is taxed at marginal tax rates with no tax offset

The tax treatment of superannuation income streams is covered in detail from ¶16-700 onwards.

¶1-295 Capital gains tax

Where an asset acquired after 19 September 1985 is disposed of, the CGT provisions generally apply to any gain or loss on the disposal. If, however, a gain is assessable under some other provision, the CGT gain is reduced by the amount assessable under that other provision.

Gains on the disposal of most depreciating assets are dealt with under the capital allowances provisions (¶1-330) and also under the CGT provisions where there is some private use.

The CGT provisions include in a taxpayer's assessable income only the net capital gain for the income year. To calculate the net capital gain, the total of the taxpayer's capital gains for the year (excluding any exempt gain by a small business taxpayer on an asset owned for 15 years) is first reduced by any capital losses made during the year. Any net capital losses from earlier years are then deducted. The result is further reduced by any discounts on particular gains and then by any concessions for small business taxpayers (see below).

Individuals and trusts can apply the general CGT discount to their capital gains on assets owned for at least 12 months by the relevant percentage. The relevant percentage for individuals that have been Australian residents (other than temporary residents) for the whole period of ownership is 50%. The percentage rate is reduced to take into account any part of the ownership period during which an individual was a foreign resident or a temporary resident on or after 8 May 2012, subject to transitional rules. However, where the individual was either a foreign resident or a temporary resident as at 8 May 2012 and makes a capital gain from a CGT event after that date, the 50%

discount is only available for any capital gain accrued up to 8 May 2012 provided the individual obtains a market valuation of the relevant CGT asset as at that date. If no valuation was obtained and the individual was a foreign resident or a temporary resident at all times since 8 May 2012, no discount will be available. The relevant percentage for trusts is 50%. The discount for complying superannuation funds is one-third. The gain to be discounted is worked out without indexation of the cost base of the asset. If the asset was acquired before 21 September 1999, the individual, trust or superannuation fund can alternatively choose to calculate a capital gain on the basis of the asset's indexed cost base, but with indexation frozen at 30 September 1999. Companies are not entitled to discount their capital gains but are entitled to use the "frozen indexation" basis for assets acquired before 21 September 1999.

As mentioned, trusts generally calculate their capital gains in the same way as individuals. Where permitted by the trust deed a capital gain may be streamed to a particular beneficiary by making them "specifically entitled" to the capital gain made by the trust. In this case the beneficiary is effectively treated as having made the capital gain. Alternatively, a trustee of a resident trust can choose to be assessed on a capital gain of the trust if no amount of the trust property referable to the capital gain is paid or applied for the benefit of a beneficiary. The concept of "specifically entitled" is discussed further at ¶1-505.

To the extent that a beneficiary is not made specifically entitled to a capital gain and the trustee does not make the choice, the capital gain will be allocated to the beneficiaries of the trust on a proportionate basis in accordance with their present entitlement to the share of the trust income (after excluding amounts to which a beneficiary was made specifically entitled). Where the discount method is chosen by the trust, a beneficiary receiving a part of the gain is required to gross up the share of the gain to remove the effect of the discount and any discount under the CGT small business concessions before calculating the beneficiary's net capital gain. The beneficiary's net capital gain is calculated by including the grossed-up share of the gain from the trust with any other capital gains made during the year and deducting any current year and prior year capital losses. The beneficiary's discount (if any) can then be applied to the grossed-up share of the trust's capital gain included in the beneficiary's net capital gain.

The CGT provisions are very extensive and are covered in detail in Chapter 2. Some significant features are, however, mentioned here.

Main residence and other exemptions

The capital gain or loss on the disposal of a dwelling will be disregarded where the owner of the dwelling occupied it as their main residence throughout the period of ownership. If the dwelling was the main residence of the owner for only part of the period of ownership, only part of the capital gain or loss will be disregarded. In accordance with the 2017-2018 Federal Budget it is proposed that the main residence exemption will not be available for foreign residents from 9 May 2017. However, existing properties held before this time will remain entitled to the exemption until 30 June 2019 under a grandfathering provision. This provision has not passed into law as yet. The main residence exemption is detailed in Chapter 12.

The CGT provisions also do not apply to the disposal of most life assurance policies (eg on payout), private motor cars or trading stock or to gambling and lottery wins. Special rules apply to gains and losses on the disposal of assets kept for personal use such as works of art and jewellery.

Disposal of small business assets

Any entity that is a CGT small business entity or satisfies a maximum net asset value test may be entitled to one or more of the four CGT concessions available for a capital gain arising on the disposal of an active asset owned by the entity.

For CGT purposes, a CGT small business entity is an entity that carries on a business during the income year and which, generally speaking, has an ''aggregated turnover'' of less than $2 million in either the previous or current income year. Alternatively, the concessions are available where the net value of all CGT assets of the taxpayer, ''affiliates'' and ''connected entities'' do not exceed $6 million.

The concessions are available to an individual, a company or a trust. A disposal of shares in a company or interests in a trust is potentially eligible for the concessions where the shares or interests themselves are active assets and certain ownership levels are satisfied. The CGT small business concessions are:

- the gain may be exempt if the asset was owned by the taxpayer for at least 15 years and occurs in relation to the retirement of the taxpayer or CGT concession stakeholder (as relevant) over the age of 55 or in the event of their permanent incapacitation
- the gain may attract a 50% exemption. The exemption applies to the gain remaining *after* any application of the general discount (see above)
- the gain may be exempt if the capital proceeds are used in connection with the retirement of the taxpayer or a stakeholder (as relevant) up to specified limits. If the taxpayer or stakeholder is under 55, the gain must be rolled over to a complying superannuation fund or RSA
- a roll-over may permit the gain to be deferred. The gain can be deferred for at least two years. A longer deferral will apply where the taxpayer acquires a replacement asset within a specified period. The gain is deferred to the extent that it does not exceed the cost base of the replacement asset.

Non-resident CGT withholding

A non-final withholding tax is imposed on the disposal of taxable Australian property (including indirect interests and options or rights to acquire such property) by a foreign resident, excluding where any of the following applies:

- the relevant CGT asset has a market value of the asset less than $750,000

- the transaction is conducted through a stock exchange or a crossing system
- the transaction is an arrangement that is already subject to an existing withholding obligation
- the transaction is a securities lending arrangement, or
- the transaction involves a vendor that is subject to formal insolvency or bankruptcy proceedings (TAA Sch 1 s 14-200; 14-215).

The purchaser is required to withhold and remit to the ATO 12.5% (or such varied amount as approved by the Commissioner) of the proceeds from the sale. The withholding is required on or before the day the purchaser becomes the owner of the asset (usually at settlement) and must be paid to the ATO without delay.

Assets passing on death

A person's death generally does not constitute a disposal of the person's assets for CGT purposes. Where a person dies after 19 September 1985, the legal personal representative or beneficiary to whom an asset passes is deemed to have acquired it when the deceased died — at market value if the deceased acquired the asset before 20 September 1985, otherwise generally at the asset's cost base at the date of the deceased's death.

DEDUCTIONS

¶1-300 Annual basis of taxation

Income tax is an annual liability worked out by reference to a taxpayer's taxable income for an income year. Taxable income is calculated by subtracting from assessable income all general and specific deductions (¶1-305). The calculation of tax payable for a year therefore depends not only on *whether* expenditure is deductible but also on *when* the deduction is allowable. In addition, progressive marginal tax rates for individuals mean that the timing of deductions can have a significant effect on the total amount of tax payable over two or more years.

Deduction when expenditure incurred

A loss or outgoing is generally deductible in the income year in which the expenditure is incurred. Expenditure can be incurred without payment being made as long as the taxpayer is definitively committed to the payment and the expenditure is properly referable to the income year. Interest expenditure, for example, is a deduction in the income year in which the interest becomes due and payable.

Deductions for expenditure incurred in advance of the provision of services are generally apportioned evenly over the period during which the services are to be provided.

Trading stock

Expenditure on acquiring trading stock of a business is deductible when the expenditure is incurred. The income tax law ensures, however, that the deduction is effectively deferred to the income year in which the trading stock is sold by taking unsold stock into account at the end of an income year and at the beginning of the next year. The amount taken into account excludes any GST input tax credit arising on acquisition of the stock. The shares of an individual who is a share dealer are trading stock, but shares that are merely held by the individual for resale at a profit are not trading stock. The land of a land dealer can also be trading stock. Small business entities do not need to account for small changes in the value of stock during an income year (¶1-280).

¶1-305 General and specific deductions

The income tax law classifies deductions as general and specific.

General deductions

A general deduction is any loss or outgoing to the extent that it is incurred in gaining or producing assessable income, or is necessarily incurred in carrying on a business for income-producing purposes. A loss or outgoing may be deductible even though it does not produce assessable income in the year in which it is incurred. The loss or outgoing must, however, be expected to produce assessable income and have the essential character of an income-producing expense. A bad debt arising out of business activities of earlier years may be deductible despite the business having in the meantime ceased operations. Interest on business loans may also be deductible after the business ceases operations.

Non-deductible losses or outgoings

Examples of losses or outgoings that are not deductible are:

- losses or outgoings of a capital, private or domestic nature (eg child care expenses)
- losses or outgoings incurred in producing exempt income
- expenditure incurred in producing the income of some other person. For example, interest on a loan taken out by a parent would generally not be deductible if the borrowed money was passed on interest-free to a daughter for use in her business to produce her assessable income
- payments of income tax
- interest on money borrowed to pay a personal income tax liability or a personal superannuation contribution.

Expenditure incurred both in producing assessable income and for private purposes needs to be apportioned into its deductible and non-deductible components.

Specific deductions

Some amounts are deductible under specific provisions of the law. These are called specific deductions. Some examples are deductions for repairs, prior years' losses, a partner's individual interest in a partnership loss and depreciation in respect of capital expenditure. Specific deductions are not necessarily in respect of expenditure related to income-producing activities, eg deductions for certain gifts (¶1-345).

In addition, some specific provisions of the law either deny deductions that would otherwise be allowable or limit the amount of a deduction. For example, salary or wages paid to a relative (eg a spouse or child) or paid by a private company to a shareholder is not deductible to the extent that the payment exceeds a reasonable amount. As a further example, under the commercial debt forgiveness rules, a debtor whose debt is forgiven may be denied a range of deductions, such as in respect of all or part of a prior year's loss.

¶1-310 Business deductions

As mentioned above, a person carrying on business can deduct losses or outgoings that are necessarily incurred in carrying on the business to produce assessable income. The person carrying on the business is the best judge of what is necessary. The expenditure does not have to be unavoidable to qualify as a deduction. A person carrying on a profession or trade is in business. A person engaging in share trading, for example, may be in business but it would depend on all the facts. Some indicators are the scale of operations, the frequency of transactions, the profitability of the activities and whether the person conducts the activity full-time and keeps adequate records.

Some examples of *deductible* business expenses are:

- the usual recurring operating expenses of a business
- the cost of keeping abreast of business trends
- pay-roll tax, sales tax and FBT (¶1-090) — but not GST (to the extent entitled to an input tax credit), and
- certain business-related capital expenditure is deductible on a straight-line basis over five years (eg expenditure to establish a business structure or expenditure to convert an existing business structure to a different structure).

Some examples of *non-deductible* expenses are:

- private travel and capital costs to expand a business structure
- dividends paid by companies.

Individuals are limited in offsetting losses from non-commercial business activity against other assessable income. Such losses can be offset against other income only if at least one of several statutory tests is satisfied, eg that the assessable income from the activity is at least $20,000. Notwithstanding the satisfaction of a statutory test a taxpayer is only able to apply a non-commercial loss where the taxpayer's adjusted taxable income for the year is less than $250,000.

¶1-320 Employment and self-employment deductions

Employees and self-employed persons are entitled to deductions for expenditure incurred in gaining or producing assessable income. Examples are:

- the cost of renegotiating an employment agreement
- the cost of travelling between two or more different places of work (including, in the case of a self-employed person, different locations of the same income-producing activity)
- depreciation on computers and tablets used for work
- technical journals
- membership of unions or professional associations
- tax return preparation and other professional tax advice
- expenses of overseas travel by professional persons and academics, whether employees or self-employed, to keep abreast of new developments or attend conferences
- net self-education expenses exceeding $250 connected with the production of assessable income, but not if the study is directed at new income-producing activities.

Some examples of *non-deductible* expenditure are:

- expenses incurred by an employee in getting or changing jobs or moving to a job — because the expenditure is incurred too soon to be regarded as incurred in gaining or producing assessable income
- child care expenses.

Home office

Where part of a home is set aside as an office, some part of the outgoings on the home may be deductible. If the home, or a particular part of it, is a real place of business (eg where a professional conducts a private consultancy practice in an area of the home that is set aside and used exclusively for that purpose, is clearly identifiable as a place of business visited by clients and is not readily adaptable for domestic use), the range of deductions is greater than if the person has a usual place of work away from the home and uses, exclusively, a part of the home as a convenient place to carry out some income-producing work. Where the home is a real place of business, deductions are generally available for:

- a proportion of home loan interest, rates, house insurance, heating, lighting and maintenance
- depreciation, insurance and repairs on equipment and fittings, such as desks, curtains and light fittings

- work-related telephone calls from home and a proportion of the rental of the home telephone, but not the cost of installing a home telephone.

If the home office does not qualify as a place of business, deductions are not available for home loan interest, rates or house insurance.

> **Caution**
>
> While deductions can normally be obtained for a portion of the running expenses for items such as telephones, heating and lighting, it may not be possible to secure deductions for connection fees for these items. Other occupancy expenses such as rates, home loan interest or house insurance will only be deductible where the home is used as a real place of business.

Clothing

Expenditure by an employee on conventional clothing generally is not deductible, but the cost of occupation-specific clothing (eg that worn by a nurse) generally is. The cost of non-conventional uniforms which an employee is compelled to wear is generally deductible, but if the uniform is not compulsory, a deduction is denied unless the design of the uniform is properly registered. Expenditure on items of protective clothing such as aprons, hard hats and steel capped boots is also deductible. The receipt of an allowance from an employer for clothing or uniforms does not necessarily mean that the employee's expenditure on conventional clothing is deductible.

Substantiation

Where work expenses of employees, such as meals, tools and trade journals, exceed $300 in total in an income year, the employee must generally satisfy substantiation rules to deduct the expenses. That broadly requires the employee to obtain written evidence of the expense from the supplier and keep it for five years. The degree of substantiation required in respect of car expenses of employees and self-employed persons varies according to the person's chosen method of claiming deductions. The $300 substantiation-free threshold is not available for car expenses.

Commissioner's guidelines for particular occupations

The Commissioner has issued rulings and guidelines about deductions for people in particular occupations, such as employee cleaners, hospitality industry employees, police officers, teachers, nurses, airline industry employees, real estate industry employees and employee lawyers (see https://www.ato.gov.au/Individuals/Income-and-deductions/Deductions-you-can-claim/Deductions-for-specific-industries-and-occupations/).

Superannuation contributions

Employees and self-employed persons may be entitled to tax concessions for contributions to a superannuation fund or RSA. The tax treatment of superannuation contributions is covered from ¶4-200 to ¶4-245.

¶1-325 Deductions for investors and landlords

A person who derives investment income, such as rents, dividends or interest, can deduct expenditure incurred in connection with the derivation of that income. Deductions include interest on money borrowed to acquire the investment, ongoing expenses of deriving the income and, in certain circumstances, investment losses.

Interest

Interest on money borrowed to acquire, say, a rental property, shares in a company or units in a property trust, is generally fully deductible if it is reasonable to expect that rents, dividends or assessable trust distributions will be derived. In determining the purpose to which borrowed funds are put, eg to acquire a rental property, the ATO traces the flow of borrowed funds to establish their usage. The security used for such a borrowing has little relevance in determining the deductibility of interest. Interest can be fully deductible in an income year even though it exceeds the investment income of that year (negative gearing). But if, at the outset, the investment is not expected to turn positive over its full term, the interest deduction in each income year is likely to be at least partly disallowed.

Additional interest payable under linked and split loan facilities is not deductible. Interest referable to the capital protection component of limited recourse loans entered into on or after 16 April 2003 is also not deductible.

Ongoing expenses

Deductible ongoing expenses in deriving investment income include:

- expenses of collecting the income, bookkeeping expenses and audit fees
- certain fees paid to an investment adviser (see below)
- costs of travelling interstate to consult a broker
- the cost of financial magazines
- bank charges
- borrowing expenses (spread over the shorter of the loan period and five years), and mortgage discharge expenses, including legal expenses connected with the borrowing or discharge
- repairs, rates and land tax, insurance, advertising and the legal costs of recovering arrears of rent
- expenses connected with the preparation and registration of leases
- depreciation of furniture and fittings (although from 1 July 2017 this is limited to the cost of actual outlays incurred by the taxpayer and exclude outlays by a previous owner)
- the cost of replacing small items such as crockery and linen.

From 1 July 2017 the travel expenses related to inspecting, maintaining or collecting rent for a residential property are not deductible.

Repairs versus improvements

While the costs of repairs to income-producing property are deductions, the costs of improvements are not. A repair involves the replacement or renewal of a worn-out part so as to restore, but not significantly improve, the functional efficiency of a thing without changing its character.

> **Example**
>
> Fencing around David's rental property has been damaged by termites. David replaces the damaged wood panes. Replacing the damaged panes of the fence would be repairs and tax deductible.
>
> At the same time David replaces the wood pergola in the backyard with an electric vergola. The replacement of the former wood pergola with the upgraded electric vergola is an improvement to the property.

The cost of initial repairs to remedy defects in an asset at the time of acquisition is also not deductible but is included in the cost base of the asset for CGT purposes or its cost for depreciation purposes.

Partial deduction

A landlord's deductions may be reduced where only part of the property is rented or where the property is let or available for let for only part of the year. Where only part of the property is let, deductions are normally allowed according to the proportion of the floor area that is rented. Where a holiday house, say, is let for only part of the income year, deductions are normally allowed according to the proportion of the year for which the house was let, including periods during which bona fide efforts were made to obtain tenants.

Financial advice fees

The ability to claim a deduction for a fee paid to a financial adviser depends upon the services which are provided in relation to the fee.

A taxpayer will not be entitled to deduction for a fee paid to a financial adviser for developing or drawing up an initial investment plan. Such a fee is not deductible as it is considered to be both of a capital nature and a preliminary expense incurred for the purpose of deriving assessable income, as opposed to being a fee incurred in the course of gaining or producing assessable income.

An on-going management fee or retainer paid to a financial adviser in relation to the servicing of the income producing investments will be deductible. To the extent that the management fee relates to investments which are not held for the purpose of producing assessable income, a deduction will not be available. Accordingly, where the taxpayer holds a mix of investments held for both income and non-income producing assets, only a portion of the fee will be deductible.

Fees which are paid to a financial adviser for advice regarding the change in mix of the investments held are generally considered to relate to the general management of investments. Such fees will be deductible unless the advice constitutes the drawing up of an investment plan.

Where a taxpayer has investments and pays a financial adviser for drawing up a new investment plan, the fee is considered to be of a capital nature and not deductible. The fee may be included in the cost base of assets acquired. For further explanation see *Taxation Determination* TD 95/60.

Losses on investments

Losses on investments such as shares and securities are deductible only if the taxpayer is carrying on a business of investing for profit or of trading in investments. Whether a person is carrying on such a business depends on all the facts. Some relevant factors are the frequency, volume and scale of transactions and whether they are carried out in a business-like way.

¶1-330 Depreciating assets

The income tax law allows deductions for the decline in value of depreciating assets to the extent the asset is used to produce assessable income or is installed ready for use for that purpose. The deduction is available to an entity that "held" the asset at any time during the income year. This is generally the owner, but another entity may be taken to hold the asset and be entitled to depreciation deductions, for example:

- a lessor, eg a finance company, of a depreciating asset that is attached as fixtures to another entity's land, where the lessor has the right to recover the asset
- a lessee of land who affixes a depreciating asset to the land and has a right to remove the asset — while the right to remove the asset exists
- a lessee of land who makes an improvement (whether a fixture or not) to the land (eg an in-ground watering system) that the lessee is not entitled to remove — while the lease exists
- a hirer under a hire purchase agreement.

A depreciating asset is an asset that has a limited effective life and is reasonably expected to decline in value over the time it is used. Land and items of trading stock are not depreciating assets. Most intangible assets are also excluded, but some are specifically included, eg items of intellectual property and in-house software.

With effect from 1 July 2017 the deduction for depreciation on an asset used in relation to a residential rental property is limited to new assets and not previously used assets. In this manner, a deduction for depreciation on second hand assets and assets acquired on the purchase of the property from the former owner will is not available.

The formulae for calculating the decline in value of a depreciating asset for an income year are:

Prime cost method

$$\frac{\text{cost}}{\text{effective life}} \times \frac{\text{days held}}{365}$$

Diminishing value method

For assets held before 10 May 2006

$$\frac{\text{base value}}{\text{effective life}} \times \frac{\text{days held}}{365} \times 150\%$$

For assets acquired after 10 May 2006

$$\frac{\text{base value}}{\text{effective life}} \times \frac{\text{days held}}{365} \times 200\%$$

Taxpayers can make their own estimate of the effective life of an asset or rely on the Commissioner's determination. This choice, and the choice of method, must be made for the year in which the asset is first used by the taxpayer for any purpose or is installed ready for use. The method chosen for a particular asset applies to that asset for all income years. The base value of a depreciating asset for a year is generally its opening adjustable value (ie broadly its cost less its decline in value up to the start of the year). There is an immediate write-off for depreciating assets costing $300 or less and used predominantly in deriving *non-business* income.

Depreciating assets costing less than, or written down to less than, $1,000 each, can be pooled and a single deduction claimed for the decline in value of the pool for the year.

There are special depreciation rules available to small business entities. For assets that are both acquired and first used or installed ready for use in the period from 7.30 pm on 12 May 2015 to 30 June 2018, with a proposed extension to 2019:

- an immediate write-off of assets (including motors vehicles) with a cost less than $20,000
- a single pool for write-off of all other assets (excluding buildings) at the single rate of 30% (15% for the first year).

A deduction is available for the balance of the pool where the balance, prior to calculating the depreciation, for the income year is less than $20,000.

Balancing adjustment

When a depreciating asset is disposed of, there is usually a balancing adjustment. A deduction is allowed if the sale price is less than the asset's adjustable value, and any excess of sale price over adjustable value is assessable. The balancing adjustment is reduced to the extent that the asset was used for non-taxable purposes.

Example

Frank sold a piece of equipment he used for income-producing purposes for $30,000. It cost $70,000 new and had been depreciated down to $20,000. The balancing adjustment of $10,000 is included in assessable income.

Balancing adjustments may be rolled over in certain circumstances, eg when an asset is transferred as a result of a marriage breakdown. The transferee then becomes entitled to depreciation deductions on the same basis as applied to the transferor, and a balancing adjustment is not calculated until the transferee ultimately disposes of the asset.

¶1-335 Capital works expenditure

Deductions are available for capital works expenditure on constructing buildings, such as factories, shops and home units, and on structural improvements. The capital works must be used in a deductible way during the income year and, for capital works started before 1 July 1997, must have been intended for use for a specified purpose at the time of completion. What constitutes being used in a deductible way varies according to when construction of the capital works commenced. The owner of capital works is generally entitled to an annual deduction of between 2.5% and 4% of the capital expenditure, even if the owner did not incur the original expenditure.

Unlike depreciating assets, there is no specific balancing charge on the disposal of a building for which the capital works deduction was available. However, any deduction claimed for capital works on a building acquired by a taxpayer after 13 May 1997 or for improvements made after 30 June 1997 will reduce the cost base of the building for CGT purposes (¶2-200).

¶1-340 Other capital allowances

Many other kinds of capital expenditure can also be written off as deductions. The write-off can be either immediate or over a period of years, depending on the kind of expenditure. For example, taxpayers engaged in mining and quarrying operations are entitled to deductions for exploration or prospecting expenditure and for expenditure on rehabilitating former mine sites.

Other examples are the deductions for pooled project expenditure (infrastructure expenditure and mining capital and transport expenditure) and expenditure on environmental protection activities. The deduction or offset available for expenditure on research and development is discussed below. For assets acquired after 13 May 1997, deductible capital expenditure is generally excluded from the cost base of the asset for CGT purposes (¶2-200).

Research and development

A research and development (R&D) tax incentive applies. The incentive currently available is as follows:

- a 43.5% refundable tax offset for eligible entities with an aggregated group turnover of $20 million or less
- a 38.5% non-refundable tax offset for all other eligible entities. Unused non-refundable tax offsets may be able to be carried forward to future years.

A limit of $100 million applies on the amount of R&D expenditure that a company can claim as an offset at the accelerated rates under the incentive. If a company exceeds this amount, the offset claimable on that excess expenditure is reduced to the relevant company tax rate.

Eligible entities are essentially companies incorporated in Australia, foreign incorporated companies that are Australian residents and foreign incorporated non-resident companies that carry on business through a permanent establishment in Australia and that are resident in a country that Australia has a double tax agreement with. Partnerships between such entities are also eligible. However, corporate limited partnerships and exempt entities are not eligible.

The refundable tax credit will not be subject to an expenditure cap and will be available to small companies in a tax loss with no limit on the level of R&D expenditure they undertake.

The definition of eligible R&D activities is categorised as either ''core'' or ''supporting'' R&D activities.

Core R&D activities are experimental activities:

- whose outcome cannot be known in advance on the basis of current knowledge but can only be determined by applying a systematic progression of work that is based on principles of established science and proceeds from hypothesis to experiment, observation and evaluation, and leads to logical conclusions, and
- that are conducted for the purpose of generating new knowledge (including new knowledge in the form of new or improved materials, products, devices, processes or services).

Certain specified activities are excluded. Supporting R&D activities are activities directly related to core R&D activities.

¶1-345 Deductible gifts and donations

Deductions are allowable for any non-testamentary gift of $2 or more in money or property (eg shares) made to certain nominated funds, institutions and other bodies in Australia. The deduction is available to any person, including individuals, companies and partnerships, and is available to both residents and non-residents. If the gift is of property, it must have been purchased within the previous 12 months, unless the property is valued by the Commissioner at more than $5,000 or is a work of art, a national heritage property or trading stock. Recipients of deductible gifts can either be in the general categories listed in the income tax law or be identified by name in the law. The general categories include:

- public or non-profit hospitals
- public benevolent institutions
- public universities
- registered environmental and cultural organisations
- approved overseas aid funds.

Deductions are only available for gifts made to political parties and independent politicians up to $1,500 where the gift is made by an individual other than in the course of carrying on a business.

A deduction can be claimed where a taxpayer enters into a perpetual conservation covenant over the taxpayer's land with an authorised body for no consideration. The deduction is equal to the decrease in the market value of the land that is attributable to the covenant.

Gifts are generally not deductible unless the recipient is registered with the ACNC Commissioner or specifically listed by name in the law. To be registered, the recipient requires an ABN (¶1-120).

Gifts of works of art that qualify under the Cultural Gifts Program are exempt from CGT. Also, deductions for gifts of property to certain environmental, cultural and heritage organisations may be spread over five income years. A similar spreading is available for deductions for gifts of property valued by the Commissioner at over $5,000 and for deductions in respect of grants of conservation covenants.

A deduction is also available for contributions to a deductible gift recipient where a minor benefit is received in return. An individual can claim a deduction where the value of the contribution is more than $150 and the minor benefit received in return is not more than the lesser of $150 or 10% of the value of the contribution. This deduction would apply where, for example, a person pays to attend a charity ball.

TAX OFFSETS

¶1-350 What are tax offsets?

Tax offsets, most of which are rebates, directly reduce the tax payable by taxpayers on their taxable income. Deductions, on the other hand, reduce taxable income and therefore reduce tax payable by a smaller amount. Some offsets are discussed elsewhere in this chapter, eg the rebates for assessable life assurance reversionary bonuses (¶1-275), ETPs (¶1-285) and certain payments in lieu of unused annual leave and unused long service leave (¶1-265) and the franking offset on franked dividends paid by resident companies to resident individual shareholders (¶1-400, ¶1-405). Other tax offsets are discussed in other chapters, eg the rebates for superannuation contributions. Most tax offsets apply only to individual taxpayers. Exceptions to this include the foreign income tax offset, the franking offset, the R&D incentive and the tax offset for an investment in an early stage innovation company.

The sum of a taxpayer's tax offsets for an income year generally cannot exceed the tax otherwise payable for the income year (ie any excess is not refundable and cannot be carried forward to later income years) and tax offsets cannot be set off against the Medicare levy (¶1-075) or any other tax liability. For example, there is no ability to obtain a refund of or carry forward any excess foreign income tax offset. However, any excess private health insurance tax offset (¶1-355) or franking offset for individuals is refundable. Any excess tax offsets arising from an investment in an early stage innovation company can be carried forward to later income years.

¶1-355 Concessional rebates and offsets

Individuals may be entitled to a range of so-called concessional rebates and offsets, such as the low income rebate, the low income aged persons rebate, the medical expenses rebate, the private health insurance tax offset and the dependent (invalid and carer) tax offset (¶20-040).

Small business income tax offset

Individuals deriving income from an unincorporated small business entity with aggregated annual turnover of less than $5 million are entitled to the ‘‘small business tax offset’’ which effectively provides a discount of 8% of the income tax payable on that business income subject to a maximum cap of $1,000 per year. See ¶1-283 for details of the offset.

Low income tax offset

The LITO is available to persons whose taxable income is less than $66,667 (see ¶1-055)

Low and medium income tax offset

With effect from 2018/19, a low and medium income tax offset (LMITO) is available to persons whose taxable income is less than $125,333 (see ¶1-055). The rebate applies as follows:

- for taxpayers with income not exceeding $37,000 — $200
- for taxpayers with income exceeding $37,000 but not exceeding $48,000 — $200 plus 3% of the amount of the income that exceeds $37,000
- for taxpayers with income exceeding $48,000 but not exceeding $90,000 — $530, and
- for taxpayers with income exceeding $90,000 — $530 less 1.5% of the amount of the income that exceeds $90,000.

The LMITO is not available for minors with unearned income and can be applied in conjunction with the LITO.

Senior Australians and pensioners tax offset

The senior Australians and pensioners tax offset (‘‘SAPTO’’) is available to persons of Age Pension age (eg self funded retirees) and recipients of certain pensions, allowances and benefits under the *Social Security Act 1991* and the *Veterans’ Entitlements Act 1986*, which are known as ‘‘rebatable benefits’’.

The amount of the offset available depends upon the person’s rebate income (being the sum of taxable income, reportable superannuation contributions, total net investment loss and adjusted fringe benefits). A married person with unused offset can transfer the unused amount to a spouse who has a tax liability. The LITO and LMITO, discussed above, may also be available where

SAPTO does not eliminate tax altogether. For more details on SAPTO, see ¶20-043.

Taxpayers entitled to an amount of SAPTO are eligible for an increased income threshold at which they are exempt from paying the Medicare levy or pay a reduced levy.

Medical expenses tax offset

The medical expenses tax offset is being phased out. For 2018/19 the tax offset is only available for taxpayers for out-of-pocket expenses relating to disability aids, attendant care or aged care until 1 July 2019 when DisabilityCare Australia is fully operational and aged care reforms have been in place for several years.

The offset is means tested resulting in the following two levels of offset that apply:

- *Level 1*: Taxpayers with adjusted taxable income of up to $90,000 if single or $180,000 for a couple or family, with the threshold being increased by $1,500 for each dependent child after the first (being the Medicare levy surcharge thresholds, see ¶1-075) are entitled to an offset equal to 20% of the excess of non-reimbursable eligible medical expenses over $2,377 for 2018/19 (being $2,333 for 2017/18).
- *Level 2*: For taxpayers with adjusted taxable income above that level, the rate of offset is decreased to 10% of the excess of non-reimbursable medical expenses over $5,609 for 2018/19 (being $5,504 for 2017/18).

These thresholds are indexed annually.

Payments in respect of a separated spouse can qualify as a dependant but payments in respect of a divorced spouse cannot.

Private health insurance tax offset

Individuals are entitled to a tax offset for the cost of the premiums on a private health insurance policy which provides hospital or ancillary cover, or both. The private health insurance tax offset is means tested and applies as follows:

INCOME THRESHOLDS				
Singles	$0–$90,000	$90,001–$105,000	$105,001–$140,000	$140,001 and above
Families*	$0–$180,000	$180,001–$210,000	$210,001–$280,000	$280,001 and above
	Maximum Rate#	**Tier 1**	**Tier 2**	**Tier 3**
Aged under 65	25.415%	16.943%	8.471%	Nil

Aged 65–69	29.651%	21.180%	12.707%	Nil
Aged 70 or over	33.887%	25.415%	16.943%	Nil

* Families threshold includes couples and single parents and is increased by $1,500 for each dependent child after the first.

These rates apply for premiums paid after 1 April 2018. The rates will decrease by an adjustment factor of 0.968 for premiums paid after 1 April 2019.

If the offset exceeds the tax otherwise payable, the excess is refundable. A person can choose to have premiums reduced instead of claiming the tax offset.

Offset for investments in an early stage innovation company (ESIC)

Investors are entitled to a non-refundable carry forward offset for qualifying investments in an early stage innovation company (''ESIC'') of 20% of the amount paid for a fresh issue of shares. As flow through entities, trusts and partnerships are not entitled to the offset in their own right. However, members of the trust or partnership can obtain the benefit of the investments made by the entity.

The conditions to be an ESIC are detailed in s 360-40 of ITAA97. In general terms, an Australian-incorporated company will qualify as an ESIC if it is at an early stage of its development (generally incorporated within three years) and it is developing new or significantly improved innovations with the purpose of commercialisation to generate an economic return. Further conditions require that the company is not listed on the ASX and in the previous income year to investment the company must not have derived assessable income of more than $200,000 or incurred expenses of more than $1 million.

The offset that may be claimed in an income year is capped at $200,000 (ie investments up to $1 million). However, a total investment limit of $50,000 a year applies to retail (non-sophisticated) investors. Such retail investors receive no offset if this limit is exceeded. To be eligible for the offset, an investment cannot exceed 30% of the interests in the relevant ESIC.

Investments entitled to the tax offset are exempt from capital gains tax for the first 10 years of the investment (excluding capital gains made in the first 12 months of ownership).

Film concessions

There are three refundable tax offsets which are available for company taxpayers investing in the Australian screen media:

- the producer offset — for Australian expenditure in making Australian films
- the location offset — for Australian production expenditure
- the PDV offset — for post, digital and visual effects production in Australia.

These refundable offsets are only available for company taxpayers.

COMPANIES

¶1-400 Method of taxing company income

Companies are taxed as separate legal entities and, like individuals, pay tax on their taxable income (¶1-050). Unlike individuals, tax is paid at a flat rate on the whole of a company's taxable income. The general tax rate for companies is 30%. A company that is a base rate entity is entitled to a lower corporate tax rate of 27.5%. A base rate entity for 2018/19 is proposed to be a corporate entity that has aggregated turnover less than $50 million for the year and no more than 80% base rate entity passive income. Base rate entity income includes:

- dividends other than non-portfolio dividends
- franking credits on such dividends
- non-share dividends
- interest income (some exceptions apply)
- royalties and rent
- gains on qualifying securities
- net capital gains
- income from trusts or partnerships, to the extent it is referable (either directly or indirectly) to an amount that is otherwise base rate entity passive income.

At the time of writing the definition of a base rate entity had not passed into law.

Certain limited partnerships and public trading trusts are taxed as if they are companies.

Dividends paid by a company are included in the assessable income of a resident shareholder and taxed at marginal rates but the imputation system (¶1-405) enables a shareholder to receive franking credits for the tax paid by the company on the income distributed. The tax treatment of dividends in the hands of shareholders, including non-resident shareholders, is discussed at ¶1-150 and ¶1-270.

Companies are generally required to appoint a public officer to be answerable for doing the things required of the company for tax purposes. In addition, directors and other officers of a company can be liable for the company's default in certain circumstances. Payment arrangements for company tax are outlined at ¶1-105.

Debt and equity

The law contains rules to distinguish between equity in a company and debt. The distinction is based on the economic substance of the relevant arrangement under which the interest in the company arises. A debt interest arises where there is an effective obligation on the company to return an amount at least equal to the issue price. Equity includes shares, interests that are convertible into shares and interests that provide returns that are contingent on economic performance — but if an interest is a debt interest it is not treated as equity.

A return paid on a debt interest may be deductible. A return on a debt interest (including a dividend on a share that is defined as a debt interest) is deductible to the extent it would be if it were interest, but the dividend is not frankable under the imputation system. The deduction for a return on a debt interest is limited to the rate of return on an ordinary debt interest (ie where returns are not contingent on economic performance) plus 150 basis points. A return on a non-share equity interest (ie an equity interest that is not solely a share) is not deductible but may be frankable.

Note that related party at-call loans of companies whose turnover is less than $20 million in a year are treated as debt interests.

Losses

If a company's deductions exceed its assessable income and any net exempt income, the resulting *tax loss* can be a deduction in calculating taxable income in later years. Companies will only be entitled to the deduction where the company satisfies either the continuity of ownership or same business test. However, a more flexible similar business test is proposed to be introduced for losses made in 2015/16 and later income years. A company may choose the amount of prior year losses they want to deduct in an income year. Generally, resident companies in the same wholly-owned group cannot transfer losses between each other unless they form part of the same consolidated group (see below). The head company of the consolidated group is then entitled to a deduction for the tax loss. A company is a resident if it is incorporated in Australia or, not being incorporated in Australia, carries on business in Australia and has either its central management and control in Australia or its voting power controlled by shareholders who are Australian residents.

Example

VS Pty Ltd, a resident company, has taxable income of $20,000 for the year ended 30 June 2019 but has tax losses of $50,000 from several years ago. During the year VS Pty Ltd was taken over, with 100% of its shares now held by new owners. It also changed the nature of its operations significantly.

VS Pty Ltd will not be able to utilise any of the losses in the company structure. It cannot satisfy the continuity of ownership or same business test and therefore cannot utilise its own losses.

Companies are not able to ''carry back'' losses to offset past profits.

Excessive remuneration

Where a company that is a private company for tax purposes excessively remunerates a past or present shareholder or associate for services rendered, the excess over what is reasonable is not deductible. The excess is assessable to the person as a deemed dividend that is not frankable under the imputation system (¶1-405). A company is a private company for tax purposes if it is not a public company for tax purposes. Examples of companies that are public companies for tax purposes are listed companies, subsidiaries of listed companies and government-controlled companies.

Loans by private company

A private company may be deemed to have paid a dividend simply by paying or lending an amount to a shareholder or associate, forgiving a debt owed to the company by such a person, providing such a person use of an asset for less than arm's length consideration or having an unpaid present entitlement owing from a trust. Specified transactions are excluded from the rules, including payments to shareholders in their capacity as employees, the payment of genuine debts owed by the company to the person, loans and payments to other companies and loans pursuant to written agreements that meet the prescribed minimum interest rate and maximum loan term. These deemed dividends are generally not frankable, ie they cannot have franking credits attached. However, the Commissioner can exercise a discretion to allow franking credits to be attached to such a dividend where the dividend arose as a result of honest mistake or inadvertent omission. The discretion will only be exercised if the dividend is taken to be paid to a shareholder of the company, as opposed to an associate of a shareholder.

The Board of Taxation released a report on the deemed dividend rules relating to private company loans for their effectiveness and whether they can be simplified. The report has identified that the rules are complex, inflexible and costly to comply with. The rules fail to achieve an appropriate balance between ensuring taxpayers are treated fairly, promoting voluntary compliance and discouraging non-compliance. The rules can also operate as an unreasonable impediment for businesses operating through a trust that wish to fund their growth by reinvesting profits back into the business. The report includes a number of recommendations to ease the compliance burden and lower the cost of working capital for companies.

Special rules

Certain types of entities that are companies for tax purposes receive special tax treatment on all or part of their income. They include life assurance companies, co-operatives, credit unions, friendly societies, trade unions and pooled development funds (these are now being phased out) and early stage venture capital limited partnerships (ESVCLP).

Consolidation of entity groups

Wholly-owned groups of companies, trusts and partnerships can choose to be treated as a single consolidated entity for income tax purposes.

The main features of the group consolidation regime are:

- the head company of a wholly-owned group of entities can make an irrevocable choice to consolidate with its wholly-owned Australian subsidiaries for income tax purposes. All of the wholly-owned consolidated subsidiaries become subsidiary members of the consolidated group with the head company
- a consolidated group is treated as a single entity for tax purposes during the period of consolidation
- intra-group transactions are ignored for tax purposes
- tax matters other than income tax, such as FBT, are not included within the consolidation regime and they continue to be the responsibility of the individual entities in the group. A withholding obligation of a subsidiary also falls outside the consolidation regime, as it relates to the income tax payable by a third party.

¶1-405 Imputation system

Tax paid by Australian resident companies is ''imputed'' to resident individual shareholders when they are paid franked dividends. That is, the dividend and a franking credit (an amount equal to the company tax attributable to the dividend as allocated by the company) are both included in the shareholder's assessable income and taxed at marginal rates, and the shareholder is allowed a tax offset (a ''franking tax offset'') equal to the franking credit. Excess franking credits are refundable for certain taxpayers but not for most company types. However, excess franking credits in a company are converted into tax losses for the year. Franking credits received by a trust that has a tax loss or nil net income will generally be lost. The tax treatment of dividends, both franked and unfranked, in the hands of residents and non-residents is discussed at ¶1-270.

Like individual shareholders, most superannuation funds and ADFs are entitled to the franking tax offset, as are life assurance companies in respect of franked dividends derived from assets included in their insurance funds. Also, resident companies are entitled to the franking tax offset when they are paid franked dividends.

Companies, non-complying superannuation funds and non-complying ADFs cannot receive a refund of excess franking credits on dividends received.

A holding period rule requires taxpayers to hold shares at risk for more than 45 days (90 days for preference shares) in order to qualify for franking credits and offsets. The 45-day holding period must occur during the period starting on the day after the taxpayer acquires the shares and ending on the 45th day after the shares become ''ex-dividend''. Subject to limited exceptions, discretionary trusts will need to make a family trust election to enable its beneficiaries to receive the benefit of its franking credits. Individuals who do not satisfy the holding period rule may nevertheless be entitled to up to $5,000 of franking rebates in relation to an income year. Entities such as complying superannuation funds, life assurance companies and widely held trusts can elect to be taken to be qualified for franking credits or rebates up to a limit calculated in accordance with a statutory formula.

Other anti-avoidance provisions dealing with franking credit trading and dividend streaming schemes are referred to below and at ¶1-605 and ¶1-610.

Franking accounts and rules for franking dividends

The imputation provisions provide that only frankable distributions can be franked and only where they are made by a franking entity (that satisfies a residency requirement at the time). A distribution will only be franked where the entity allocates franking credits to the distribution.

Franking entities basically include companies and similar entities, but not non-fixed or discretionary trusts.

An entity can determine the extent (up to 100%) to which it will frank its dividends. The main limitations are:

- the maximum franking credit rule, which limits the credits that can be allocated
- a benchmark rule, which provides that all frankable distributions within a franking period have to be franked to the same extent.

The maximum franking credit that can be allocated to a frankable distribution is equal to the maximum amount of tax that the entity making that distribution could hypothetically have paid on the profits underlying the distribution.

To calculate the maximum franking credit, the formula is:

$$\begin{array}{c}\text{Amount of the}\\ \text{frankable distribution}\end{array} \times \frac{\text{(corporate tax rate for imputation purposes)}}{\text{(1 − corporate tax rate for imputation purposes)}}$$

The ‘‘corporate tax rate for imputation purposes’’ is generally the entity’s corporate tax rate for the income year of payment worked out on the assumption that the company’s aggregated turnover for the income year is equal to its aggregated turnover for the previous income year.

Example

In 2017/18, Imagine Pty Ltd has an aggregated turnover of $30m. In 2018/19 its aggregated turnover increased to $55m.

Therefore, for 2018/19 Imagine Pty Ltd will have:

- a corporate tax rate of 30% (having regard to its aggregated turnover of $55m in 2018/19)
- a corporate tax rate for imputation purposes of 27.5% (having regard to its aggregated turnover of $30m in 2017/18).

Where Imagine pays a fully franked dividend of $7,000 in 2018/19, the maximum franking credit that can be attached to the frankable distribution is $2,655 worked as follows:

$$\$7{,}000 \quad \times \quad \frac{27.5\%}{72.5\%} \quad = \quad \$2{,}655$$

In the circumstances, the maximum franking credit will be:

- where the company has a corporate tax rate for imputation purposes of 27.5% — 37.93% of the distribution
- in any other case — 42.86% of the distribution.

A private company's franking period is the same as its income year, ie 12 months. For other companies, the franking period is generally six months.

Special rules cause franking debits to arise where a company enters into a dividend streaming arrangement. Dividends are streamed where, broadly, a company directs franked dividends to shareholders who are able to fully use the franking tax offset to offset tax otherwise payable while directing unfranked dividends to shareholders (eg non-residents) who are unable to use the franking tax offset. Other anti-avoidance provisions are mentioned at ¶1-605 and ¶1-610.

Franking credits can arise from a number of events, including paying a PAYG instalment and receiving a franked dividend. Franking debits can arise in a variety of circumstances, including an amendment of an assessment that reduces tax payable and the payment of a franked dividend.

Franking accounts are expressed in dollars of tax paid, rather than the corresponding amount of after-tax taxable income.

Example

The aggregated annual turnover of ABC Pty Ltd for 2017/18 was $51m and for 2018/19 is $55m. The corporate tax rate for 2018/19 is 30% giving rise to a tax liability of $300,000 for the year. When this tax is paid, it will give rise to a credit in the company's franking account of $300,000.

ABC's corporate tax rate for imputation purposes for 2018/19 is also 30% (based on turnover of $26m in 2016/17). Where ABC pays a $700,000 fully franked dividend in 2018/19 the franking credit attached will be $300,000.

If instead ABC only had an aggregated annual turnover of $45m in 2017/18 the corporate tax rate for 2018/19 would still be 30% giving rise to a tax liability of $300,000 for the year. This will give rise to a credit in the franking account of $300,000. However, its corporate tax rate for imputation purposes for 2018/19 is 27.5%. If ABC pays a fully franked dividend of $700,000 in 2018/19 the franking credit attached to the dividend will be $265,517.

If a company taints its share capital account by transferring amounts from other accounts to it (eg by capitalising profits), a franking debit arises and subsequent distributions from the account are treated as unfrankable and unrebatable dividends. If the company elects to untaint the account, a further franking debit may arise and the company may also be liable to pay untainting tax.

Below is an illustration of straightforward movements in a franking account of a company that is subject to both a corporate tax rate and a corporate tax rate for imputation purposes of 27.5%.

Date	Details	Debit $	Credit $	Balance $
1 July 2018	Opening balance	–	–	300,000
28 July 2018	PAYG instalment of $65,000	–	65,000	365,000
30 September 2018	Fully franked dividend of $200,000 received from public company ($200,000 × 30/70)	–	85,714	450,714
28 October 2018	PAYG instalment of $65,000	–	65,000	515,714
28 February 2019	PAYG instalment of $65,000	–	65,000	580,714
20 March 2019	Refund on assessment of $22,500	22,500	–	558,214
28 April 2019	PAYG instalment of $65,000	–	65,000	623,214
22 June 2019	Payment of fully franked dividend of $750,000 ($750,000 × 27.5/72.5)	284,483	–	338,731
30 June 2019	Closing balance (this will be the opening balance on 1 July 2019)	–	–	338,731

Removal of tax preferences

Taxing shareholders on dividends has the effect of removing any tax preferences the company may have enjoyed. That is, if a company receives exempt or concessionally taxed income, that exemption or concession is effectively lost when the income is distributed to individual shareholders as dividends. Generally, such dividends can only be franked to an extent which reflects the lower tax paid by the company because of the exemption or concession. Tax preferences are lost in many other situations too, eg where depreciation deductions for tax purposes exceed the depreciation charged in the company’s accounts, effectively exempting some profit from tax or the concessional tax rate for corporate small business entities. Partners in partnerships and beneficiaries of trusts, on the other hand, generally do not lose tax preferences when income is distributed.

PARTNERSHIPS

¶1-450 Wide definition of partnership for tax purposes

A partnership for tax purposes means an association of persons carrying on business as partners in the general law sense or an association of persons in receipt of income jointly, but not including companies. This extended definition has the effect that, for example, persons receiving rents as joint owners of rental property, whether joint tenants or tenants in common, are partners for tax purposes even though they may not be partners at general law because their association and activities as landlords may not amount to carrying on business. Joint ownership of other income-earning investments, such as shares, may also constitute a partnership for tax purposes. Companies, trustees and minors can all be partners. In the case of jointly owned rental properties and other investments, the ATO does not usually require the lodgment of a partnership tax return.

Whether a partnership exists is a question of fact. The intention to act as partners is essential but the conduct of the parties must also support that intention. A partnership agreement is not conclusive evidence of the existence of a partnership, but it is significant, as long as the parties act in accordance with the agreement. The Commissioner has published his views on the factors that tend to support the existence of a business partnership. Despite the existence of a partnership where a partner over 18 years of age does not have real and effective control of the partner's share of partnership income, further tax may be payable so as to, broadly, bring the rate of tax on that uncontrolled partnership income to 45% for 2018/19, being the top marginal rate.

A new partnership comes into existence when a partner in an existing partnership dies or retires or when a new partner is admitted.

¶1-455 Method of taxing partnership net income or loss

Partnerships are not taxable on their income (except limited partnerships, which are taxed as companies). Instead, partners are assessed individually on their respective interests in the net income of the partnership. The net income of a partnership is its assessable income, calculated as if the partnership were a resident taxpayer, less its total deductions. If a partnership exists for tax purposes only, ie the partners are not carrying on a business but are in receipt of income jointly, the partners' shares of partnership net income are determined by their interests in the income-earning property.

Although a partnership is not liable to tax, it is still required to lodge an income tax return.

Partners derive their share of the partnership net income when partnership accounts are taken, generally at the end of the income year even if the income distribution does not occur until the next income year. Partnership income retains its character in the hands of the partners. Accordingly, where partnership income includes franked dividends, for example, the dividends and the corresponding franking credits and franking tax offsets are apportioned between the partners according to their shares in the partnership net income or partnership loss (see below). Similarly, foreign source income and related foreign income tax offsets retain their identity upon apportionment between the partners.

Individuals are entitled to a discount on the income tax payable, up to a maximum of $1,000, on the business income derived from a partnership that is a small business entity pursuant to the small business income tax offset. The discount is currently 8% in 2018/19 (¶1-283).

Partnership loss

A partnership loss arises when the deductions exceed the assessable income. However, a partnership loss is not trapped inside the partnership and carried forward as a deduction against future income of the partnership. Rather, the partners are allowed a deduction for their individual interest in the partnership loss. If the partnership is carrying on a business, the non-commercial loss rules must be satisfied before an individual partner can offset their partnership loss against other income. The individual interest of a partner in any exempt income (¶1-260) of a partnership is taken into account in calculating and deducting the partner's own tax losses.

Non-resident partners

Non-resident partners are not assessed on any part of an individual interest in partnership net income that is attributable to foreign source income derived during a period when the partner was not a resident. Similar rules apply to non-resident partners' interests in a partnership loss.

Interest on partnership borrowings

A business partnership is entitled to a deduction for interest on borrowings used to replace working capital of the partnership, thus allowing partners to withdraw the amount of capital contributed and so reduce the net worth of each partner's interest in the partnership. A deduction is not allowable to the extent the loan replaces capital represented by internally generated goodwill or an unrealised revaluation of assets. A partnership of joint owners of rental property would not be entitled to a deduction for interest on a loan to replace their equity in the property unless their activities as landlords constituted a business partnership under the general law.

Partner's salaries and payments to associated persons

Salaries paid to partners are really distributions of the partnership net income. Partnership salaries are not deductible to the partnership, but rather are a way of distributing the net income of the partnership between the partners by allowing some partners to receive larger amounts for their proportionately larger contribution to the partnership. A partnership is not entitled to a deduction for superannuation contributions made in respect of a partner.

If a partnership makes a payment or incurs a liability, eg for salary or interest, to a relative of a partner or to another associated person or entity, a deduction is allowed only to the extent that the amount is reasonable having regard to commercial practice. The disallowed amount is generally not assessable income of the recipient.

¶1-460 Exceptions: direct application of law to partners

Some provisions of the income tax law apply directly to the partners and do not affect the calculation of the partnership net income or partnership loss. Examples are the provisions allowing deductions for investment in Australian films and the CGT provisions (see Chapter 2). On disposal of a partnership asset, no capital gain or loss arises to the partnership under the CGT provisions. The gain or loss is taken into account in working out whether each partner's assessable income includes a net capital gain.

¶1-465 Assignment of partner's interest in partnership

A partner may be able to assign an interest, or a part of an interest, in a partnership to, for example, a spouse so as to shift to the spouse the liability for income tax on the portion of partnership net income that is attributable to the assigned interest. The assignment is, however, treated as a disposal of the relevant part of the partner's interest in the partnership for CGT purposes. That, in turn, is treated as a disposal or part disposal of the partner's interests in each of the partnership assets.

TRUSTS

¶1-500 What is a trust?

The income tax law contains special rules for taxing the net income of a trust estate. A trust estate (in this chapter called a trust) is property that is vested in a person (the trustee) and held by the trustee for the benefit of other persons (the beneficiaries) under a fiduciary obligation imposed on the trustee. The trustee must act in accordance with the terms of that obligation. A deceased estate is a trust for tax purposes both before and after administration of the estate is completed. The income of unit trusts is generally taxed under the rules applying to trust income, but some public unit trusts are taxed as companies.

¶1-505 Method of taxing trust income or loss

A trust is not liable as a separate taxpayer to pay tax on the income of the trust, but it is still required to lodge tax returns. The rules for taxing trust income are set out below. The government has indicated that it proposes to rewrite the rules regarding the taxation of trusts as a result of the High Court's decision in *Bamford v FC of T* 2010 ATC ¶20-170 (Bamford). Trustees are only liable as trustees to pay tax on trust income in the limited circumstances provided for by these rules. Any such liability is in the trustee's representative capacity rather than in a personal capacity. A trust can incur a loss for an income year. If it does, the loss is carried forward and may be allowable as a deduction in a later year (¶1-525).

Calculation of net income of trust

The tax base for trusts is the net income of the trust. The net income of a trust is its total assessable income calculated as if the trustee were a resident taxpayer, less all deductions. The question of whether a receipt is income is determined by tax law principles rather than by trust law. For example, a capital gain would be capital under trust law, but may be assessable income for tax purposes.

Distributed income retains its character

Trust income retains its character in the hands of beneficiaries. Accordingly, where trust income includes franked dividends, for example, the attached franking credits and corresponding franking tax offsets flow through to beneficiaries, or the trustee, in proportion to their share of the net income of the trust that is attributable to the dividends (see below). Where permitted by the trust deed, a beneficiary may be made specifically entitled to franked dividends (¶1-270) and capital gains (¶1-295). The tax law does not provide for streaming of other types of income. Foreign source income retains its identity when it flows through to beneficiaries and a foreign income tax offset is available to the beneficiary for its share of the foreign income tax paid by the trustee. Foreign source income is included in the net income of a trust but whether and how it is taxed to beneficiaries or the trustee depends on the operation of the rules set out below.

Net income for tax purposes v net income in trust law

It is possible for the net income of a trust for tax purposes to be different from the net income calculated according to trust law, eg if a receipt is treated as income for tax purposes and capital for trust purposes or if depreciation deductions for tax purposes exceed the depreciation charged in the trust's accounts. If the net income for trust purposes exceeds the net income for tax purposes, the excess is generally not assessable. If the net income for tax purposes exceeds the net income for trust purposes, the ATO will generally assess the beneficiaries on the excess in proportion to their share of the distributable income.

The case of *Bamford* also raised the question of whether different types of income (eg dividends, capital gains, foreign income) could effectively be streamed for taxation purposes or whether beneficiaries are simply taxed on their proportionate interest in the net income of the trust. The tax law specifically permits capital gains and franked dividends to be streamed to beneficiaries where permitted by the relevant trust deed. To the extent that such amounts are not streamed in this manner they will be apportioned between the beneficiaries proportionately to their share of the trust income.

Rules for taxing net income of trust

The taxation of trust income depends upon whether:

- a beneficiary is ''specifically entitled'' to a streamed amount
- a beneficiary is presently entitled to the income (¶1-510). The treatment will then vary depending upon whether the beneficiary:
  - is under a legal disability (¶1-515), and
  - is a resident, or
- no beneficiary is presently entitled to the income (¶1-520).

Beneficiary specifically entitled

Where permitted by the trust deed a beneficiary may be streamed capital gains and franked distributions of a trust fund. In such a case the beneficiary is considered to be specifically entitled to the relevant amount. Where the beneficiary is specifically entitled to a capital gain the beneficiary will effectively be treated as if it made the capital gain itself.

Where the beneficiary is specifically entitled to a franked distribution the beneficiary is assessed on the amount of the franked distribution made by the trust and on the franking credits attached to that distribution.

If the beneficiary that is specifically entitled to a share of the income of the trust is either under a legal disability (¶1-515) or is not a resident (¶1-550) at the end of the income year, the trustee may be assessed and liable to pay tax on those amounts. The trustee will also be taxed where it chooses to be assessed on a capital gain of the trust if no amount of trust property referable to the capital gain is paid or applied for the benefit of a beneficiary.

Beneficiary presently entitled

Where a beneficiary is presently entitled (¶1-510) to a share of the income of the trust (excluding the amounts a beneficiary is specifically entitled to), the beneficiary's assessable income includes that share of the net income of the trust if the beneficiary is not under a legal disability (¶1-515) and is a resident at the end of the income year. A beneficiary is assessable on a share of trust income in the year in which the trust derives the income even if it is not distributed until the following income year (eg a distribution from a cash management trust). The distribution itself will not be taxed. The assessable share does not include any income that is attributable both to foreign sources and to a period when the beneficiary was not a resident. However, such foreign source income is generally assessable income of the beneficiary on distribution if the beneficiary is a resident at any time during the year of distribution.

An exempt entity is treated as being presently entitled to any amount of the trust's income unless it has been paid or notified of their entitlement within two months of the end of the income year. Such amounts will be assessed to the trustee if the requirements are not met.

Where a beneficiary is presently entitled to a share of the income of the trust but is either under a legal disability (¶1-515) or is not a resident (¶1-550) at the end of the income year, the trustee is liable to pay tax on that share of the net income of the trust. The trustee is not assessable on any income that is attributable both to foreign sources and to a period when the beneficiary was not a resident. In the case of a beneficiary who is not a resident at the end of the income year, the beneficiary is also assessred on the share of trust income on which the trustee has been assessed but is allowed a credit for the tax paid by the trustee and a refund of any excess.

Trustees of certain closely held trusts (eg discretionary trusts) with a presently-entitled beneficiary that is a trustee of another trust must disclose to the Commissioner the identity of the ultimate beneficiaries of certain net income and tax-preferred amounts of the trust. The purpose is to ensure that the ultimate beneficiaries (eg individuals) pay tax on their share of the income. Failure to disclose will result in tax at the highest marginal rate being imposed on the net income. Ultimate beneficiary statements do not have to be lodged unless the trustee has an ultimate beneficiary non-disclosure tax liability for the year or the Commissioner requests a statement. The closely held trusts measures do not apply to:

- complying superannuation funds, complying ADFs and PSTs
- deceased estates for five years after the death
- fixed unit trusts wholly owned by tax-exempt persons, or
- listed unit trusts.

Example

The GT Trust has received income for the year of $65,000 and incurred deductions of $27,000. The net income of the trust is $38,000. Any beneficiary who is presently entitled to a share of this income and is not under a legal disability will be assessed on that share of the net income.

Individuals are entitled to a discount of 8% on the income tax payable, up to a maximum of $1,000, on the business income received as a beneficiary of a trust that is a small business entity pursuant to the small business income tax offset (¶1-283).

No beneficiary presently entitled

The balance of the net income of the trust, ie net income to which no beneficiary is either specifically entitled or presently entitled (¶1-520) or accumulating income, is assessed to the trustee, generally at the maximum marginal personal tax rate. If the income has a foreign source, the trustee is assessable only if the trust is a *resident trust*, ie at any time during the income year either a trustee is a resident or the central management and control of the trust is in Australia.

Foreign source income that has accumulated in a non-resident trust without being taxed in the hands of the beneficiary or trustee is generally assessable on distribution to a beneficiary who is a resident at any time during the year of distribution. A non-resident trust is a trust that does not have a resident trustee and its central management and control is outside Australia. Additional tax may be payable in such a case by way of interest. Special rules apply to the income of transferor trusts (¶1-570).

Distributions to superannuation funds

Distributions by trusts to superannuation funds are taxed at 47%, except where the fund has a fixed entitlement to the income. If the fixed entitlement is acquired under a non-arm's length arrangement, any distribution in excess of an arm's length amount is also taxed at 47%. Arm's length distributions to complying superannuation funds with fixed entitlements are taxed at 15%.

Exempt income

Exempt income of a trust is also allocated among beneficiaries, who are presently entitled and not under a legal disability, according to their individual interests in the exempt income. A prior year's trust loss, however, must first be set off against exempt income of the trust of the current year before any exempt income is allocated to beneficiaries.

Consolidation of entity groups

Wholly-owned groups of companies, trusts and partnerships can choose to be treated as a single consolidated entity for income tax purposes. For further details, see ¶1-400.

¶1-510 When is a beneficiary presently entitled?

Generally speaking, a beneficiary is presently entitled to trust income if the beneficiary has an indefeasible, absolutely vested, beneficial interest in possession of the income, the income is legally available for distribution and the beneficiary can demand immediate payment. The beneficiaries of a deceased estate, for example, are generally not presently entitled until the residue of the estate can be ascertained with certainty. *Draft Taxation Determination* TD 2017/D4 outlines the Commissioner's preliminary views on the impact an early trustee resolution will have on present entitlement. TD 2017/D4 considers whether a beneficiary of a discretionary trust who borrows money at interest and on-lends it to the trustee of a discretion trust interest free can deduct the interest under s 8-1. It is noted that for the interest (or any part of it) to be deductible, the beneficiary must be presently entitled to the trust income at the time the interest expense is incurred. However, in the Commissioner's preliminary view present entitlement to the income of the trust estate cannot ordinarily be conferred via an irrevocable early trustee resolution made at the beginning of the income year to appoint income to the beneficiary, because at that time it is uncertain as to whether distributable income will be available. Present entitlement does not arise even if it is appointed by an early resolution. However, the Commissioner notes that it may be possible to make an effective early resolution appointing income before the end of the income year where it is clear that the trust has income available for distribution and an irrevocable resolution is made to appoint income to the beneficiary.

Beneficiary deemed presently entitled

A beneficiary who is not otherwise presently entitled is deemed to be presently entitled to trust income if:

- the beneficiary has a vested and indefeasible interest in the income. If such a beneficiary is an individual, the income is generally assessed to the trustee rather than to the beneficiary, or
- the trustee exercises a discretion to pay or apply trust income to or for the benefit of the beneficiary. For income to be applied for the benefit of a beneficiary it must be immediately and irrevocably vested in the person.

In a further statutory expansion of the concept of presently entitled, a person with an interest in a non-resident trust is deemed to be a beneficiary presently entitled to a share of the income of the trust, the share being calculated according to special rules.

¶1-515 Beneficiary under a legal disability

Beneficiaries are under a legal disability if they cannot give a discharge for money paid to them, eg minors and bankrupts. Where a beneficiary under a legal disability derives income from more than one trust, or from other sources (such as interest or dividends) as well as the trust, the beneficiary is required to lodge a tax return and is assessed on all of the income, including trust income that is assessed to the trustee. The beneficiary is entitled to a credit for the tax paid by the trustee on the beneficiary's share of trust income, but is not entitled to a refund if the tax paid by the trustee exceeds the tax for which the beneficiary would otherwise be liable. Unearned income of a trust to which a minor is presently entitled can be taxed at the highest marginal tax rate (¶1-070).

Example

Matthew, who is 15 and therefore under a legal disability, is absolutely entitled to a one-fifth share of the income of the First Trust, although he cannot actually receive it until he is 18. The net income of the First Trust is $30,000, and the trustee is therefore liable to pay tax on Matthew's share of $6,000. Matthew is also a discretionary beneficiary of the Second Trust. In the relevant year, the trustee of the Second Trust pays $2,000 towards Matthew's school fees. Matthew is deemed to be presently entitled to the $2,000 and the trustee is liable to pay tax on it. In addition, Matthew earns $3,000 from regular part-time work at the local supermarket. Matthew is assessable on $11,000 ($6,000 + $2,000 + $3,000), but the tax he would otherwise pay is reduced by the aggregate of the tax paid by the trustees.

¶1-520 No beneficiary presently entitled to income of deceased estate

Before the administration of a deceased estate (a trust for tax purposes) is complete the income is treated as income to which no beneficiary is presently entitled unless some interim distribution of residue is made, in which case the beneficiaries are treated as presently entitled to the distribution. Amounts received by the trustee which would have been assessable to the deceased had they been received before death are treated as income to which no beneficiary is presently entitled. These amounts include investment income, ETPs (¶1-285) and certain fees for professional services, but payments for unused annual leave and unused long service leave are exempt from tax. Where the trustee of a deceased estate is taxed on income to which no beneficiary is presently entitled, the general individual rates (or similar) are likely to apply for a period of up to three years from death rather than the highest marginal rate (which applies generally to trust income to which no beneficiary is presently entitled).

¶1-525 Restrictions on deductions for trust losses

A trust loss is not shared among beneficiaries in the way net income of a trust is or in the way partnership losses are shared among partners. Rather, the loss is carried forward in the trust and may be allowed as a deduction in calculating the net income of the trust in subsequent years. Losses are deductible only if the trust satisfies comprehensive tests which relate to ownership, control and trading in units and which restrict the practice of injecting income into loss trusts as a tax shelter. Only the last of these tests applies to family trusts, and then only in a limited way.

Family trusts

A family trust that survives an income injection test (see below) is allowed a deduction for a prior year loss if it is a family trust at all times during the income year in which the loss was incurred, the income year in which the loss is to be deducted and all intervening years. A trust is a family trust for the purposes of the trust loss rules if it satisfies a family control test and the trustee has made a *family trust election*, generally in the trust's tax return for the income year from which the election is to take effect. The election must specify an individual as the person on whom the family group is based.

The *family control test* is satisfied if the individual and/or other family members control the trust. The law contains a comprehensive list of the relationships that qualify people as family members and sets out, in detail, what constitutes control. Control may be exercised through interposed entities. A family trust or interposed entity may be subject to family trust distribution tax on any distribution made to a person outside the family group, which is widely defined for this purpose. The family trust distribution tax rate is 47% for 2018/19. A family trust may be denied a deduction for a prior year loss where assessable income is injected into the trust under a scheme to take advantage of the deduction and, broadly, to give the trustee or a beneficiary and an outsider benefits under the arrangement. This rule does not, however, prevent members of the family group injecting income into the trust for their benefit.

¶1-530 Tax consequences of a trust vesting

A trust vests when interests in the trust property are vested in interest and possession. Most trust deeds will specify a date when interests in the trust will vest and outline the consequences of the vesting date occurring. This is to ensure that the trust does not breach the rule against perpetuities.

Draft Taxation Ruling TR 2017/D10 sets out the Commissioner's provisional views on the tax consequences of a trust vesting and the ability to validly amend a trust deed. The Commissioner notes the following:

- Prior to a trust vesting it may be possible for the trustee or court to amend the vesting date of the trust. However, once the vesting date has passed it is not possible to amend the vesting date. This is because the interests in the trust property are fixed at law. Behaviour of the trustee and beneficiaries in a way that is consistent with the terms of the trust before vesting will not be sufficient to extend the vesting date (see example 1 of TR 2017/D10). Extension of the vesting date is subject to the rule against perpetuities which limits extension to a statutory perpetuity period.

- The vesting of the trust itself will not cause the trust to come to an end or a new trust to arise. However, circumstances may arise where parties to a trust relationship act in a manner that results in creation of a new trust.

- Vesting of a trust may result in capital gains tax issues, such as CGT event E5 or E7 occurring. Vesting of a trust in itself will not generally result in CGT event E1 occurring (see ¶2-110).

- In the income year when a trust vests different beneficiaries may be presently entitled to the trust income before and after the vesting date. For example, a trustee of a discretionary trust may exercise their discretion to appoint income of the trust to particular beneficiaries. However, after vesting the beneficiaries who are "takers on vesting" will have a fixed entitlement to income of the trust estate and will be assessable on their share of the trust net income. The Commissioner will accept an allocation of trust estate income before and after the vesting date, undertaken on a fair and reasonable basis, having regard to relevant circumstances. Any purported distribution by the trustee after vesting is not consistent with the fixed interests of "takers on vesting" is void.

The ATO has established a webpage detailing the meaning of a trust vesting and the consequences associated with vesting.

CROSS-BORDER ISSUES

¶1-550 Resident v non-resident

There are major differences in the way Australian residents and non-residents are taxed under Australian income tax law.

Tax consequences of being a resident

- a resident is assessable on income derived from all sources, whether in or out of Australia, unless an exempting provision applies. Some examples of exempt income are given at ¶1-260.
- a resident is assessable on an accruals basis on certain income attributed to the resident as the income is derived by certain *controlled foreign companies* or by certain non-resident trusts (*transferor trusts*) to which the resident transferred property or provided services.
- a resident is subject to the Medicare levy and potentially the Medicare levy surcharge (if adequate private health insurance is not held).
- a resident individual who is a shareholder in an Australian company is entitled to a franking tax offset in respect of franked dividends paid by the company.
- a resident is entitled to an offset for foreign tax paid on income from sources outside Australia.
- a resident is entitled to the CGT discount on a capital gain arising from assets held for at least 12 months.

Tax consequences of being a non-resident

- a non-resident is assessable only on income from Australian sources (¶1-555).
- a non-resident's assessable income does not include dividends, interest or royalties on which final withholding tax is payable (¶1-150) or franked dividends that are exempt from withholding tax.
- a non-resident individual is not entitled to concessional rebates/offsets or the tax-free threshold (¶1-355).
- a non-resident is not liable for the Medicare levy or Medicare levy surcharge.
- partners in partnerships and beneficiaries of trusts are not assessed on income derived from foreign sources while the partner or beneficiary was a non-resident.
- subject to certain transitional rules, a non-resident is not entitled to the CGT discount on asset held for at least 12 months.
- a non-resident is subject to non-resident CGT withholding tax of 12.5% (unless varied) on the disposal of certain taxable Australian property.
- with effect from 9 May 2017, it is proposed that the main residence exemption will not be available to a non-resident, subject to grandfathering of properties held as at that date to 30 June 2019.

- special CGT rules apply (see Chapter 2).

Who is an Australian resident?

Individuals

An individual is regarded as an Australian resident for income tax purposes if the person either resides in Australia within the ordinary meaning of the term or satisfies one of three statutory tests set out in the income tax law.

Ordinary meaning of reside

A person who permanently dwells in Australia would usually be considered to reside in Australia. Because it is possible to reside in more than one country at a time, a person who lives permanently abroad may still be an Australian resident if, for example, the person makes visits to Australia as part of the regular order of the person's life.

Statutory tests for residence

The income tax law also treats as Australian residents individuals who:

- are domiciled in Australia, unless the person's permanent place of abode is outside Australia. In the absence of evidence of a permanent place of abode outside Australia, a person who leaves Australia with the intention of returning within two years will normally remain an Australian resident
- spend more than half the income year in Australia, unless their usual place of abode is outside Australia and they do not intend to take up residence in Australia, or
- are members of a Commonwealth Government superannuation scheme (or are the spouse or child under 16 years of a person who is a contributing member).

Companies

A company is a resident if it is incorporated in Australia or, not being incorporated in Australia, carries on business in Australia and has either its central management and control in Australia or its voting power controlled by shareholders who are Australian residents.

Other entities

The income tax law also contains definitions of a resident superannuation fund, a resident trust estate and a resident public unit trust for specified purposes of the law.

Residency status of common situations

The following table lists some common situations showing whether the individual would generally be considered a resident or non-resident (note that exceptions exist and professional advice should be sought). Note that residency status may also be affected by double taxation agreements (see below).

Situation	Residency status
– goes overseas temporarily, and – does not set up a permanent home in another country	– may continue to be treated as an Australian resident for tax purposes
– is an overseas student enrolled in a course at an Australian institution that is more than six months long	– generally treated as an Australian resident for tax purposes
– is visiting Australia for more than six months and for most of that time works in the one job and lives at the same place	– generally treated as an Australian for tax purposes
– is holidaying in Australia, or – is visiting for less than six months	– will generally not be considered an Australian resident for tax purposes
– migrates to Australia, and – intends to reside in Australia permanently	– generally considered to be Australian resident for tax purposes from the date of arrival
– leaves Australia permanently	– will generally not be considered an Australian resident for tax purposes, from the date of departure

Double taxation agreements

Australia's double taxation agreements with other countries reserve taxing rights over certain classes of income (eg most pensions, purchased annuities and income from independent professional or personal services) to the country of residence of the person deriving the income. The agreements use the countries' domestic rules to classify each person as a resident of either Australia or the other country but contain ''tie breaker'' tests to deal with situations where a person would be a resident of both Australia and the other country. The tests have the effect of deeming the dual resident to be a resident solely of one country or the other.

Double taxation agreements are also discussed at ¶1-555.

¶1-555 Source of income

Like residence, the source of income is a fundamental determinant of liability for Australian income tax. For example:

- non-residents are generally assessable only on income from sources in Australia
- there are comprehensive rules for taxing residents on foreign source income (¶1-570), allowing offsets for foreign tax paid (¶1-575)
- under *double taxation agreements* between Australia and other countries, income may be taxed in the country in which the income has its source unless taxing rights over the income are reserved entirely to the country of residence (¶1-550) of the person. A deemed source in one or the other country is attributed by agreements to some classes of income, otherwise the source is determined under the laws of each country. If the country of residence and the source country both tax the income, the country of residence allows a credit for the tax levied by the source country.

Source of particular classes of income

Ascertaining the source of income has been described as a practical, hard, matter of fact process to be determined separately in each case. The following is a guide to the source of some classes of income:

- the source of a *dividend* is the place where the company paying the dividend made the profits out of which the dividend is paid
- the source of *interest* is generally the place where the loan contract was entered into
- the Commissioner considers the source of *pensions* to be where the pension fund is located but the source of *annuities* to be where the annuity contract is executed
- the source of income from *personal services* is generally the place where the services are performed, but where special knowledge or creativity is involved the source is likely to be the place where the contract was made.

¶1-560 Thin capitalisation

The ''thin capitalisation'' rules may disallow a proportion of the interest (and other finance expenses) attributable to debt used to finance the Australian operations of Australian and foreign multinational investors. The rules are designed to prevent such investors allocating a disproportionate amount of debt to their Australian operations in order to exploit the more favourable tax treatment of debt compared to equity. The thin capitalisation rules do not apply where the total of the taxpayer's annual interest and other debt deductions is $2 million or less.

Where the thin capitalisation rules apply, debt deductions are reduced to the extent that the debt used to fund an entity's Australian operations exceeds a specified maximum. If the entity is a foreign-controlled Australian company, trust or partnership or the entity is a foreign entity that operates in Australia, the maximum permissible ratio of debt to equity is 1.5:1. A higher arm's length limit can be substituted where justified. These limits also apply to an Australian entity with foreign operations, but it may be able to use a higher limit again, based on the level of debt it uses in its worldwide operations. The thin capitalisation rules do not apply to such Australian entities (other than foreign-controlled ones) if at least 90% of their assets are Australian assets. Different debt limits apply to financial entities and authorised deposit-taking institutions (ADIs) such as banks. For an outline of how the tax law determines what is debt and what is equity, and how it treats returns on debt and equity interests, see ¶1-400.

¶1-565 Australians investing overseas

An Australian resident with foreign investments can have the following amounts included in assessable income:

- income, such as dividends, interest and rent, actually derived by the resident

- the resident's share of certain income derived by non-resident entities or accumulating through certain offshore investments, ie the resident is assessed on an accruals basis (¶1-570) without actually deriving the income.

An offset is allowed for foreign tax paid (¶1-575). The thin capitalisation rules may restrict deductions for interest (¶1-560).

¶1-570 Accruals taxation system

Australian residents are taxed on a share of the income of certain foreign entities which is not comparably taxed overseas. Taxing the resident on an ''accruals'' basis as the income is derived by the foreign entity prevents tax deferral and avoidance. There are two separate groups of accruals taxation rules, being the controlled foreign company (CFC) and transferor trust provisions.

Controlled foreign companies

The controlled foreign company (CFC) rules include in the assessable income of Australian resident controllers (attributable taxpayers) of a CFC a share of, broadly, the CFC's income from investments and from transactions with associates (attributable income). The rules do not generally apply, however, if the CFC derives more than 95% of its income from genuine business activities. There are also significant exclusions from the attributable income of a CFC (eg franked dividends). The rules apply differently according to whether the CFC's country of residence is included in one of two categories listed in the law or is an unlisted country.

A resident who has more than a specified control interest (including associates' interests) in a CFC is an attributable taxpayer in relation to the CFC. The law also contains control tests to determine whether a company is a CFC and tests to determine the percentage of a CFC's attributable income that is attributable to a particular attributable taxpayer.

Where a resident's assessable income has included an amount of attributable income from a CFC, the subsequent distribution of the income by the CFC to the resident is exempt from tax if the resident can establish that the distributed amount has already been attributed. A resident can maintain an attribution account for this purpose.

Transferor trusts

The ''transferor trust'' rules include in the assessable income of a resident (an ''attributable taxpayer'') income derived by a non-resident trust to which the resident has transferred property or provided services (attributable income). As a separate rule, income distributed by a non-resident trust to a resident beneficiary may attract additional tax if the income has not been subject to the transferor trust rules or otherwise taxed to the trustee or beneficiary when derived.

For the purposes of the rules, the attributable income of a non-resident trust is broadly based on the trust's net income, reduced in several ways (eg by amounts that, broadly, are assessable in Australia to the trustee or a beneficiary as the income is derived). The whole of the attributable income of the trust can be attributed to each attributable taxpayer, subject to reduction by the Commissioner where there is more than one transferor. In some cases, the amount included in the attributable taxpayer's assessable income is determined by reference to a deemed rate of return on the property transferred.

Whether a resident is an attributable taxpayer depends on, among other things, whether the transfer was to a discretionary trust and whether the transfer was at arm's length. The rules do not apply where transfers are made to non-resident family trusts. As with CFCs, attributable income of a non-resident trust is not assessable to the resident transferor when the income is distributed.

¶1-575 Foreign income tax offset

The foreign income tax offset (FITO) system allows taxpayers to claim a foreign income tax offset where they have paid foreign tax on amounts included in their assessable income (ITAA97 Div 770).

Under the FITO system the offset is allowed for the income year in which the foreign tax is paid. There is no quarantining of offsets to particular classes of income. The offset may also extend to foreign tax on certain non-assessable income, ie amounts paid out of income previously attributed from a CFC. It is generally not a requirement that the taxpayer be a resident, though in practice this will normally be the case.

Normally, the tax must have been paid by the person claiming the offset, though there are exceptions in certain situations, such as where the tax has been deducted at source, or otherwise paid on the taxpayer's behalf. Special rules also allow the offset to be claimed where foreign tax is paid by CFCs on attributed income. The rules governing attributed income have been considerably simplified, eg by eliminating the need to trace through attributed tax accounts. The offset may be adjusted where the amount of foreign tax is refunded or inflated.

For more details on FITO, see Chapter 21 of the CCH *Australian Master Tax Guide (59th ed)*.

¶1-580 Foreign losses

Foreign losses are able to be offset against both Australian and foreign sourced income. There is no ability for non-utilised foreign losses to be carried forward.

TAX AVOIDANCE

¶1-600 How the law deals with tax avoidance

The income tax law deals with tax avoidance in several ways:

- specific anti-avoidance provisions deal with particular tax avoidance practices
- the general anti-avoidance provisions of the *Income Tax Assessment Act 1936* Pt IVA apply to an arrangement as a last resort only after the application of all other provisions of the law has been considered
- *Income Tax Assessment Act 1997* Div 815 deals with transfer pricing arrangements to shift profits out of Australia.

Further, the general deduction provision of the law, which allows deductions for losses and outgoings to the extent to which they are incurred in gaining or producing assessable income, may disallow a deduction to the extent it is incurred in the pursuit of a tax minimisation objective. There would then be no need for recourse to either the general or a specific anti-avoidance provision.

¶1-605 Specific anti-avoidance provisions

Arrangements to which specific anti-avoidance provisions apply include:

- dividend streaming and franking credit trading, such as:
  - the streaming of dividends, or of dividends and other benefits, to provide franking credit benefits
  - the streaming of capital benefits and dividends
  - dividend substitution schemes
- where excessive wages are paid to relatives
- non-arm's length and other unacceptable transactions relating to R&D expenditure
- arrangements to shift value involving interests in companies and trusts
- arrangements which take advantage of the tax-exempt status of charitable trusts
- where property income is derived by a minor
- where a tax-exempt entity is interposed between an Australian resident payer and a non-resident recipient of dividends, interest or royalties
- the alienation of personal services income to interposed entities (¶1-265)
- the multinational tax avoidance rules that apply to artificial or contrived arrangements to avoid the attribution of business profits to a taxable permanent establishment in Australia of a multinational entity with worldwide turnover of $1 billion or more
- where an entity engages in conduct that results in either the promotion of a tax exploitation scheme, or in conduct that results in a scheme that has been promoted on the basis of conformity with a product ruling, but implemented in a materially different way from that described in the product ruling.

¶1-607 Distribution washing provisions

To counteract the practice of ''distribution washing'' (also known as ''dividend washing''), special measures in ITAA97 s 207-157 apply.

''Distribution washing'' essentially refers to the process whereby shareholders who place a relatively high value on franking credits (such as superannuation funds, income tax exempt not-for-profit entities and other shareholders with low marginal tax rates) sell shares on an ex-dividend basis and purchase shares on a cum-dividend basis (in the period after a share goes ex-dividend). This practice enables the shareholder to receive two sets of dividends and claim two sets of franking credits, although in substance, they only ever held one parcel of shares at any point in time. The shareholders who buy ex-dividend shares and sell cum-dividend shares are those who place a relatively low value on franking credits (such as non-residents). The process results in the transfer of value of franking credits from shareholders who should not be able to use them to those who can.

In accordance with the special measures, where a taxpayer receives franked distributions due to distribution washing, the taxpayer will not be entitled to a tax offset or the taxpayer will be required to include the amount of the franking credit in their assessable income.

For these purposes, the distribution washing rules will apply to a franked distribution received in respect of a membership interest (the ''washed interest'') where:

- the washed interest was acquired after the member or a connected entity of the member disposed of a substantially identical membership interest, and
- a corresponding distribution was made to the member or a connected entity in respect of the substantially identical interest.

However, where a connected entity has disposed of the substantially identical interest, the dividend washing rules will only apply if it would be concluded that either the disposal or the acquisition took place only because at least one of the entities expected or believed that the other transaction had or would occur.

The term substantially identical interest is a flexible concept to accommodate a wide variety of financial instruments that currently exist as well as new instruments that may be created in the future. For example, an interest will be substantially identical where it is fungible with, or economically equivalent to, the washed interest.

However, the distribution washing measures do not apply to an individual that does not receive more than $5,000 in franking credit offset entitlements in a year.

In addition to the distribution washing measures, the Commissioner may also apply the general anti-avoidance provisions under ITAA36 Pt IVA (see ¶1-610) to a distribution washing arrangement. The potential application of franking credit trading scheme provisions in ITAA36 s 177EA of Pt IVA are addressed in *Taxation Determination* TD 2014/10. Despite the exemption from the distribution washing measures, individuals who do not receive more than $5,000 in franking credits in an income year are still potentially subject to the anti-avoidance provisions in ITAA36 s 177EA.

The ATO has issued a bulletin about dividend washing arrangements that are intended to provide imputation benefits to Australian taxpayers (including individuals and superannuation funds) who are not the true economic owners of shares (*Taxpayer Alert* TA 2018/1). The ATO considers that s 177EA could apply to these arrangements

¶1-610 General anti-avoidance provisions: Pt IVA

The general anti-avoidance provisions (ITAA36 Pt IVA) authorise the Commissioner to cancel a tax benefit obtained by a taxpayer in connection with a scheme where it would be concluded that a person who entered into the scheme did so for the sole or dominant purpose of enabling the taxpayer (or the taxpayer and others) to obtain a tax benefit in connection with the scheme. Part IVA has been applied to a variety of schemes, including a scheme to exempt interest from Australian tax by giving the interest a foreign source, and several schemes to split personal exertion income where the income flowed predominantly from personal services rather than from business assets. Virtually any arrangement or course of conduct, whether carried out alone or with others, can be a scheme.

Tax benefit

Part IVA applies where a taxpayer obtains a tax benefit in connection with a scheme. A tax benefit has been obtained in connection with a scheme if as a result of the scheme:

- an amount is not included in the taxpayer's assessable income where the amount would have, or might reasonably be expected to have, been included
- a deduction is allowable to the taxpayer where the deduction would not have, or might reasonably be expected not to have, been allowable
- a taxpayer is not liable to pay withholding tax on an amount where that taxpayer would have, or could reasonably be expected to have, been liable to pay the withholding tax
- a capital loss for CGT purposes is incurred by a taxpayer where the capital loss would not have, or might reasonably be expected not to have, been incurred
- a foreign income tax offset is allowable which would not have, or might reasonably be expected not to have, been allowable
- an amount is not included in a taxpayer's assessable income because of a dividend stripping scheme (a deemed tax benefit)
- a disposition of shares or an interest in shares (ie franking credit trading) and the payment of a franked dividend would, but for Pt IVA, give rise

to a franking credit in the hands of the taxpayer (this is called a ''franking credit benefit'').

The ''would have'' and ''might reasonably be expected to have'' limbs are alternative bases on which a tax benefit can be demonstrated. Where obtaining a tax benefit depends on the ''would have'' limb, that conclusion must be based solely on a postulate that comprises all of the events or circumstances that actually happened or existed other than those forming part of the scheme. Where obtaining a tax benefit depends on the ''might reasonably be expected to have'' limb, that conclusion must be based on a postulate that is a reasonable alternative to the scheme, having particular regard to the substance of the scheme and its effect for the taxpayer, but disregarding any potential tax costs.

Sole or dominant purpose

The application of Pt IVA starts with the consideration of whether, having regard to matters specified in the law, it can be objectively concluded that a person participated in the scheme for the sole or dominant purpose of securing a particular tax benefit in connection with the scheme. That conclusion may be reached even though the particular course of action bears the character of a rational commercial decision or the purpose was that of the taxpayer's professional adviser. For franking credit trading schemes the relevant purpose need not be the sole or dominant purpose. There is no purpose test for dividend stripping schemes.

Mass-marketed tax schemes

Part IVA has been applied by the ATO to mass-marketed tax-effective schemes. In recent years the Commissioner has been taking a tougher stance on tax scheme promoters, more than doubling the number of tax officers involved in its scheme task force and increasing its budget. There has been particular focus in relation to the offshore schemes under the widely publicised Project Wickenby.

¶1-615 Transfer pricing

The transfer pricing provisions provide a legislative framework for dealing with arrangements under which profits are shifted out of Australia, primarily through the mechanism of inter-company and intra-company transfer pricing. Transfer pricing allows an Australian resident to reduce assessable income or increase deductions by, for example, reducing selling prices or inflating purchase prices in non-arm's length dealings.

The transfer pricing provisions are contained in ITAA97 Subdiv 815-B (entities), 815-C (permanent establishments) and 815-D (trusts and partnerships) and align the application of the arm's length principle in Australia's domestic law with international transfer pricing standards.

The transfer pricing rules apply where an entity would otherwise obtain a tax advantage in Australia from cross-border conditions that are inconsistent with the internationally accepted arm's length principle. Where this applies, the rules provide that the entity's Australian tax position is determined as if the arm's length conditions in fact existed. The arm's length principle applies:

- to relevant dealings between both associated and non-associated entities, and
- to attribute an entity's actual income and expenses between its parts.

The purpose of the provisions is that, irrespective of whether the entities are related, the amount brought to tax in Australia from non-arm's length dealings should reflect the economic contribution made by the Australian operations.

The transfer pricing rules are ''self-executing'' in their operation, rather than relying on a determination by the Commissioner. Entities are required to determine the overall tax position that arises from their arrangements with offshore parties on the basis of independent commercial and financial relations or (in the case of the permanent establishment of an entity, on the basis of arm's length profits) occurring between the entities or the parts of the entity.

However, the provisions have a de minimis rule, pursuant to which no penalty is imposed where the scheme shortfall amount is equal to, or less than, the ''reasonably arguable threshold''. The threshold is $10,000 or 1% of income tax payable by the entity for the income year. For trusts and partnerships, the threshold is $20,000 or 2% of the entity's net income for the year.

Where an entity would be liable for an administrative penalty under the transfer pricing rules, it will only be able to obtain a reduction of that penalty on the grounds that it has a reasonably arguable position where the entity keeps records that:

- are prepared before the time by which the entity lodges its tax return for the relevant income year
- are in English, or readily accessible or convertible into English, and
- explain the particular way in which the transfer pricing provision applies (or does not apply), and why the application of the provisions in that way achieves consistency with the relevant OECD guidelines and regulations.

The ATO has developed simplified record keeping options for certain eligible businesses to use to minimise some of their record-keeping and compliance costs associated with the transfer pricing rules.

The ATO has issued various taxation rulings and guidance on the application of the transfer pricing rules including:

- *Taxation Ruling* TR 2014/8 (transfer pricing documentation requirements)
- *Practice Statement* PS LA 2014/2 (administration of transfer pricing penalties)
- *Practice Statement* PS LA 2014/3 (simplifying transfer pricing record-keeping)

- *Draft Practice Statement* PS LA 3673 (guidance for transfer pricing documentation), and
- *Taxation Ruling* TR 2014/6 (application of s 815-130, about the relevance of actual commercial or financial relations to arm's length conditions).

Also see the ATO publication entitled ''Simplifying Transfer Pricing Record Keeping'' on its website at www.ato.gov.au.

Since 1 January 2016, multinational companies with worldwide turnover of $1 billion or more are required to provide country-by-country statements to the Commissioner on an annual basis to assist the Commissioner with carrying out transfer pricing risk assessments.

Further a diverted profits tax will apply to large multinational corporations with global annual revenue of $1 billion or more. The diverted profits tax is applied at the rate of 40% on profits that are artificially diverted from Australia.

RULINGS

¶1-650 Role of rulings

The Commissioner can make private, public and oral rulings, binding on the Commissioner, on the way in which, in his opinion, a particular income tax law or FBT law applies in relation to an arrangement. Rulings are intended to help reduce taxpayers' uncertainty about the application of the law in a self-assessment environment where the Commissioner makes assessments (or, in the case of companies, is deemed to make assessments) without a technical examination of the information contained in a taxpayer's return and is given wide powers to amend assessments in the light of subsequent audits — generally for up to four years after tax became due and payable under the original assessment. For assessments in respect of the 2004/05 and later income years, the period is only two years for most individuals and small business entities (¶1-280). A person can object against an unfavourable private ruling (¶1-665). All private rulings are available on a public database with taxpayer identifiers deleted. Individual taxpayers are able to obtain oral rulings in respect of non-complex non-business matters.

The Commissioner also issues other types of guidance including Law Companion Rulings and Practical Compliance Guidelines.

Types of public rulings and ATO advice

Product rulings

Product rulings are binding public rulings on the availability of claimed tax benefits from investment ''products''. A product refers to an arrangement in which a number of taxpayers individually enter into substantially the same transactions with a common entity or a group of entities. The product may be described as an investment arrangement, a tax-effective arrangement, a financial arrangement or an insurance arrangement.

Product rulings are designed to protect investors, provided the arrangement is carried out in accordance with details provided by the applicant and described in the product ruling. Individual investors do not need to apply for private rulings on the arrangement.

Promoters, or the persons involved as principals in the carrying out of the arrangement, may apply for a product ruling. A written application is required and a draft of the proposed product ruling must also be provided in the specified format.

Class rulings

Class rulings are binding public rulings on the application of tax laws to specified classes of persons (participants) in relation to particular arrangements, such as employee retention bonus schemes, employee share and option plans, bona fide redundancy plans, corporate or industry restructures and scrip-for-scrip roll-overs. Class rulings will not be given in relation to investment schemes or similar products — the promoters of such schemes can apply for a product ruling (see above). As with product rulings, the aim of the class rulings system is to provide certainty to participants and eliminate the need for individual applications for private rulings.

Taxpayer alerts

The ATO issues ''Taxpayer alerts'' as an early warning to taxpayers of significant new and emerging tax planning issues or arrangements that the ATO has under risk assessment. The alerts, which are not public rulings, are available on the ATO website ATO assist.

Law Administration Practice Statements

The ATO issues ''Law Administration Practice Statements'' that provide direction to ATO staff on the approaches to be taken in performing their duties. They are not used to provide interpretative advice and do not convey extra statutory concessions to taxpayers but outline the approach that should be taken.

Law Companion Rulings

Law Companion Rulings (''LCR'') express the Commissioner's view on how recently enacted law applies to taxpayers. They seek to provide insight into the practical implications of new law in ways that may go beyond mere questions of interpretation.

Practical Compliance Guidelines

Practical Compliance Guidelines (''PCG'') provide broad compliance guidance in respect of significant law administration issues. They may include administrative safe harbour approaches which the Commissioner will administer the law in accordance with provided they are followed in good faith.

While a PCG is not generally a public ruling and is not legally binding, they represent guidance material on how the ATO will allocate its compliance resources according to assessments of risk.

Scope of rulings

Rulings can be made on any matter involved in the application of a relevant tax law provision including the administration and collection of taxes. The ATO can provide rulings on ultimate questions of fact, such as the residency status of a taxpayer and whether a business is being carried on.

Private rulings must be applied for, and can apply only to the particular person whose arrangement is the subject of the application, and only in respect of a particular income year, whether the current year or a past or future year. Public rulings are generally initiated by the Commissioner and can apply to classes of persons and in relation to classes of arrangements. Product rulings and class rulings can be applied for.

¶1-660 Rulings binding on Commissioner

A ruling is binding on the Commissioner where a taxpayer has relied on the ruling. The Commissioner may apply a relevant provision of the law as if the taxpayer had not relied on the public ruling, if doing so would produce a more favourable result for the taxpayer.

A ruling is *not* binding on the Commissioner if it has been nullified because of subsequent legislative change that causes the law that was ruled on to not apply to the arrangement. Nor is a ruling binding if it has been properly withdrawn by the Commissioner, or if the arrangement implemented is different from the one ruled upon.

Example

Big Wheels Pty Ltd makes and sells bicycles. It has incurred significant legal costs trying to stop a competitor from using a similar trade name. The company does not know whether these expenses are deductible and so decides to apply to the Commissioner for a private ruling. The Commissioner advises that the expenses would be deductible. Big Wheels Pty Ltd relies on the ruling to claim the deduction. However, when the company is subject to a tax audit three years later, the auditor holds that the expenses were non-deductible.

Big Wheels can rely on the private ruling given by the Commissioner as they have relied upon it to claim the deduction. The deduction is allowed, even if the ruling is shown to be incorrect.

¶1-665 Objection and review of rulings

A person who is dissatisfied with a private ruling can object against it (¶1-710) within a specified period — generally the four years following the due date for lodgment of the person's tax return for the income year to which the ruling relates (see also ¶1-705). This period is reduced to two years for most individuals and for small business entities.

If dissatisfied with the Commissioner's objection decision, the person can seek review of the decision by the Administrative Appeals Tribunal (AAT) or appeal to the Federal Court (¶1-710). A review cannot consider facts other than those identified by the Commissioner as being part of the arrangement that was the subject of the ruling.

There is no right of objection against a public ruling or an oral ruling.

RETURNS, ASSESSMENTS AND REVIEW

¶1-700 Tax returns

A person must lodge a tax return if required to do so by the Commissioner in the relevant Legislative Instrument made annually. The Legislative Instrument also specifies the date by which returns must be lodged. Individuals, partnerships and trusts are generally required to lodge by 31 October following the end of the income year. The Legislative Instrument for 2017/18 was issued on 10 May 2018.

Companies and superannuation funds are expected to lodge their returns for 2017/18 in accordance with the ATO's lodgment program for 2017/18. Details of this program can be found on the ATO website at www.ato.gov.au.

Taxpayers are liable to pay an administrative penalty for late lodgment (¶1-755). Failure to lodge a return is an offence (¶1-760). The Commissioner can grant extensions of time to lodge returns.

¶1-705 Tax assessments

The Commissioner makes an assessment of an individual's taxable income and tax payable on the basis of the information contained in the return without examining the return in detail. This process is known as ''self-assessment''. The Commissioner issues a notice of assessment to the individual requiring payment of any balance of tax payable not collected under the PAYG system (¶1-105). The assessment system for companies is known as ''full self-assessment''. Here, the Commissioner is deemed to have made an assessment of the taxable income and tax payable specified in the company's tax return.

The Commissioner can make a default assessment if a taxpayer fails to lodge a return or the Commissioner is dissatisfied with a return. Taxable income under the default assessment is the amount upon which, in the Commissioner's judgment, income tax ought to be levied.

Amendment of assessments

The Commissioner has the power to amend any assessment by making such alterations or additions as he/she thinks necessary, even though tax has been paid. Where there has been avoidance of tax due to fraud or evasion, the amendment can be made at any time. Otherwise, the amendment must generally be made within four years from the date on which tax became due and payable under the assessment. This period is reduced to two years for most individuals and for small business entities.

¶1-710 Review of assessments and other decisions

Objection

A taxpayer who is dissatisfied with an assessment can object to the Commissioner against it and, if not satisfied with the Commissioner's decision on the objection, either apply to the AAT for review of the decision or appeal to the Federal Court against the decision. The procedures for exercising these rights are contained in general provisions in the *Taxation Administration Act 1953* which apply not only in relation to income tax assessments but also in many other situations where a person is specifically given the right to object against a decision or determination of the Commissioner. The procedures apply, for example, where:

- a person is dissatisfied with a determination on a taxpayer's claim for foreign income tax offsets
- a superannuation fund member is dissatisfied with certain features of an assessment of superannuation contributions surcharge
- a person is dissatisfied with a private ruling.

A person's objection against an assessment must set out the grounds on which the person relies but the objection can generally only challenge the Commissioner's application of the substantive law and not the process by which the assessment was made.

Objection against ''self-assessment''

An objection can be lodged against an assessment even though the assessment was made under the ''self-assessment'' system solely in reliance on the information contained in the taxpayer's return, including, in the case of a company, an assessment that was deemed to have been made on that basis. This can happen where the taxpayer, wishing to avoid the risk of administrative penalty, files the return on the basis of the Commissioner's view of the law as expressed in a ruling but then seeks to challenge that view.

Review of objection decision by AAT or Federal Court

A taxpayer who is dissatisfied with the Commissioner's objection decision may apply to the AAT for a review of the decision or appeal to the Federal Court. In either case, the taxpayer has the burden of proving that the assessment is excessive and is generally limited to the grounds stated in the objection. Costs associated with a review or appeal are generally deductible.

AAT hearings are generally held in private and the reasons for the decision do not reveal the taxpayer's identity. AAT proceedings are generally less formal than a court. The AAT need not apply the laws of evidence, may exercise all of the Commissioner's powers and discretions, and may confirm, vary or set aside the Commissioner's objection decision. An appeal to the Federal Court against an objection decision is heard by a single judge. The court cannot interfere with the exercise of a discretion by the Commissioner unless the discretion was not exercised in accordance with law. The court may make such order in relation to an objection decision as it thinks fit, including an order confirming or varying the decision.

The Commissioner or the taxpayer can appeal to the Federal Court from a decision of the AAT on a question of law. The Federal Court can make such order as it thinks fit. It could, for example, remit the matter to the AAT to be heard again. The Commissioner or the taxpayer can appeal to the Full Federal Court from a decision of a single judge, whether the decision is on an appeal against an objection decision or on an appeal against an AAT decision. An appeal can be made from an order of the Full Federal Court to the High Court, but only with the special leave of the High Court.

The Commissioner must give effect to the decision of the AAT or the order of the Federal Court when that decision or order is final, generally by amending the assessment. A decision or order is final once the time for any further appeal has expired.

Judicial review of Commissioner's decisions

If the law does not specifically give a person the right to object against a decision of the Commissioner, the further rights of review by the AAT and appeal to the Federal Court just discussed are not available. Some of these decisions may be reviewable by the Federal Magistrates Court or the Federal Court under the *Administrative Decisions (Judicial Review) Act 1977*. A breach of natural justice, an improper exercise of power or an error of law, for example, would be grounds for review of a decision. Examples of decisions that could be open to this form of administrative review are a refusal to grant a remission of GIC or an extension of time to pay tax and a refusal to vary PAYG withholding amounts.

PENALTIES

¶1-750 Scheme of income tax penalties

Three kinds of penalty may be imposed for failure to comply with the requirements of the income tax law and for other specified behaviour related to the operation of the income tax law:

- the general interest charge (GIC) or the shortfall interest charge (SIC)
- administrative penalties imposed by the income tax law
- a fine or a term of imprisonment imposed by a court in respect of an offence.

If a particular act or omission of a person attracts both a liability for administrative penalty and the institution of a prosecution for an offence, the administrative penalty is not payable.

General interest charge (GIC)

The GIC is payable if an amount owing to the Commissioner is not paid on time, and in certain other circumstances. Examples are:

- late payment of tax due on assessment or amendment

- late payment of a PAYG instalment (¶1-105).

The GIC is calculated daily on a compounding basis. The rate is adjusted quarterly. The GIC is deductible.

Shortfall interest charge (SIC)

For assessments relating to the 2004/05 and later years, the shortfall interest charge applies instead of the GIC to the period from which the shortfall arose to the date the tax is due and payable. After that date the GIC applies to both the tax shortfall and any SIC accumulated to that point. The SIC is four percentage points lower than the general interest charge. The SIC is deductible.

¶1-755 Administrative penalties

Administrative penalty is imposed where:

- a taxpayer fails to lodge a return or other document by the due date (late lodgment penalty) — the penalty is one to 25 penalty units, depending on how late the document is and, broadly, the size of the taxpayer's business (the value of a penalty unit since 1 July 2017 is $210). Where the document is necessary for the Commissioner to determine the taxpayer's tax liability accurately and the Commissioner determines that liability without the assistance of the document, the taxpayer is also liable to a further administrative penalty of 75% of the liability. This behaviour also constitutes an offence

- a taxpayer fails to keep or retain records as required, fails to retain or produce a declaration about an agent's authority to lodge a tax return or fails to give reasonable facilities to a taxation officer exercising access powers — the penalty in each case is 20 penalty units. The behaviour also constitutes an offence

- a taxpayer has a ''shortfall amount'' (an understatement of tax liability) caused by specified behaviour, such as failing to take reasonable care (for details of the behaviours and the penalty, see the table below). Some shortfall behaviour could also constitute the offence of making a false or misleading statement or omitting something which makes the statement misleading, eg where statements giving rise to a shortfall exhibited intentional disregard of the law or deliberate evasion (see the table below). SIC and GIC will also be payable on the shortfall in tax if it is not paid on time

- the Commissioner has applied an anti-avoidance provision, eg if Pt IVA is applied the penalty is 50% of the resulting increase in tax payable (25% if the taxpayer's position is reasonably arguable).

"Shortfall amount" administrative penalties

Culpable behaviour	Penalty (% of shortfall)
Intentional disregard of the law (deliberate evasion)	75
Recklessness about correct operation of the law	50
Failure to take reasonable care to comply with the law	25
Treatment of law in statement not reasonably arguable	25

Administrative penalties for shortfalls and for tax avoidance provisions applying can be increased in certain circumstances, eg if the taxpayer takes steps to prevent the Commissioner from discovering the shortfall or the applicability of the tax avoidance provision or was liable to pay the same penalty in an earlier accounting period. Conversely, administrative penalty can be reduced if the taxpayer voluntarily tells the Commissioner about the matter. The Commissioner has the discretion to remit administrative penalty.

¶1-760 Offences against the taxation laws

A person is guilty of an offence for failing in specified ways to comply with the requirements of the taxation laws and for various other specified forms of behaviour related to the operation of the taxation laws, such as:

- making a false or misleading statement
- falsifying records with intent to deceive
- structuring investments to ensure that TFN withholding tax is not payable on investments where the person has not quoted a TFN.

Some offences, if committed by a natural person, are punishable by a fine and/or imprisonment. Others are punishable only by a fine. The penalties are substantial and are higher for second and subsequent offences, ranging from a fine of 20 penalty units for certain first offences to a fine equal to 100 penalty units and/or two years' imprisonment for certain second and subsequent offences by an individual (fine of 500 penalty units if committed by a company). In addition, a convicted person may be ordered by the court to pay up to twice or three times the tax sought to be avoided. A penalty unit equates to $210.

Fines of up to 120 penalty units and/or two years imprisonment (or 600 penalty units if committed by a company) can be imposed for obstructing ATO officers.

Prosecution prevails over penalty tax

If particular behaviour attracts both a liability for an administrative penalty and the institution of a prosecution for an offence, the administrative penalty is not payable. An example is where a person fails to lodge an income tax return.

Example

Richard has deliberately not included some income in his return. After an ATO audit, he was found to have not included $50,000 for two consecutive years. Administrative penalty is imposed for the first year at the rate of 75% of the tax avoided. Richard will also be liable to pay GIC in relation to the underpaid tax.

In relation to the second year, the Commissioner decided to prosecute Richard for recklessly making false and misleading statements. Administrative penalty in respect of the shortfall is therefore not payable for the second year. But note that, if convicted, Richard could be ordered by the court (for a first offence) to pay up to double the amount of tax sought to be avoided.

Company officers

An officer of a company, such as a director or secretary, is liable to be prosecuted for a taxation offence committed by the company as if the person had committed the offence, although the Commissioner will usually institute prosecution action against the company rather than the officer.