Tax Planning

High income individuals not in business

This e-book applies to:

- → Doctors and medical specialists (not using a service trust arrangement)
- → Professionals working as an employee
- → High income earners deriving income from wages
- → Anyone deriving high levels of personal exertion income

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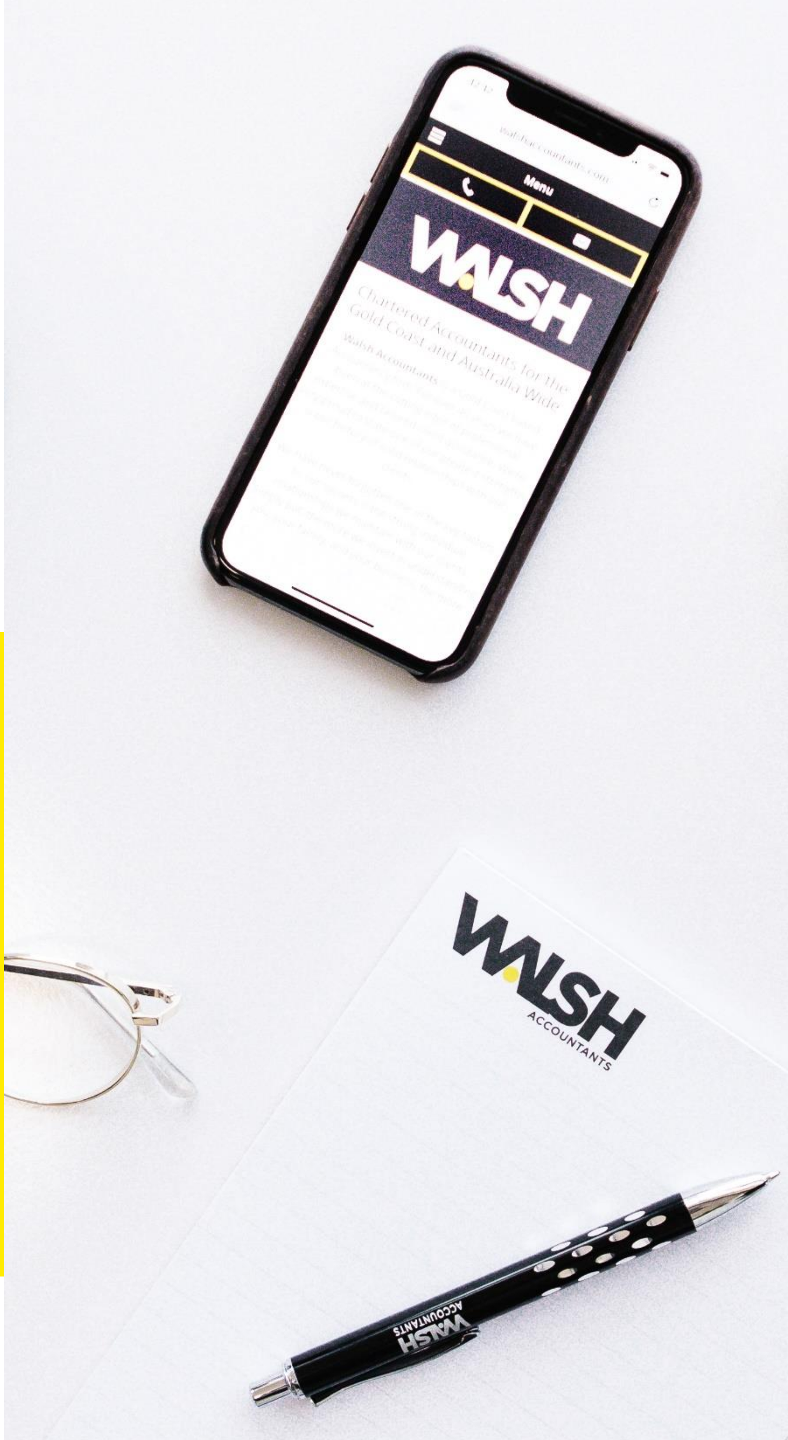

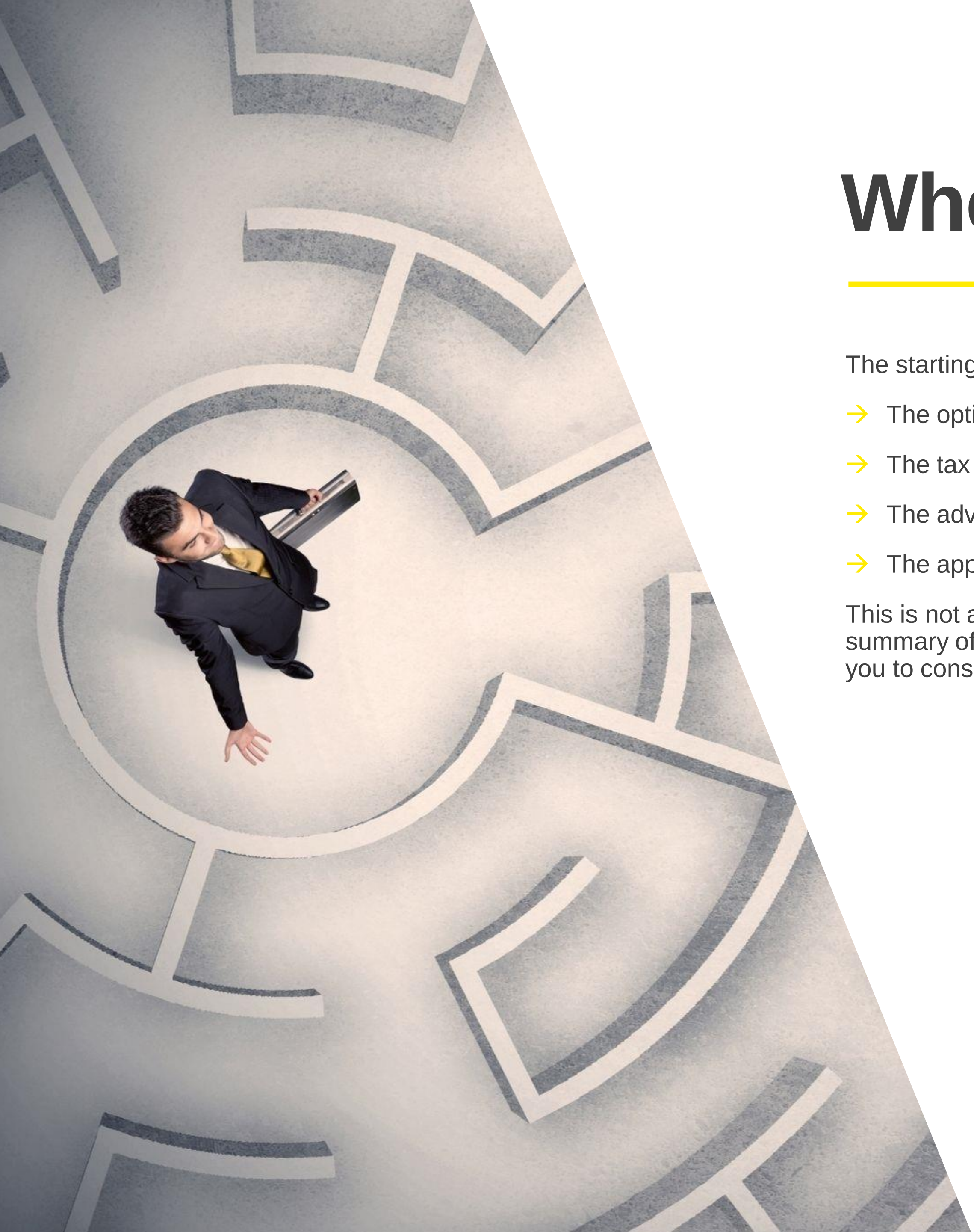

Where to start?

The starting place is to gain an understanding into:

- The options available
- The tax value of those options
- The advantages and disadvantages of each
- The applicability of each to your scenario now and in the future

This is not an exhaustive guide on every tax deduction or item, but a summary of the major or most common deductions and the major issues for you to consider as part of your overall tax planning.

Basic tax deductions

The first option to reducing income is to obtain additional tax deductions – but as discussed earlier – only the ones which make sense!

We don't want to bore you with the numbers here but check out our examples in the appendices which are noted as we go along.

Superannuation

Super is paid by your employer currently at the rate of 9.5% of your gross income. From 2018 financial year you can make also personal contributions into superannuation and receive a tax deduction. However, note that the maximum you can put into super is $25k per financial year (including employer contributions).

From the 2019/20 financial year, any un-used contributions up to the $25k limit are carried forward and can be used in subsequent financial years, for up to a maximum of 5 years. The first year eligible for this carry forward is 2018/19. The only catch is that the total balance of your super must be less than $500k. Below is an example of how this carry forward cap can work to increase you super contributions in the current year:

	Contributions made	Limit	Carry forward
2018/19	20,000	25,000	5,000
2019/20	19,000	25,000	6,000
			11,000
Total unused cap carried forward	11,000		
Add: 2020/21 contributions limit	25,000		
Total allowable contributions in 2020/21 year	**36,000**		

*Note: the SG rate will increase to 10% on **1 July 2021**, and then continue to increase until it reaches 12% on 1 July 2025.*

Insurances

Some insurances will be deductible while some are deemed as capital. The general rule with the deductibility of insurance premiums is to consider whether in the event of a payout the proceeds would be assessable.

A quick table as per below:

Income Protection/Sickness and Accident	Deductible
Trauma	Not deductible
Life insurance	Not deductible
Total and permanent incapacity	Not deductible
Business expenses insurance	Deductible

Motor vehicle deductions

There are now two different methods for claiming motor vehicle deductions:

- **Log book method –** this entitles you to claim all costs of operating and ownership (interest and depreciation) based on the business use of your car which is determined by a log book.

- **Cents per km –** you get a deduction of 72c per km up to 5,000 and no questions asked – well almost.

  You don’t need a logbook but you still need to show a reason for travelling that far. Some notes in relation to the above methods:

  - Depreciation is limited to luxury car limit of $59,136 regardless of cost

  - Interest on finance is deductible for the full amount borrowed to purchase the car

  - If either the cost of the car is high or you have a high work related use, then the log book method will usually result in the best outcome

  - If you are slack at keeping records or have low business use, then use cents per km method may work best for you

  - If you are using the log book method, you will need to keep a new log book every 5 years. There are different automated applications that link into smart devices that can track business use of your vehicle

Everyone’s circumstances are different so you should choose the method that will work best for you to maximise your deductions.

Self Education & Training

The cost of furthering your education and training will be tax deductible provided that it can be related to your current employment activity. Courses that are provided by a private provider such as your governing body will be fully deductible. Courses subsidised by HELP will generally not be deductible; but other costs associated with study such as text books, equipment, parking, and travel will be deductible.

Travel

If you need to travel for work or study then this will also be a deductible expense. If there is a combination of work and pleasure then remember to keep a record of your travel, especially receipts for courses or an email confirming you are meeting someone.

Donations

Helping others is also another way to reduce your tax bill. Remember, if you get something in return it may not be deductible. Be careful with charity dinners and golf days ensuring there is clear separation between the donation and any activity that you may be enjoying.

Salary sacrificing – what is it?

Salary sacrificing refers to requesting that your employer divert some of your pre-tax income to pay for something.

For example, you can direct your employer to make an additional super contribution over the SGC rate (currently 9.5%) or you have them make a car lease payment on your behalf.

Why would you want to do this?

- For those in the top tax bracket (over $180,000), the tax savings could be as high as 32% of the amount sacrificed for additional superannuation contributions.
- By making salary sacrificing payment on deductible assets such as a car you don’t have to pay GST as your employer can claim it.
- Full expense deductions can be claimed for cars with no or low business use. As the FBT on a car can be calculated on a formula basis, this will often result in providing an advantage to the taxpayer.
- For those who don’t like paying super; salary sacrificing can decrease the amount that has to be paid into super by decreasing your taxable income on which SGC is applied.

You should note that salary sacrificing generally only works for items where tax deductions are available such as superannuation and motor vehicles. If you sacrifice your home loan payments then you will be no better off.

See **Appendix 2 & 3** for some numbers.

Negative gearing

We have all heard a lot of media about negative gearing. Despite the impression that this represents a pot of gold for property owners, it is widely misunderstood.

In a nutshell the key points are:

- Negative gearing occurs because there is a loss.
- The maximum tax refund will be 47% of that loss.
- If your property value does not increase by more than your annual loss you will not get your money back.

While tax is a factor, it should not be the reason for making a property investment (nor any investment). In assessing the appropriateness of geared property to your situation, the focus should be on your longer term expectations of price growth and rental income.

You should also understand that a tax loss may not equal actual cash flow as building depreciation is a tax deduction but you don’t outlay cash for it. Therefore, you can have positive cash flow even though you have a taxable loss position

The important thing here is to remember negative gearing generally needs growth to work.

See the numbers at **Appendix 4 & 5**.

Tips and tricks for rental properties

- **Prepayments –** note that where you are borrowing to buy shares or property, you can prepay up to 12 months in advance. This can give you an additional advantage in the first year but be aware you will need to keep paying in advance if you don't want to lose the advantage.

- **Building Allowances –** depreciation on your building requires a Quantity Surveyor report to establish the value so make sure you get one when you purchase your property. Remember depreciation will keep coming off your asset value whether you claim or not! You can claim depreciation on initial building costs (for 40 years) but also on renovations or improvements.

  Major renovations may give you opportunity to write off existing capital works value as well as claim depreciation on new building, essentially double dipping.

- **Purchase deposits –** people often obtain purchase deposits out of existing home loans or other lines of credit they may have available. As it's common to forget about these deposits, don't forget you can claim an interest expense for any borrowings used to get your deposit!

Share investment and gearing

Similarly to negative gearing of property, it is possible to borrow money to purchase shares. Typically this will be done through margin lending or some other product.

The same principles apply unless your share portfolio is increasing in value; any losses you make will remain just that – a loss.

Whilst there are no depreciation type deductions which can provide a tax benefit, many listed companies will pay dividend income with franking credits attached. These credits will offset any tax payable on the dividends to the extent of 30%.

See **Appendix 6** for an example.

Tax advantaged investments = Growth for the future

As outlined on our first page, the advantage of investing in superannuation, shares, and property is that you can obtain tax deductions to decrease your tax payable, while at the same time increasing your asset portfolio

In turn, this is transferring your income production stream away from personal exertion into asset based income which, from a future perspective, will help you maintain your level of income when your body may no longer be up to making the money for you.

Asset protection – what should you do?

Being a high income earner brings its own set of risks in terms of being sued for damages.

Therefore, the preference is always to have assets (particularly those of value) in a name or entity other than the ‘at risk’ individual. This is usually a spouse or a family/discretionary trust.

The catch with geared investments is that it’s usually the high income earner who needs the tax deductions and needs to have these assets in their personal name to obtain the tax benefit planned.

What to do?

- Look for other ways to structure to reduce the risk or considerable equity being exposed – this can be done by:
    - Keep gearing high on assets held by the ‘at risk’ person but don’t confuse effective asset protection with inflated interest deductions, which are not tax deductible.
    - Investigate a trust gifting strategy as significant equity arises in the name of the ‘at risk’ person
- Many events can be insured against which greatly reduce the risk of assets being lost.

Understanding the ‘tax’ value or benefit

When considering tax planning, people often misinterpret the real value of expenses that are tax deductible. The ‘value’ is essentially the tax refund or tax saved by incurring the tax deduction. It is not uncommon for one to assume the $1,000 tax deduction means $1,000 tax refund or saving.

The reality is that the value of a $1,000 deduction is:

For a tax payer on the 32.5% marginal rate	$325
For a tax payer on the 37% marginal rate	$370
For a tax payer on the 45% marginal rate	$450

Considering the options in this way should help keep the hunt for deductions into perspective.

Remember it makes no sense to spend $1,000 just to save $450 if there is no other benefit in the outlay.

Tax rates

One of the main issues as a high income tax payer in managing your tax; is to understand how the marginal tax rates impact on you and the 'tax' effectiveness or value of any deductions or anticipated deductions.

In Australia, we have a marginal tax rate system. This means that our taxes increase as our income increases, but you are not taxed extra for income within a lower range. Therefore, if you earn $18,210 you are only taxed at 19% of $10 not 19% of $18,210 as the $18,200 remains at 0%.

Australian income tax rates for 2020/21 (residents)

Income thresholds	Rate	Tax on this income
0 - $18,200	0%	Nil
$18,201 - $45,000	19%	19c for each $1 over $18,200
$45,001 - $120,000	32.5%	$5,092 plus 32.5c for each $1 over $45,000
$120,001 - $180,000	37%	$29,467 plus 37c for each $1 over $120,000
$180,001 and over	45%	$51,666 plus 45c for each $1 over $180,000

** The above rates do not include the Medicare levy of 2%*

Now where do I go from here?

Am I considered a high income earner? What can I do to reduce my tax bill?

Should I pay more super?	Should I buy a new car?	Should I salary sacrifice?	Should I negative gear into property or shares?
Do you earn more than $263K pa?	Do you use it a lot at work?	Do you earn over $180K?	Do you earn over $180K?
YES: Max reached	YES: You can claim business use	YES: GO – Refer Appendix 2	YES / NO: Depends upon the investment. Refer **Appendix 4-6**
NO: GO – Refer **Appendix 1**	NO: No – but maybe salary sacrifice	NO: Only for certain items. Refer **Appendix 3**	

Appendix 1

Paying more into super

You can reduce your taxable income with super by entering a salary sacrifice arrangement with your employer, or by making personal super contributions.

The contribution limits are set at $25k per annum, which means that once you are earning in excess of $263k, this option won't be available as you will already be at your contribution limit. This is unless your total super balance is less than 500k and you have unused contributions from the 2018/19 or later financial years which have been carried forward and can be used in the current year.

On the right is a calculation showing the tax savings on additional superannuation contributions:

Result

As can be seen the result is a tax benefit of $4,192 per annum for a salary of $150k topped up to the maximum superannuation contribution of $25k. Even better news is that the money you put in super is still yours!!

No additional super

Gross salary	150,000
Taxable income	150,000
Less PAYE tax	(43,567)
Income after tax	**106,433**

Additional super

Gross salary	150,000
Less salary sacrifice / personal contribution	(10,750)
Taxable income	139,250
Less PAYE tax	(39,375)
	99,875
Add benefits sacrificed	10,750
Income after tax	**110,625**

Appendix 2

Salary sacrificing a motor vehicle (over $180K income)

When you salary sacrifice a motor vehicle, you need to be aware that the cost of the car will impact the FBT payable. Generally, a lower value will result in more favourable result. However, you can buy a car up to the value of $59k.

The benefit to salary sacrificing a car with low business use is that you can save tax by turning non-deductible car use into a tax deduction.

No salary sacrifice

Gross salary	250,000
Taxable income	250,000
Less PAYE tax	(88,167)
	161,833
Less car operating costs (non deductible)	(10,000)
Income after tax	**151,833**

Salary sacrifice

Gross salary	250,000
Less salary sacrifice ($10k less GST)	(9,091)
Taxable income	240,909
Less PAYE tax	(83,894)
	157,015
Less FBT paid ($45k car)	(8,799)
Add operating costs sacrificed (inc. GST)	10,000
Total income – salary packaged	**158,216**
Tax savings	6,383

Result

By sacrificing salary into car payments the overall annual tax benefit is $6,383 for the year.

Note that if the value of the car was $59k then the tax saving would decrease to $3,645.

Appendix 3

Salary sacrificing a motor vehicle (under $180K income)

When you salary sacrifice a motor vehicle, you need to be aware that the cost of the car will impact the FBT payable. Generally, a lower value will result in more favourable result. However, you can buy a car up to the value of $59k.

The benefit to salary sacrificing a car with low business use is that you can save tax by turning non-deductible car use into a tax deduction.

No salary sacrifice

Gross salary	150,000
Taxable income	150,000
Less PAYE tax	(43,567)
	106,433
Less car operating costs (non deductible)	(10,000)
Income after tax	**96,433**

Salary sacrifice

Gross salary	150,000
Less salary sacrifice ($10k less GST)	(9,091)
Taxable income	140,909
Less PAYE tax	(40,022)
	100,887
Less FBT paid ($45k car)	(8,799)
Add operating costs sacrificed (inc. GST)	10,000
Income after tax – salary packaged	**102,088**
Tax savings	5,655

Result

Again, by sacrificing salary into car payments the overall annual tax benefit is $5,655 for the year.

Note that if the value of the car was $59k, then the tax benefit would decrease to $2,917.

Appendix 4

Negative gearing – the kind you need

When considering negative gearing, the two factors you need to consider are tax rates and cashflow.

In this example, we assumed the taxpayer who is on the top tax rate purchased an investment property for $450k and rents that property at $480 per week.

Rental income	25,000
Less: Cash expenses	
Body corporate	6,000
Insurance	1,000
Mortgage repayments	
Interest (deductible)	12,000
Principal (non-deductible)	4,000
Management fees	2,000
Rates and water	2,500
	27,500

Less: Tax expenses	
Depreciation	6,000
Building write-off	5,000
Borrowing expense write-off	400
Net rental income for tax	(9,900)

Rental Income	25,000
Cash expenses	(27,500)
Tax refund	4,653
Net annual cash flow	2,153

Result

As can be seen the end cash-flow is positive so even if the property does not go up in value for the year you are still making money!

Appendix 5

Negative gearing – cash flow negative

In contrast to Appendix 4, we have assumed a taxpayer on a lower tax rate of 39% rents a property which was purchased for $450k but only rents at $430 per week.

Rental income	22,360
Less: Cash expenses	
Body corporate	6,000
Insurance	1,000
Mortgage repayments	
Interest (deductible)	12,000
Principal (non-deductible)	4,000
Management fees	2,000
Rates and water	2,500
	27,500

Less: Tax expenses	
Depreciation	5,000
Building write-off	5,000
Borrowing expense write-off	400
Net rental income for tax	(11,540)

Rental Income	22,360
Cash expenses	(27,500)
Tax refund	4500
Net annual cash flow	(639)

Result

The end cash-flow is negative so unless the value of the property increases more than this amount, the taxpayer will be losing money.

Appendix 6

Gearing into shares

Where gearing is used for shares, a slightly different equation arises as shares generate their tax benefits from dividends and franking credits.

Compared to property, shares can be more volatile so careful analysis needs to be undertaken in respect of dividend yield and growth.

In this example, we assume a taxpayer on the top tax rate borrows $100k to buy shares. The shares have a 5% dividend yield which is fully franked.

Result

This results in a tax benefit of $340 but care needs to be taken that the shares are also growing in value. Always consider obtaining financial planning advice when investing in shares.

Dividend income	5,000
Franking credits received	2,142
Total income	7,142
Interest	6,500
Taxable income	642
Tax payable	302
Less franking credit offset	302
Net tax payable	-

Cash flow status	
Dividend income	5,000
Cash expenses	(6,500)
Additional tax credits	1,840
Net benefit	340

Case study

Background

John is a lawyer at a large law firm where he is an employee. He is currently earning $200k per annum. He is a little frustrated with the amount of tax he is paying and would like also like to start investing for the future. He is considering investing in shares and a rental property to have some diversity in his investment base.

As his firm is a strong believer in employee retention, they have recently introduced a salary packaging option for their employees allowing packaging of motor vehicles and superannuation.

After speaking to a financial planner and an accountant, he has decided to invest in shares using a margin loan and use negative gearing to purchase a rental property.

Using his employers salary sacrifice option, he has decided to obtain a new motor vehicle for $50k through a novated lease arrangement and make additional superannuation contributions up to the maximum amount of $25k.

Arrangements

- John enters into a novated lease for a new car for $50k. His monthly lease payment of $800 and estimated running costs of $400 will be deducted from his pre-tax income.
- John will also salary sacrifice an additional $500 per month into superannuation.
- For investment, he has purchased a property for $600k which will bring in an income of $550 per week. The purchase price was 95% borrowed at an interest rate of 4.5% per annum.
- He has also entered into a margin loan for the purchase of $100k of shares in a publicly listed company. The shares will pay a dividend yield of 5% at the current time.
- As he would like to further develop his knowledge in intellectual property law. He has commenced a course in this area which will cost approximately $20k over the next two years. His firm will provide 50% of the funding.
- In addition, a friend in the USA works at a large tech firm in Silicon Valley. He has arranged for John to spend a week as an observer with their in-house lawyer who handles the security and processes around intellectual property. John will have to self-fund this trip which will cost $7,000 for airfares, accommodation, and meals.

Salary sacrifice component

No salary sacrifice

Gross salary	200,000
Taxable income	200,000
Less PAYE tax	(64,667)
	135,333
Less car operating costs (non deductible)	(14,400)
Income after tax	**120,933**

Salary sacrifice

Gross salary	200,000
Less salary sacrifice - super	(6,000)
Less salary sacrifice – car (less GST)	(13,091)
Taxable income	180,909
Less PAYE tax	(55,694)
	125,215
Less FBT paid	(9,777)
Add operating costs sacrificed	14,400
Add superannuation sacrificed	6,000
Total income after tax	**135,838**

Result

Salary sacrificing the car and additional superannuation benefits has reduced John’s tax bill from $64,667 to $55,694 resulting in his after tax income being $8,973 better off (when all benefits are included in his total income)

John receives additional benefits from having larger motor vehicle deductions than the $10,000 on which the FBT formula calculates his car expense value to be.

Rental income component

Rental income	28,600
Less: Cash expenses	
Body corporate	6,000
Insurance	1,000
Mortgage repayments	
Interest (deductible)	12,000
Principal (non-deductible)	4,000
Management fees	2,000
Rates and water	2,500
	27,500

Less: Tax expenses	
Depreciation	5,000
Building write-off	5,000
Borrowing expense write-off	400
Net rental income for tax	(5,300)

Rental Income	28,600
Cash expenses	(27,500)
Tax refund	2,067
Net annual cash flow	3,167

Result

John has generated a tax deduction of $5,300 to offset against his income whilst still having positive cashflow on the property.

As John has decreased his taxable income on his salary to below $180k, his refund is calculated using a 39% tax rate. For a higher income earner the result would be even better.

Share investment component

Margin loan

Dividend income	5,000
Franking credits received	2,142
Total income	7,142
Interest for year $100k @ 6.5% pa	6,500
Taxable income	642
Tax payable	250
Less franking credit offset	250
Net tax payable	-

Cash flow status	
Dividend income	5,000
Cash expenses	(6,500)
Additional tax credits to offset against other tax payable or be refunded	1,892
Net benefit	392

Result

John is cashflow positive as a result of the franking credits being higher than the tax payable.

In this initial year, John could also choose to prepay interest for 12 months and double his interest deduction. However, as he will become eligible for a bonus next year; he has decided to wait for the extra income before utilising this option as the additional deduction can only be obtained once.

The final outcome

Original position

Taxable employment income	200,000
Less deductions:	
Intellectual property course	(5,000)
Travel to USA	(7,000)
Taxable income	164,251

Net tax payable	**59,027**
Tax rate on gross salary of $200k	**29.5%**

Result

By undertaking a combination of investment decisions and salary sacrificing, John has reduced his tax rate by 6% and saved over $12,000.

At the same time as reducing his tax, he has begun building an investment portfolio for the future.

Adjusted position

Taxable employment income (after salary sacrifice)	180,909
Net rental loss	(5,300)
Dividend income after interest	642
Total income	176,251
Less deductions:	
Intellectual property course	(5,000)
Travel to USA	(7,000)
Taxable income	164,251
Less franking credit offset	(2,142)

Net tax payable	**46,983**
Tax rate on gross salary of $200k	**23.5%**

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