

# Understanding tax

Version 5.1



This document provides some additional information to help you understand the financial planning concepts discussed in the SOA in relation to **tax**.

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This document contains general information about the benefits, costs and risks associated with certain product classes and strategies.

It is designed for use in conjunction with a Statement of Advice that takes into account the circumstances and objectives of an individual. Before making a commitment to purchase or sell a financial product, you should ensure that you have obtained an individual Statement of Advice.

As legislation may change, you should ensure you have the most recent version of this document.

This information is not intended to be a substitute for specialised taxation advice or an assessment of any liabilities, obligations or claim entitlements that may arise under taxation law and we recommend you consult with a registered tax agent. Any tax estimates provided by us are intended as a guide only and are based on our general understanding of taxation laws.

## HOW TO READ THIS DOCUMENT

Managing your finances to meet your day to day requirements as well as your long-term goals can be a complex task. There are all sorts of issues you need to consider such as taxation, legislation, protecting your wealth and assets, associated costs and the inherent risks of investment. When undertaking a financial plan it is important you understand how these issues will impact you and what you should expect over time.

Your financial adviser will provide you with a Statement of Advice (SOA) which sets out the details of the advice and how it will meet your goals and objectives.

This document provides some additional information to help you understand the financial planning concepts discussed in the SOA in relation to **tax**.

It is very important you read this document to help you understand the benefits of the strategies recommended to you and the associated costs and risks.

This is general information only and you should not rely on it to determine your personal tax obligations. Seek advice from a registered tax agent as GWM Adviser Services Limited is not a registered tax agent.

Please contact your adviser if you do not understand anything, or need further information or clarification.

## Tax

The main tax you'll pay is income tax which is calculated on income you receive such as salary and wages, investment income and business income. Generally, you pay income tax during the year as you earn it. For example, if you're an employee your employer will deduct it from your wages and pay it to the Australian Tax Office (ATO). This is called Pay As You Go (PAYG) Withholding.

If you earn income that has not had tax withheld by the payer – for example, if you're paid as a contractor or you receive rent or interest income – you may need to make payments during the year to the ATO. These payments are called PAYG instalments.

### How much income tax will you pay?

The amount of income tax and the tax rate you pay depends on how much you earn and whether you're an Australian resident for tax purposes. The more you earn, the higher your rate of tax. If you're an Australian tax resident, some of the income you earn is tax-free. If you're a non-resident for tax purposes, generally only your Australian sourced income will be subject to Australian tax.

You should seek tax advice from a registered tax agent to confirm how much tax you need to pay.

### Income you must declare

You pay income tax on assessable income you receive such as salary and wages, certain Centrelink payments, investment income from rent, bank interest or dividends and capital gains from selling assets such as shares or property.

## Deductions and offsets you can claim

You can reduce the amount of tax you pay with deductions such as some work-related expenses, donations, rental property expenses and interest on loans used to purchase income producing investments. You may also be eligible for tax offsets that reduce the amount of tax you pay. You claim deductions and offsets when you complete your annual income tax return.

### Tax effective investments

An investment is 'tax-effective' if you pay less tax than you would on another investment with the same return and risk. While lower tax can help your savings grow faster, you should not invest based on tax benefits alone. A worthwhile strategy needs to be a sound investment first. Any tax benefit should be secondary. You should also be aware severe penalties can apply under taxation law where the dominant purpose for entering into an arrangement is to obtain a tax benefit.

A good way to understand how tax affects you is to know what 'marginal tax bracket' you're in for your ordinary income. This means if you earn an extra dollar, you'll know how much extra tax you'll pay.

If you can invest in a way that means you pay less tax on your investment returns than your marginal tax rate, then you're ahead. For example, superannuation is generally considered to be tax-effective as the tax rate is 15% on investment earnings. This is generally lower than most individuals' marginal tax rates.



## Shares and property

Income you receive from investing in shares and property – dividends or rent – will generally be taxed at your marginal tax rate.

'Franked' dividends are dividends paid by an Australian company out of profits it has already paid tax on. You'll generally be entitled to a credit for the 30% company tax already paid if the dividend is 'fully franked'. This credit is called an 'imputation credit' or 'franking credit'. This means a \$7 franked dividend is effectively worth the same as a \$10 unfranked dividend. As you pay comparatively less tax on a franked dividend than with an unfranked dividend, shares that pay fully franked dividends can be 'tax effective' investments.

A capital gain may arise from the disposal of your investment. A capital gain is the profit you make when you dispose an investment for more than what you paid for it and will form part of your assessable income. Please see the 'Managing gains and losses' section for details. You should be aware you don't need to sell the asset to realise a capital gain. If you transfer your asset or simply give up a right to something, you may be considered to have disposed of an asset and therefore may have to pay capital gains tax (CGT).

## Managing gains and losses

When you make a profit from selling your investments, you may have to pay CGT.

A capital gain is added to your assessable income in the year you sell the investment and taxed at your marginal rate. If you hold the investment for more than one year you're only taxed on half the capital gain (this is called the CGT discount). So if your marginal tax rate is 37%, your capital gains are effectively only taxed at 18.5% (not including Medicare levy). Special rules apply to non-residents which may result in no/limited CGT discount being applied.

For superannuation funds, if an investment is held for more than one year the fund receives a reduction of 33.3% of the nominal gain, instead of the 50% reduction received by individuals.

Keep a record of any losses you make as they may be used to offset capital gains. Capital losses that aren't used against gains in the current year can be carried forward for use in later years.

## Superannuation

The government gives incentives through the tax system to encourage people to save for retirement including:

- investment earnings being taxed at a maximum of 15% (10% for capital gains if the assets were held by the fund for more than one year)
- superannuation contributions made by salary sacrifice (up to the contribution caps) to reduce your income tax
- claiming tax deductions for superannuation contributions (up to certain limits)
- paying no tax on the money they take out of super for people aged 60 or over

- investment earnings being tax-free when you retire and start a super pension or reach age 65,<sup>1</sup> or
- paying tax at the concessional rate of 15% on earnings within a 'transition to retirement pension' (a transition to retirement pension can be started once you reach your preservation age. There are limits on how much income you can withdraw from this type of pension on an annual basis).

<sup>1</sup>A lifetime limit of \$1.6m applies to the total amount you can transfer to retirement phase pensions. Penalties apply for excess transfers.

## Small business CGT concessions

### What tax concessions are available for small businesses?

As a small business owner, you may be entitled to tax concessions that reduce the assessable capital gain from business assets. There are four small business CGT concessions:

- 15-year exemption
- 50% active asset reduction
- retirement exemption, and
- rollover.

The rules governing these concessions are very complex and it is strongly recommended you seek professional tax advice from a registered tax agent to determine your eligibility.

Further details are also available at [ato.gov.au](https://www.ato.gov.au)

## What are the eligibility conditions?

### 1. The basic conditions

Generally, there are three 'basic' conditions which need to be met in the first instance before you consider each specific concession. The conditions are:

1. the asset must be in relation to a 'small' business entity. Broadly this means the business has aggregated turnover of less than \$2 million or the net aggregated value of the assets of the business does not exceed \$6 million
2. the asset must be an 'active asset' – that is, used in the course of carrying on a business, and
3. if the business asset is a share or an interest in a trust:
  - a. an 80% market value test applies (in relation to the 'active asset' test), and
  - b. a '90% small business participation' or 'CGT concession stakeholder' test applies.

After meeting these basic conditions, you may also need to meet other conditions depending on which type(s) of concession you're considering. As more than one type of CGT concession can apply to the one CGT event, the concessions need to be considered in a particular order.

### 2. Conditions specific to each concession type

#### Small business 15 year exemption

This concession provides a small business entity (including an individual who is a sole trader or partner of a partnership) with the option to 'disregard' the full amount of a capital gain made from a CGT asset that it has owned. To be eligible for this concession you/the entity needs to:

- meet all of the basic conditions for small Business CGT concessions (as outlined above)
- have owned the asset for a period of 15 continuous years leading up to the time of the transaction
- be over your preservation age and retiring at the time of the transaction or otherwise be permanently incapacitated, and
- satisfy a 'significant individual' test, in relation to these earlier requirements, if you're disposing a share in a company or interest in a trust.

If you do not meet the requirements for the 15 year exemption, you may be eligible for other concessions.

#### Small business 50% active asset reduction

This provides a small business/individual with a 50% reduction to their capital gain. (This is in addition to the standard CGT discount that applies to individuals who have held the asset for more than 12 months.)

To be eligible for this concession:

- you/the entity must meet all of the basic conditions for small business CGT concessions, and
- you must not have claimed the 15 year exemption in relation to the particular capital gain.

If you're eligible for this concession, you may also be eligible to apply the small business retirement exemption and/or small business rollover relief to the reduced capital gain amount (provided you meet the relevant criteria).

You can also choose not to apply this concession (for example where you work out you're better off applying one of the other concessions below without applying the 50% reduction first).

#### Small business retirement exemption

This exemption effectively converts a taxable capital gain you have made from the disposal of your small business asset into a tax-free gain if you use the capital proceeds from the disposal in connection with your retirement. A lifetime limit of \$500,000 applies.

To be eligible for this concession:

- you need to meet all of the 'basic conditions' for small business CGT concessions
- you must contribute the CGT exempt amount if you're under age 55 to a complying superannuation fund by the later of the time you made the choice to use the exemption or the time the proceeds are received (ie you cannot keep the proceeds as cash unless you're 55 years or older), and
- a 'significant individual test' must be satisfied if a company or trust is seeking to use the concession (instead of an individual), and other special conditions apply.

This exemption is to be applied to the capital gain:

1. after the 50% discount applicable to individuals/trusts who sell assets held for more than 12 months, and
2. after the CGT small business 50% discount (unless you have chosen not to use that concession).

### Small business rollover relief

CGT rollover relief allows a person/entity to defer a capital gain arising from the sale of one or more small business asset(s) where a replacement asset is acquired within a certain time period.

To be eligible for this concession you generally need to:

- meet all the 'basic conditions' for small business CGT concessions, and
- acquire a replacement asset by the end of the 'replacement asset period'. You still may be able to claim the concession if you do not acquire a replacement asset within this time but some/all of the capital gain may be assessable.

### What is a superannuation CGT cap?

If you make a contribution to superannuation which is using capital proceeds from the disposal of small business assets, you may be able to elect them to be counted towards a special 'CGT cap' rather than your non-concessional contributions cap.

To use the CGT cap, you must have:

- claimed either the small business retirement exemption or small business 15-year exemption, and
- notified your fund you have made an election to use the cap before or at the time you made the contribution. (This must be done in a particular format/using an ATO form.) You or your tax adviser must complete this form.

If you're not eligible to use the superannuation CGT cap, your contribution will count towards either the non-concessional contribution cap or the concessional contribution cap depending on the type of contribution.

## Fringe benefits tax

### What is a fringe benefit?

A fringe benefit is generally a non-cash benefit received by an employee (or an associate of the employee) as a result of their employment. This may include the use or ownership of something, enjoyment of a privilege or use of a service. While fringe benefits do not form part of your assessable income, the 'grossed-up' value of fringe benefits may be included in a broader definition of 'income' when determining your eligibility for certain government benefits and concessions or liability for levies.

### Reportable fringe benefits

A reportable fringe benefit is simply the 'grossed-up' taxable value of the fringe benefit provided and is the amount shown on the employee's payment summary. 'Grossing-up' involves applying a specific formula to the value of the fringe benefit received.

Your employer is required to include such reportable fringe benefits amounts on your payment summary. Examples where reportable fringe benefits are added to your other income are for the purpose of determining:

- Medicare levy surcharge
- child support payments
- Higher Education Loan Program (HELP) repayments, or
- Government co-contribution.





Adjusted fringe benefits are effectively reportable fringe benefits 'grossed-down' for the effect of the fringe benefits tax. Examples where adjusted fringe benefits are added to your other income are for the purpose of determining:

- Family Tax Benefit
- Child Care Benefit, or
- the Parental Income Test for Youth Allowance

### Fringe benefits tax

Fringe benefits tax is payable by employers and is based on the value of fringe benefits provided to employees or their associates. As fringe benefits tax is paid by the employer, the actual fringe benefit provided to the employee is generally not taxable in the hands of the employee.

Generally, employers may place restrictions on the amount and type of fringe benefits received by employees and this may involve adjusting the employee's total remuneration package to take into account any potential fringe benefits tax that may be payable by the employer.

### Taxation of Employee Share Schemes (ESS)

Special tax treatment applies to shares, stapled securities and rights (including options) you acquire at a 'discount' under an employee share scheme (these are referred to as your 'ESS interests'). 'Discount' broadly means you either did not pay anything for the interest or what you paid was less than market value. This 'discount' on your ESS interest is subject to tax under the ESS tax rules. Under these rules, most ESS interests are subject to tax 'up front' (that is, at grant) rather than at vest. Some ESS interests such as those that carry 'real risk of forfeiture', certain salary packaging arrangements and certain pre 1 July 2009 interests may be instead taxed on a deferred basis however to be eligible, the scheme must meet very strict criteria.

The tax treatment and calculation of your taxable ESS discount is determined by reference to the particular scheme you participate in and is not something you can choose. Your employer will advise you of the type of scheme you're participating in and will also provide you with an 'ESS statement' each year which details the ESS interests you have acquired during the year for tax purposes. Your employer also gives this information to the ATO.

The taxation implications may also be different if you were a non-resident of Australia for tax purposes at any stage during the ESS vesting period. Also, if you eventually dispose your ESS interest (such as if you sell your shares), there may be CGT implications which is in addition to the tax you might have to pay under the ESS rules.

As the taxation implications of ESS interests are complex, you should consult a registered tax agent who has specialist knowledge. Further information is also available at [ato.gov.au](http://ato.gov.au)

