Introduction and Income Tax Basics

Key Equation

- Assessable Income – Deductions = Taxable Income: s 4-15(1)
- \([\text{Taxable income} \times \text{Income Tax Rate}] – \text{Tax offsets} – \text{Credits} = \text{Income Tax Payable/Refundable}\)

Individual resident income tax rates for 2016-17: *Income Tax Rates Act 1986*

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>Tax on this income</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1 - $18,200</td>
<td>Nil</td>
</tr>
<tr>
<td>$18,201 - $37,000</td>
<td>19 cents for each $1 over $18,200</td>
</tr>
<tr>
<td>$37,001 - $87,000</td>
<td>$3,572 plus 32.5 cents for each dollar over $37,000</td>
</tr>
<tr>
<td>$87,001 - $180,000</td>
<td>$19,822 plus 37 cents for each dollar over $87,000</td>
</tr>
<tr>
<td>$180,001 and over</td>
<td>$54,232 plus 45* cents for each dollar over $180,000</td>
</tr>
</tbody>
</table>

**As part of the 2014-15 federal budget the government announced that it will impose a temporary Budget Repair levy of 2% on that part of a person’s taxable income which Exceeds $180,000. The levy will apply from 1 July 2014 and apply to the 2014/15, 2015/16 and 2016/17 financial years. With the Medicare levy (2%) included, the top marginal rate is 49% from 1 July 2014 to 30 June 2017**

Key Tax Offsets

- A tax offset (sometimes known as a rebate) is an amount that reduces income tax payable:
  - Low Income Rebate
  - Seniors and Pensioner Tax Offset
  - Beneficiary Rebate
  - Medical Expenses Tax Offset (being phased out)
  - Private Health Insurance Offset
  - Zone and Overseas Forces Rebate
  - Mature Age Worker Tax Offset
  - Dividend Franking Tax Offset
  - Primary Producer Averaging Tax Offset
  - Research and Development Tax Offsets

Credits

- Tax credits reduce the income tax payable
Medicare Levy

- 2% of taxable income subject to low income thresholds

Medicare Levy Surcharge

- An additional Medicare Levy only applies for taxable income bands as follows

<table>
<thead>
<tr>
<th>Taxable Income Band</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singles 90,001–105,000</td>
<td>1%</td>
</tr>
<tr>
<td>Singles 105,001–140,000</td>
<td>1.25%</td>
</tr>
<tr>
<td>Singles &gt;140,000</td>
<td>1.5%</td>
</tr>
<tr>
<td>Families 180,001–210,000</td>
<td>1%</td>
</tr>
<tr>
<td>Families 210,001–280,000</td>
<td>1.25%</td>
</tr>
<tr>
<td>Families &gt;280,000</td>
<td>1.5%</td>
</tr>
</tbody>
</table>

Company Income Tax Rate

- 30%

Complying Superannuation Fund Income Tax Rate

- 15%

Assessable Income Steps

1. Do international tax issues apply to the receipt?
2. What tax accounting rules apply?
3. Is the receipt ordinary income?
4. Is the receipt statutory income (excluding capital gains tax)?
5. Is the receipt non-assessable income?
6. Do the CGT provisions apply?
7. Do the entity rules apply?
8. Determine whether the receipt is assessable income.

Deduction Steps

- What tax accounting rules apply?
- Is the outgoing a general deduction?
- Is the outgoing a specific deduction (excluding capital allowances)?
- Do any of the deduction limitations apply?
- Is the outgoing a capital allowance?
- Do the entity rules apply?
- Determine whether the expense is deductible.
Tax Accounting

Tax Period

The tax year generally commences on 1 July of a year and ends on 30 June of the following year. Under ITAA 1936 s 18 a taxpayer can apply to the Commissioner to have a substituted accounting period. This will be accepted where the 30 June tax year is clearly inappropriate or impractical for the taxpayer: see Practice Statement Law Administration PSLA 2007/21. For most taxpayers, the tax year ends on 30 June of each year.

2017 income year – that started on the 1 July 2016 and ended on 30 June 2017

Cash Receipts Basis

- Income is included in AI in the year that it is received.
- Sole practitioners (lawyers, architects, doctors), employees.

Accruals Basis

- Income is included in AI in the year that the taxpayer becomes entitled to the income.
- Large professional firms & businesses with employees.
- Complex structure of business with significant business operations.
- Large turnover & offer credit.

Which Method?

- Income from business: Sole traders and entity structure such as partnerships, trust and companies running businesses will generally utilize accruals.
  - In *J Rowe & Son Pty Ltd v FCT*, Menzies J noted that accruals accounting principles should apply to the income tax accounting of business income.
  - To be earned and therefore derived, a recoverable debt must be created such that a taxpayer is not required to take further steps before becoming entitled to payment: see *FCT v Australian Gas Light Co*.
- Income from professional practices: a small sole practitioner practice should use the cash basis: *Carden*.

Timing of Income

- ITAA 1997 s 6-5(2) and (3) require that you include your ordinary income derived directly or indirectly during the income year.
- A large professional practice should use the accruals basis: *Henderson*.
- *Salary and wages* are derived when received: *Brent*
• **Interest** is generally derived when received or credited: *Leigh*
• **Rent** is generally derived when it is received.
• **Prepaid income:** it is possible to defer assessable income if the income is subject to a contingency and treated as a liability in the books: *Arthur Murray.*

**Deemed Derivation**

• For both ordinary and statutory income, you are deemed to have derived the income as soon as it is applied or dealt with in any way on your behalf or as you direct: see ITAA 1997 ss 6-5(4) – ordinary income and 6-10(3) – statutory income.

**Timing of Deductions**

• The timing of deductions is generally governed by when an expense is incurred under ITAA 1997 s 8-1.

1. **Where a taxpayer makes payment for an outgoing during the income year**
   - A debt is incurred where the taxpayer is definitively committed or is completely subject to the debt: *James Flood Pty Ltd*

2. **Where a taxpayer has not made payment for an outgoing during the income year**
   - A debt is incurred where the taxpayer is definitively committed or is completely subjected itself to the liability: *James Flood Pty Ltd*
   - A debt is generally incurred when a taxpayer owes a debt for which the taxpayer has a presently existing pecuniary liability: *New Zealand Flax Investments; Nilsen Development Laboratories; James Flood*
   - A liability to pay that is contingent, pending, threatened or expected for an outlay that is certain in a future income year will not be incurred: *Nilsen Development Laboratories*

3. **Payment can be estimated:** For certain taxpayers (for example, insurance companies) an outgoing that is a pecuniary liability in the year of income, and that is able to be reasonably estimated, is incurred. (*RACV, Commercial Union*)

4. **Prepaid expenses**

   Generally prepaid expenses are deductible when incurred: *Brand* (but deduction limitations apply in ITAA 1936 ss 82KL, 82KZO).

   Different regimes restrict deductions for prepaid expenses. These regimes apply to small business and non-business taxpayers, large and medium business, and for tax shelter prepayments under ITAA 1936 ss 82KL–82KZO.

   The time of the pre-paid expense or the time when the benefit was received? – it would be incurred at the time when the paid the nature or if it was at point too soon.
Prepaid expense rules - Prepayment regime for SBE taxpayers

- Prepayments are immediately deductible for SBE taxpayers where the eligible service period (the period of the benefit) of the prepayment was 12 months or less and where the prepayment is otherwise deductible under ITAA 1997 s 8-1 or ITAA 1936 ss 73B, 73BA, 73BH or 73Y.
- Where the prepayments did not meet this requirement, s 82KZM applies to pro rata deductions over the lesser of eligible service period or 10 years.
- Exceptions:
  - expenses of less than $1000 (then it is just in the year incurred)
  - expenses required to be incurred by law, or by an order of a court
  - expenses of salary or wages made under a contract of service.

Tax in Real Life

- RED Pty Ltd is an SBE. On 30 June it prepays $100,000 to Alf for 12 months worth of rent. Since the prepayment period is 12 months or less the amount is fully deductible: ITAA 1936 s 82KZM(1).

Individuals with non-business prepayments:

They obtain an immediate deduction for prepayments where the eligible service period of the prepayment is 12 months or less and the eligible service period ended no later than the last day of the following income period after the prepayment was incurred.

Otherwise, the prepayment is deducted proportionally over each income year containing all or part of the prepayment’s eligible service period, up to a maximum of 10 years.

For non-SBE non-individuals (companies and trusts) that are not carrying on a business:

The prepayment is deducted proportionally over the eligible service period up to a maximum of 10 years.

5. Expenses referable to future years
   - The general principle is that expenses are deductible when they are incurred, although the exception in Coles Myer Finance applies to certain discounts incurred with bills of exchange.
6. **Expenses referable to an earlier year**
   - Expenses referable to earlier years of income may be deductible, depending upon the degree of connection: *Amalgamated Zinc, Peyton, Queensland Meat, ACG Advances, Placer Pacific*

**Trading Stock: ITAA 1997 Div 70**
- ‘Trading stock’ is defined as anything produced, manufactured or acquired that is held for purposes of manufacture, sale, or exchange in the ordinary course of a business; and livestock. Trading stock does not include:
  - Div 230 financial arrangements; or
  - Certain CGT assets covered by s 275-105; or
  - Registered emissions units.
- Trading stock is on hand when the taxpayer has power to deal with the stock as if it were his or her own: *FCT v Sutton Motors.*

**Accounting for Trading Stock: Subdiv 70-C**
- The excess of closing stock over opening stock is included in assessable income.
- The excess of opening stock over closing stock is deductible.

**Value of Opening Stock**
- You must use the same value of opening stock as that used at the end of the previous income year.

**Value of Closing Stock**
- You can elect to value each item of trading stock at the end of the income year at (s 70-45):
  - Cost; or
  - Marketing selling value; or
  - Replacement
- If stock is obsolete then you can use a reasonable value.

**Assessable Income from Trading Stock: Subdiv 70-D**
- Disposals outside the ordinary course of business: s 70-90
- Disposal when you stop holding trading stock: s 70-100
- Death of owner: s 70-105
- You stop holding trading stock but still own it: s 70-110
• Compensation for lost trading stock: s 70-115

Trading Stock Exemption — SBE

• Where the difference between the value of the trading stock on hand at the start of an income year and the reasonably estimate value at the end of the year is less than $5,000.

What is an SBE? Div 328

• SBEs may apply for the various small business concessions. The concessions are not compulsory and therefore not automatically available without application.
• An entity is an SBE if it:
  o Carries on a business; and
  o Satisfied the $2 million aggregated turnover test.
International Tax

Key Legislation

- ITAA 1936 s 6(1)
- ITAA 1997 Div 6

Key Concepts

- Residence and source
- Residence and source are important to determine assessable income per Div 6.

Definition

**Australian resident** means a person who is a resident of Australia for the purposes of the *Income Tax Assessment Act 1936: s995-1(1)*.

**Foreign resident** means a person who is not a resident of Australia for the purposes of the *Income Tax Assessment Act 1936: s995-1(1)*.

**Person** includes a company: *s995-1(1).*

Residence — Individuals

- Apply the four alternative tests in *ITAA 1936 s 6 (1)* (if any one test is satisfied then an individual is a resident) as follows:

1. **Resides — ordinary principles**
   - Physical presence: *Applegate, Miller, Pechey.*
     - Generally, physical presence is the most important factor. Note exceptions *Rogers and Slater*
   - Family employment or business ties: *Levene* — maintenance of a place of abode.
   - Frequency, regularity and duration of visits.
   - Habits and mode of life — *Lysaght*
   - Nationality

**Commissioner considers 2 elements:**

- the person’s *behaviour* while in Australia; and
- *physical presence* (6 months is a considerable time)
Behaviour factors:

• intention and purpose of presence
• family and business/employment ties
• maintenance and location of assets; and
• social and living arrangements

If any of these is satisfied, then the individual is a resident.

2. Domicile test (two requirements)
   - Must have Australian domicile
     - Domicile of origin: the domicile of the person’s father at the date of the person’s birth. A person retains their domicile of origin until they acquire a domicile of choice: *Bell v Kennedy*
     - Domicile of choice: The intention that a person must have in order to acquire a domicile of choice in a country is the intention to make his or her home indefinitely in that country: *Domicile Act 1982 s 10.*
   - Exception: permanent place of abode overseas (determined by whether the taxpayer is leaving Australia indefinitely or only for a fixed period).
     - The court has viewed that a place of abode is where a man lives with his family and sleeps at night: *Hammond*
     - Courts consider the following factors:
       - intention as to length of stay
       - actual length of stay
       - abandonment of place of abode in Australia
       - acquisition of place of abode outside Australia
       - Other factors, nature of abode, duration and continuity at abode, association with abode and community with bank account, employment etc
     - The leading case in this area is *Applegate*.
     - *Taxation Ruling IT 2650*

3. 183-day rule (three requirements)
   - Must be physically present in Australia for more than one half a year of income; AND
   - Usual place of abode must not be outside of Australia (same as the resides test); AND
   - Intends to take up residence in Australia.

If all three requirements are satisfied, then the individual is a resident.
4. Superannuation test
   o A person is a resident if he or she is a member of the superannuation scheme for Commonwealth Public Servants. This includes his or her spouse and children: Section 6(1)(a).

Residence — Companies
   • Apply the three alternative tests in ITAA 1936 s 6(1) (if any one test is satisfied then then a company is a resident) as follows:
     1. Incorporated in Australia; or
     2. Carries on business in Australia and central management and control in Australia; or
        • ‘Carry on business’ does not refer to the day-to-day operations but to where the ‘brains’ of the business are located. If the central management and control is in Australia then the business will definitely be a resident: see Malayan Shipping Co Ltd v FCT (1946) 8 ATD 75.
        • Central management and control refers to:
           o Where the directors meet to do business (Koitaki Para Rubber Estates Ltd v FCT (1941) CLR 15) is generally the most important factor
           o Where the real business activities are undertaken (North Australian Pastoral Co Ltd v FCT (1946) 71 CLR 623)
           o Place of incorporation and location of registered office (Esquire Nominees v FCT 72 ATC 4076)
           o Residence of parent company (Unit Construction Co Ltd v Bullock (1959) 38 TC 712)
     3. Carries on business (day-to-day business) in Australia and voting power controlled by shareholders resident in Australia.

Resident — Trust
   • Apply the preceding resident tests (on individuals or companies as appropriate) to the trustee to determine this. Only one trustee need be a resident for the trust to be a resident.

Residence — Partnerships
   • It is the residence of the partners themselves that is important.