Chapter 1

Understanding the Australian Tax System

In This Chapter

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

If you find tax a — excuse the pun — taxing subject, you're not alone. Most people are confused by taxes and, of course, would rather not pay them. However, we all know the cliché: Death and taxes are the only sure things in life. So, put another way, you probably need to take some time to understand taxation.

This chapter goes over some basic info that you need to understand in order to lodge your tax return in Australia. I explain the basics of the Australian tax system, tell you how to work out sources of income, and examine what tax you need to pay if you're setting up as a company.

Explaining the Australian Tax System

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

Taxing matters: How it all began

In 1915, the Fisher Government introduced an Act to impose a tax on income from personal exertion, income from property and company profits. The major reason given was to help fund Australia’s involvement in the Great War. However, after you let such a genie out of the bottle, stopping a politician from continually dipping a hand in your wallet or purse is nigh impossible. The federal government has since introduced three additional taxes — capital gains tax (CGT, introduced in 1985), fringe benefits tax (FBT, 1986) and the goods and services tax (GST, 2000). When you come to think about it, the federal government has just about covered every conceivable way you can be taxed. The only thing it hasn’t done is tax the air you breathe. But, wait on, hold your breath . . . I’m quite sure some diligent bureaucrat in Canberra is currently examining this possibility!

Understanding Your Income Tax Rates

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

The federal government has also set a Temporary Budget Repair levy on high income earners, to help reduce the federal budget deficit. For the 2015–16 tax year you’re levied 2 per cent of your taxable income if you earn more than $180,000 per annum. This levy is to apply up to 30 June 2017 and effectively increases the top marginal tax rate from 45 per cent to 47 per cent (see Chapter 5).

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

TECHNICAL STUFF

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

TIP

If you want to quickly know your tax obligations in a nutshell visit the Tax Office website (www.ato.gov.au) and check out 'Tax in Australia — what you need to know'.

Federal taxes

The most important federal taxes include the following:

- *Capital gains tax* (CGT) is paid on gains you make when you sell assets you own and on the occurrence of certain CGT events. Your main residence is exempt from tax and some other concessions may potentially be available (see Chapters 11 and 17 for more).
- *Customs duty* is paid on certain goods you import into Australia (for example, cameras, perfume, alcohol and cigarettes).
- *Excise duty* is levied on certain goods manufactured in Australia, such as alcohol and tobacco.
- *Fringe benefits tax* (FBT) applies to certain benefits you may receive (for example, your employer provides you with a car for private use). See Chapter 16.
- *Fuel tax* is levied on petrol.
- *Goods and services tax* (GST) is applied to most purchases and sales. See Chapter 15.
- *Income tax* is paid on income you derive from worldwide sources. See Chapters 5 to 7.
- *Withholding tax* is paid on certain income derived by a non-resident (see Appendix A).
- The *Medicare levy* is used to help fund the Australian health system and disability care insurance scheme 'DisabilityCare Australia'. The rate is 2 per cent of your taxable income.

In the 2014–15 tax year, if you earned below $20,896 as an individual or $35,261 as a couple/family, you were exempt from paying the Medicare levy. ***Note*:** For each dependent child, the family threshold increases by $3,238. Rates for the 2015–16 tax year are not available at the time of writing so check the Tax Office website (www.ato.gov.au) for this information.

If you don't have private health insurance, you may be liable to pay a Medicare levy surcharge if you earn more than a certain amount. For the 2015–16 tax year, the levy is 1.0 per cent if your taxable income is above $90,000 for individuals or $180,000 for couples/families. The Medicare levy surcharge increases (in stages) to 1.5 per cent if you're an individual earning more than $140,000, or couples/families earning more than $280,000. ***Note:*** The family threshold for the Medicare levy surcharge increases by $1,500 for each dependent child after the first child.

If you have private health insurance, you can claim a 27.82 per cent rebate if you're under 65 years of age, a 32.46 per cent rebate if you're between 65 and 69 years of age, and a 37.09 per cent rebate if you're 70 years or over. The private health insurance rebate is income tested and reduces in stages if you're an individual earning more than $90,000 or a couple/family earning more than $180,000. Individuals miss out completely if they earn more than $140,000, and couples/families miss out if they earn more than $280,000. For more details see the Department of Health website (`www.health.gov.au`).

State and local taxes

Following are some of the taxes levied by states:

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

In a local context, *property valuation* and *rates* charges fund local government services (such as rubbish collection).

Taxing Major Income Streams

Income is normally derived from three major sources:

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

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

Taxing your treasures: CGT assets

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

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

Bringing home the money: International sources of income

As an Australian resident, you're required to disclose income you earn from worldwide sources and non-residents are required to disclose income that only has an Australian source. Unfortunately, the tax Acts don't provide a statutory definition of *source*. So it basically boils down to a 'practical hard matter of fact'. Generally, three key tests are used to determine the origin or 'source' of income:

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

Ordinarily, your source of income is where you perform the services. For example, if you earn salary and wages, the source of income is the place where you perform the work, while the source of business profits is where you carry on the business activities.

Checking your residency status

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

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

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

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

As a general rule, if you're out of the country for more than two years and you sever your economic and social ties with Australia (for example, you quit your job and your family goes with you), you're most likely going to be treated as a non-resident for income tax purposes (refer to the Taxation Ruling 'IT 2650 Income tax: residency — permanent place of abode outside Australia' at `www.ato.gov.au`). Of course, after you leave Australia, you can still change your mind and come back in the future. On the other hand, if you migrate to Australia, you're generally considered a local for tax purposes from the date of your arrival, which means you're taxed as a resident from day one, and you gain all the tax concessions available to residents.

If you become a resident of Australia part way during the financial year, you can't claim the full *tax-free threshold.* (The tax-free threshold is the maximum amount of income you can receive that isn't taxed — see Chapter 5.) You need to pro rata the amount. You can claim one-twelfth of the amount for each month you're in Australia including the month you arrive. For example, if you arrive in Australia on 13 October 2015, at the time of writing your tax-free threshold is $13,650 ($18,200 ÷ 12 × 9 months).

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

If you're a resident of Australia deriving foreign employment income such as salary and wages, you need to include the amount you earn overseas in your Australian tax return and pay tax here. If you pay foreign tax while working overseas, you can claim a foreign income tax offset in respect of the foreign tax that you pay. However, this rule harbours an exception. Foreign employment income derived by charity workers, certain government employees (for instance, the military and police) and people working on approved projects of national importance is exempt from tax in Australia. This exemption applies on the proviso that you work overseas for more than 90 days and you're liable to pay foreign tax on the income you earn. If you don't pay tax on income you earn overseas, the bad news is you have to include it in your Australian tax return and pay tax here. Unfortunately, you can't win all the time! (***Note*****:** The federal government has advised that from 1 July 2016 government employees (other than the military and police) will be ineligible to claim this exemption.)

If you want more info about foreign employment income visit the Tax Office website (`www.ato.gov.au`) and check out Tax Determination 'TD 2012/8' and Tax Office publications 'Exempt foreign employment income' and 'Foreign income while working on an approved overseas project (NAT 11543)'.

If you earn foreign income such as dividends, interest and royalties, and withholding tax is deducted from the payment, you need to include both the foreign income and withholding tax as part of your assessable income, and you can ordinarily claim a foreign tax credit for the foreign tax you pay. You need documentary evidence to substantiate your claim for a foreign tax credit (for example, notice of assessment and receipt of payment). For more details visit the Tax Office website (`www.ato.gov.au`) and check out the fact sheet 'Foreign income of Australian residents — what you need to know'.

The Tax Office has issued Taxpayer Alert 'TA 2012/1 Non disclosure of foreign source income by Australian tax residents' warning Australian resident taxpayers of their obligations to disclose their worldwide income. You can get a copy from the Tax Office website (`www.ato.gov.au`).

Taxing a Company

A *company* is a separate legal entity. It must apply for a tax file number (see Chapter 13) and lodge a company tax return at the end of the financial year, disclosing the taxable income it earns (see Chapter 3). A company is liable to pay a 30 per cent flat rate of tax on taxable income it earns (derives); this reduces to 28.5 per cent if you run a small business and your company's annual turnover (sales) is less than $2 million. The good news is that a company isn't liable to pay a 2 per cent Medicare levy.

A company can also be a resident or non-resident of Australia. Under Australian income tax law, a company is a resident of Australia if it incorporates in Australia. If this scenario isn't the case, a company can still be a resident for tax purposes if

- It runs a business in Australia.
- Its central management and control is in Australia.
- Its voting power is controlled by shareholders who are residents of Australia.

A company's central management and control is usually where the company directors ordinarily meet to manage and run the company's ongoing business operations. In Chapter 12, I guide you through choosing a company structure. Chapters 13 to 17 go into the tax issues that arise when running a small business, covering GST, FBT and CGT.