

Tax Summary

A simple guide to Tax

FREE PREVIEW

Chapter 14: **Business deductions**

2017

14: Business deductions

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14.000 Overview

Business deductions may be allowed to those carrying on a business under s8-1, or specific deductions within the tax acts. The second limb of s8-1 expands the deductibility of expenses to be necessarily incurred in the course of carrying on a business for the purposes of gaining or producing assessable income. This permits deductions for loss or outgoings due to theft.

The factors that determine whether a business is being carried on are outlined in TR 97/11 and Chapter 11.

A checklist of deductible expenses available to taxpayers in various businesses is available at 14.000. Also see *Checklist for employees* from 13.000.

14.005 Checklist of business deductions

This non-exhaustive checklist is designed to provide an easy reference guide to the types of deductions that might be claimed by businesses. It should be read in conjunction with a similar checklist for employees (see from 13.000). Before deciding on the deductibility of an outgoing the taxpayer's particular circumstances should be taken into account.

All businesses are required to maintain records of every transaction that relate to their income and expenditure as well as CGT transactions, GST, FBT and other requirements. The rules for recording those transactions are summarised from 4.700. If there is any private use element, that should also be noted in the records.

Car and travel expenses must be substantiated (see 13.160, 13.190 and 13.225).

NOTE: All section and division references are to the *Income Tax Assessment Act 1997* (ITAA97) unless otherwise stated.

- **Accident insurance premiums**
- **Accounting fees** Preparation of income tax and FBT returns etc. (s25-5) including costs relating to investigations, objections and appeals (see from 13.900)
- **Advertising expenses**
- **Agent's commission** Collection of rent
- **Annual leave** If actually paid by the employer (but not on accruing liabilities)
- **Audit fees**
- **Bad debts** See from 14.160 and 6.600
- **Bank charges** Including Debits tax
- **Borrowing expenses** Claim in full if \$100 or less, otherwise over the period of the loan or one fifth each year if five years is shorter commencing from the date finance is acquired (see 14.135)
- **Bribes** (public officials) No deduction is allowed, nor can the amount form part of CGT cost base
- **Business trips** See 13.160
- **Business-related cost** See 15.110 for business related costs of a capital nature that can be written-off in equal amounts over five years commencing from the first day in the income year that the expense was incurred
- **Capital works** On buildings and structural improvements (see 15.200)
- **Car expenses** Applies to employees, partners and self employed persons (see 13.220)
- **Car parking** 13.290 but see 25.300
- **Cleaning expenses**
- **Clothing** See 13.300
- **Conference expenses** see 13.700
- **Copyrights, patents and designs** See Capital allowance provisions (Division 40) (see 15.060) also consider the R&D concessions for companies
- **Cultural bequests** If made to Australian fund, public art gallery museum or library (see 13.835 & 13.870)
- **Decline in value** (depreciation) Of plant or articles used in business (see from 15.000 and 10.600)
- **Directors' fees**

- **Discharge of mortgage expenses** Where loan money used to derive assessable income (s25-30) (see 14.140)
- **Distributions by co-operatives** To members
- **Donations of property to deductible gift recipient** If market value is greater than \$5,000 (see 13.880)
- **Education expenses** If paid for employees (see 13.700) but FBT may apply (see 25.000)
- **Electricity connection costs** To business premises (see 14.185). Capital allowance provisions (Division 40)
- **Entertainment of employees** But FBT payable (see 25.900)
- **Environmental impact studies** Pooled and treated under the Uniform Capital Allowance system (decline in value) (see from 15.000 and 15.600)
- **Environment protection expenditure** See 15.600
- **Equipment service fees**
- **Exploration or prospecting** For minerals (including petroleum) and quarry materials (see 15.100)
- **Film investment** 100% deduction for investment in certain Australian made films (see 14.700)
- **Freight costs**
- **Fringe benefits tax** See from 25.000
- **Fuel and oil**
- **Gifts of \$2 or more** To certain prescribed or approved organisations (see 13.800)
- **Gifts to clients, etc** But not if entertainment (see 25.900)
- **Gratuities to employees** Recognition of past services (s25-30)
- **GST** Claims should be GST exclusive for those businesses that are registered for GST. The GST-inclusive price is deductible for those taxpayers not registered or required to be registered for GST
- **Home office expenses** Apportionment of interest, rates, etc. only if a business is carried out on the premises and where an area is set aside exclusively for that purpose (see 13.600)
- **Illegal activities** Where taxpayer convicted of indictable offences (no deduction allowed nor can the amount form part of CGT cost base – see 14.166).
- **Insurance premiums** Accident insurance paid by employees, and other insurance paid in relation to a business or some income-producing property. This is subject to the prepayment rules (see 14.170)
- **Interest paid** See 14.130
- **Internet and data access costs** Share investing and business websites – see also 14.000 for capital expenditure
- **Land tax** Business or rental premises. Deductible when incurred. The ATO has released guidance specifying that land tax is incurred in the year to which it refers, not when it is paid (see the ATO's *Rental Properties Guide*)
- **Lease payments** See 14.155
- **Lease preparation, registration or stamping expenses** Paid by either the landlord or (a business) tenant (s25-20) (see 14.115)
- **Leave payments** Paid by employer (but not on accruing liabilities)
- **Legal expenses** Unless capital expenditure, including discharge of a mortgage (s25-30) or relating to borrowing expenses (s26-40) (see 14.115 and 14.135) the nexus with ordinary activities of the business in producing assessable income will determine deductibility
- **Licenses to operate business** Prepayment rules may apply (see 14.170)
- **Losses, current year** Loss claims by companies may be limited in certain situations (Division 165), (s170-10) (see 13.950 and 7.400) Losses by trusts are subject to Trust Loss Provisions (see 7.900)
- **Losses, previous years** Company losses brought forward may be limited unless the company can pass the continuity of ownership test (s165-12) or the 'same business' test (s160-10); no time limit for losses incurred after 30 June 1989 (s36-10) (see 13.950 and 7.400) Losses by trusts are subject to Trust Loss Provisions (see 7.900)
- **Loss (book loss) on disposal of depreciable assets** (s40-285(2))

- **Loss on sale of property** If acquired before 20/09/85 for resale at a profit (s25-40); if property is sold in the ordinary course of business the loss will be on revenue account (see TR 92/3), otherwise a capital loss arises pursuant to Part 3 of ITAA97
- **Loss through misappropriation by employees, or by theft** (s25-45) See 14.165
- **Maintenance expenses** (s8-1)
- **Management expenses** Annual fees but not the capital cost of subscribing to some income-earning investments
- **Managing tax affairs** Costs of travel, accommodation, advice, booklets, seminars etc, depreciation on computers, software and other capital expenditure is deductible if incurred in managing tax affairs (see 13.900)
- **Mortgage protection insurance** (s8-1)
- **Moving trading stock**
- **Newspapers for employees** Depends on occupation. Share traders (and maybe investors) can claim
- **Overseas travel expenses** Substantiation rules apply (see 13.160 and 13.205)
- **Payroll tax** See from 26.000
- **Petrol and oil** Not subject to substantiation rules (see 13.242)
- **Petroleum resource rent tax**
- **Postage** For investors or businesses
- **Power, lighting and heating**
- **Primary producers** See from 21.000
- **Printing and stationery**
- **Professional or business association subscriptions and fees** (see 13.000) Prepayment rules may apply (see 14.170)
- **Project expenditure** To be written-off over life of project (see 15.100)
- **Protective clothing** See 13.310
- **Rates and taxes** On income-producing or business properties (see 14.125)
- **Rebates and discounts** Given to customers
- **Rent of business premises** Including part of the costs for a home used for a business (say, trading stock is stored in an area set aside exclusively for that purpose); but with a home office (or a study) rent cannot be apportioned, but some associated costs are claimable (see 13.600)
- **Repairs to cars, equipment, or to an income-producing property** (s25-10) See 14.150
- **Research & Development costs** See 15.500
- **Retiring allowances** Paid to ex-employee (or their dependent) for past services (s25-50) (see 14.120)
- **Royalties** Paid for use of equipment etc. – withholding tax may apply
- **Salaries and wages paid to employees**
- **Scientific research related to business** If incurred before July 1995 and R&D claim is not available: accelerated write-offs for capital expenditure into scientific research (s73A ITAA36)
- **Self-education expenses** Only if related to employment/business (see 13.700)
- **Seminars** see 13.700
- **Sickness/accident premiums In some cases**
- **Solicitors' fees** (see 14.115)
- **Storage expenses**
- **Structural improvements** (see 15.200)
- **Subcontractors** May be considered employees and subject to the 9.5% superannuation guarantee provisions in certain circumstances (see 19.516)
- **Superannuation contributions**
- **Support payments to a subsidiary** (see 14.169)
- **Tax agents fees** Preparation of income tax, fringe benefits tax returns, GST etc. (s25-5) including costs relating to investigations, objections and appeals (see from 13.900)
- **Telephone expenses**

- **Telephone line installation** See 21.650
- **Tool replacement** Depreciation (see 15.030)
- **Trade journals**
- **Trading stock purchases** See 14.200 and 21.400
- **Travelling expenses** Domestic and overseas, but note the substantiation provisions (see 13.160)
- **Traveller accommodation buildings** See 15.200
- **Uniforms** See 13.340 and from 25.000 (FBT)
- **Workcover/Workers compensation premium**
- **Worker entitlement funds** Only if fund approved under regulations

14.100 Types of business expenses

14.105 Costs of a new business

Acquiring or commencing a business is a capital transaction. Costs incurred may form part of the “cost base” of particular assets for capital gains tax purposes. Alternatively, a deduction equivalent to 20% per annum may be available under s40-880 as a cost in establishing a business (see 15.110). Note that amendments enacted through the Tax Laws Amendment (Small Business Measures No.3) Act 2015 allow small businesses and individuals to claim an immediate deduction for professional fees in relation to starting up a business (see 15.110).

Examples of new business related costs included in capital expenditure include:

- the cost of feasibility studies and setting up the business entity
- business restructuring costs, and
- legal expenses incurred to acquire the business.

Once the business is established and operating, expenses of a revenue nature incurred are allowable (eg rent, light, power) unless denied by the application of a particular provision of the tax law.

Capital expenditure incurred to prepare the new premises for occupation is not deductible under the standard provisions. Such capital costs include:

- initial repairs required when an asset is acquired
- alterations to a building (see 15.200)
- removal costs (but see 15.060 “second element of cost”), and
- any money paid to a former tenant so the taxpayer can gain possession of premises from which the business is to be operated.

NOTE: With new and second-hand equipment (whether or not as part of the overall business), removal and installation costs are additions to capital costs. Depreciation can be claimed on the higher total.

14.110 Presently existing obligation

Insurance industry taxpayers

Once an event has occurred which gives rise to a legal liability to pay, a deduction may be claimed for the present value of the obligation to pay in the future (*FCT v MMI (Workers Compensation) Ltd* 99 ATC 4404 involving the liability of an insurance company for outstanding insurance claims reported but not settled and incurred but not reported).

Other taxpayers

Once a legal liability to pay exists, a deduction will be available in respect of the amount payable even though the amount cannot be precisely ascertained and the debt may be defeasible in certain circumstances. No deduction is available in respect of provisions for such things as employee leave entitlements on the basis that no amount has been “incurred” at that time (*FCT v James Flood Pty Ltd* 88 CLR 492).

Specific provisions impacting deductibility, such as the prepayment rules, may require consideration.

14.115 Decline in value (Depreciation)

Taxpayers claiming deductions for the decline in value of assets may adopt the safe harbour of the Commissioner's rates of effective life (see TR 2015/2 from 1 July 2015) or alternatively, self-assess the life of the asset. Evidence as to the appropriateness of a self-assessed effective life may be requested by the ATO. Depreciation claims are covered from 15.000. Some special rules are set out at 15.060 and 15.800. The rules for the simplified tax system are detailed from 10.000. A listing of the depreciation rates that apply to depreciable assets in rental properties is contained at 18.360.



An immediate write off of assets under \$100 (GST Inclusive value) is allowed for business taxpayers in accordance with PS LA 2003/8. This threshold for immediate write-off is different for small business (see 10.600).

14.120 Legal expenses

The deductibility of legal expenses incurred by businesses is generally determined under s8-1. When a legal expense is incurred in the operation of a business to produce assessable income (ie when the expense satisfies the second positive limb of this section) it is generally allowable as a deduction. Exceptions are when the legal fee is capital, domestic or private in nature (negative limbs of this section), specifically excluded by another section of the income tax legislation or incurred in earning exempt and non-assessable non-exempt income.

In addition, the following types of legal expenses are not deductible under s8-1 because of their capital and private nature, instead they are made deductible under a specific provision of the ITAA97:

- the preparation of an income tax return, the disputing of a tax assessment and the obtaining of professional tax advice (s25-5)
- the preparation of leases (s25-20) (see below)
- certain borrowing expenses (s25-25)(see 14.135), and
- certain mortgage discharge expenses (s25-30) (see 14.140).

Business lease expense

The cost of preparing, registering and stamping a lease is deductible under s25-20 if the taxpayer is using or will use the property for earning assessable income. The lease payments themselves will be deductible under s8-1 and are therefore subject to the prepayment rules (see 14.170).

Evicting a tenant

A taxpayer may acquire premises (all or a portion of) which were leased to a tenant of the former owner. Any expenses incurred trying to evict the tenant will not be deductible. This expense becomes part of the cost of acquiring the property and a capital expense for income tax purposes. Arguably, it would form part of the "cost base" of the property, being expenditure of a capital nature incurred in establishing the taxpayer's title to, or a right over, the asset (ss110-30(6)).

Valuation expenses

If valuation fees are paid to help decide whether to buy a business, these are generally capital costs and not an allowable deduction under s8-1. However, if the valuation is used to support an application to borrow money for use in the business, those expenses can be claimed as borrowing costs immediately if under \$100 or over the life of the loan or 5 years from the date of the loan whichever is shorter (s25-25) (see 14.135).

Fines and breaches of law

Deductions are specifically denied for fines or penalties (however described) that are imposed as a consequence of a breach of any Australian or foreign law (s26-5). This rule does not apply to administratively imposed penalties such as General Interest Charge (GIC) and penalties for under estimating GST instalments. While the fines and penalties may be specifically disallowed, the costs incurred in defending the action may be deductible.

Legal expenses that can be claimed

Circumstances where legal fees are usually deductible include:

- negotiating current employment contracts (including disputes) in respect of existing employment arrangements (see TR 2000/5)
- defending a wrongful dismissal action brought by former employees or directors
- defending a defamation action brought against a company board
- arbitration in settling disputes (depending on the facts)
- recovering misappropriated funds of the business
- opposing neighborhood developments that are likely to adversely affect the taxpayer's business (depending on the facts of the case)
- evicting a rent-defaulting tenant
- recovering wages of an employee as a result of a dishonored cheque
- defending a libel action provided the case was directly related to comments in pursuit of the company's business
- pursuing claims for workers compensation, and
- defending the unauthorised use of trademarks (depending on the facts of the case).

Legal expenses that cannot be claimed

Circumstances where legal fees are generally not deductible include:

- the cost of negotiating employment contracts with a new employer
- defending driving charges (regardless of whether the transgression occurred while driving on company business)
- defending charges of sexual harassment or racial vilification which occurred in the workplace
- eviction of a tenant whose term had expired
- resisting land resumption, rezoning or disputing the amount of compensation, and
- disputing redundancy payout or seeking to increase the amount of any redundancy payout (TD 93/29).

Common examples of legal fees that may be deductible under other provisions of the Act (and therefore not deductible under s8-1) include s40-880 "Business related" expenditure (see 15.110).

14.125 Payments must be reasonable

Payments for any services rendered, the purchase of goods or any other outgoings, made to a relative or partnership in which a relative is a partner ("related entity" s26-35), are deductible only to the extent they would be considered reasonable. (See also *Personal services income* from 16.000.) Any amount disallowed as a deduction is deemed not to be assessable or exempt income of the related party (s26-35).

EXAMPLE

A property owned by a taxpayer's spouse is rented to a business operated by the taxpayer: the amount of rent claimed must be reasonable. The interest paid on money borrowed from a relative must also be reasonable (ie no greater than a fair commercial rate) s26-35.

Lump sums on ceasing employment

As a general rule an employer is entitled to claim a deduction for lump sum payments to employees when they retire or cease employment. However, that deduction may be limited if the amount is excessive. Irrespective of whether the amount is paid as a pension, gratuity or retiring allowance to an employee (or a dependant of an employee), the payment must be reasonable and made in good faith for the past services of the employee to the business. If the amount is excessive, under s25-50, the ATO can deny a deduction for that excessive amount. The amount allowed is limited to what is reasonable based on the employee's service.

These arrangements would not typically affect the concessional taxing of that payment in the hands of the employee (see ETPs etc. from 11.210).



Employers should be mindful when paying gratuities to retiring employees that this type of expense cannot create or increase a tax loss.

Any part allowable only under s25-50 (eg where there is a loss) not claimed in the year it is incurred cannot be carried forward to the next year (see 13.950 and 6.400).

14.130 Rates and land taxes

Claims for rates and land taxes incurred in respect of properties which are used to produce assessable income are allowable under s8-1.

Rates and land taxes paid on purchase

The purchase price is adjusted by certain rates and taxes:

- some already paid by the vendor, to which the purchaser contributes. That part can be claimed, and
- others left for the purchaser to pay, and for which the vendor “allows” a reduction to cover part of what you will pay. The tax claim is the full expense less the amount reimbursed by the vendor.

The “rate adjustment” notice shows the expenses for which a taxpayer is liable.



Whether or not paid at settlement, or adjusted some other way, rates and land tax costs can be claimed as a deduction if the property is used for income-producing activities.

14.135 Interest

Interest incurred as an expense of running a business or to acquire other income-producing assets or investments is allowed as a tax deduction at the time the liability is “incurred” (see also *Negative gearing* from 14.190). For business taxpayers under the accruals accounting method, a claim can be made for the calculated interest liability to the end of the income year (usually 30 June), provided the interest on the debt accrues on a daily basis (which would usually be the case).

NOTE: The prepayment rules may impact the time at which a deduction is available (see 14.170).

Deductions for interest incurred

The availability of deductions for interest are typically impacted by the following factors:

- interest must have a sufficient connection with the income earning operations or activities of the taxpayer
- the character of the interest will generally be determined by the use to which the borrowed funds are put
- interest on borrowings will not continue to be deductible if the borrowings cease to be employed in the borrower’s business or for some income producing activity, or which are used to earn exempt income
- interest on a new loan is deductible if the new loan is used to repay an existing loan, which, at the time of the second loan, was used to produce assessable income or as part of a business to produce assessable income
- interest may still be deductible even if the borrower’s business has ceased (refer to: *Brown* 99 ATC 4600 and *Jones* 2000 ATC 2103). This rule can apply to other assessable income-producing activities but would not apply to the derivation of exempt income
- interest may be deductible if incurred prior to business commencing or assessable income being derived (see TR 2004/4 and *Steele v FC of T* 99 ATC 4242 (*Steele*))
- the “rule of 78” may be used in limited circumstances to calculate the interest component of instalments paid under a fixed term loan or extended credit transaction. For details of when the ATO accepts use of the rule see TR 93/16 and TR 93/16A,
- penalty interest for early repayment of a loan may be deductible; see TR 93/7, and
- interest deduction can be claimed for money borrowed for the business used to pay tax (see IT 2582).



The High Court has ruled that the additional interest incurred under split or linked loans (see below) arising in the circumstances evident in Hart’s case is not deductible because of the anti-avoidance rules of Part IVA (see 4.510).

NOTE: In *Hart's case* the split or linked loan was both a private loan (to finance a home) and a business loan (to finance an investment or business). All of the interest payments are applied against the private loan leaving the taxpayer to claim compounding interest deductions on the business loan.

General law partnerships

Interest on borrowings by a common law partnership is deductible if it is to fund repayment of moneys originally advanced by a partner, used as partnership capital and was used to earn assessable income. This is seen as effectively refinancing the working capital of the partnership business. No claim is allowed for interest on borrowings used to replace capital which is represented by internally generated goodwill or an unrealised asset revaluation.

EXAMPLE

The taxpayer borrows \$25,000 which is used as capital invested in a business with several other partners (ie general law partnership). The partnership later borrows \$25,000 to return the taxpayer's initial capital contribution. At the time of borrowing, the initial capital was being used to derive assessable income in the partnership, so the interest on those borrowed funds is deductible.



Claims for interest on borrowings used to replace capital used in a business which is a tax partnership but not a common law partnership may not be deductible. See from 8.000, TR 95/25, TR 95/25A and TR 95/25A2.

Companies

Interest incurred by companies may be deductible if the funds are used to:

- repay share capital to the shareholders if that capital was employed as working capital in the company business and is used to derive assessable income, or
- fund the payment of a declared dividend to the shareholders where the funds representing that dividend are employed as working capital in the company business and it is used to derive assessable income.

A deduction is not allowed if the borrowed funds are used to:

- repay share capital to shareholders to the extent it represents bonus shares paid out of an unrealised asset revaluation reserve or other equity account (eg internally generated goodwill), or
- pay dividends out of unrealised profit reserves.

Also, interest incurred by a foreign bank on borrowings that fund the bank's general reserve liquid assets, managed and controlled for use outside Australia, is not deductible (ATO ID 2012/92).



The High Court has confirmed that interest is usually on revenue rather than capital account. The decision in Steele's case concluded that interest incurred before a business starts operations (eg during the construction or establishment phase) can be deductible provided that at all times the taxpayer's intention was to use the borrowed funds for the purposes of generating assessable income. See also TR 2004/4. Interest on borrowed funds must be apportioned between income-producing and non-income-producing purposes. An example of where interest was held to be on capital account arose in Macquarie Finance Ltd v FCT (2005) FCAFC 205.

14.140 Borrowing expenses

If costs are incurred to obtain a loan, the costs of arranging it are allowable as a deduction to the extent the loan is used to produce assessable income (s25-25). Expenses claimable under this heading include:

- legal expenses associated with the mortgage documents (see 14.115)
- valuation fees incurred (see 14.115)
- procuration fees and mortgage insurance (Case R116 84 ATC 761) (if any)
- stamp duty payable on mortgage documents, and
- any other cost items for taking the loan.

If the total cost is less than \$100, it can be claimed in the income year the expense is incurred.

Costs over \$100 – claim is spread

The deduction of borrowing expenses is spread equally over the lesser of the loan term, and five years commencing from the date the facility or loan was entered into.



If you incur borrowing costs on a number of dates for different facilities you cannot simply add them to the opening balance of your undeducted borrowing costs for that year. It is necessary to do a separate calculation for these new borrowing costs.

Early repayment

When this occurs, and some of the “costs of borrowing” have not been claimed, these may be deducted in the year in which the borrowings are paid out. Generally any so-called “rebate” given when a loan is paid out is merely a figure to adjust the interest. Any refund would diminish the final claim for the “costs of borrowing”.

Mortgage protection insurance for a bank loan used to purchase an income-producing asset is deductible under s25-25. Penalty interest on early repayment of the loan may also be deductible.

Discharging a mortgage

A claim may be made for the costs of arranging to borrow money to be used in a business or to produce assessable income. Section 25-30 allows a taxpayer to claim in full the cost of discharging a mortgage where the money was used (whether or not in a business) for producing assessable income.

If only part of the borrowings were used for that purpose, apportion the discharge expenses.

14.145 Bills of Exchange discount

When the proceeds of a bill of exchange are used in the conduct of a business for the purposes of deriving assessable income, a deduction will typically be available in respect of the discount, which represents a liability at the time the bill is negotiated. The ATO position is that, whilst the deduction is “incurred” when the bill is negotiated, it must be taken over the life of the instrument, calculated on a straight line basis. Where the bill is issued on, say, 1 June for a period of 90 days, a deduction equal to one-third of the discount would be available in year one with the balance in the subsequent year, as the taxpayer has applied the funds to their business operations in both years. This approach reflects the views expressed by the High Court in *Coles Myer Finance Ltd v FCT* (1993) HCA 29. Further information outlining the ATO arguments is available in TR 93/21. An exception to this approach arises when bill proceeds are applied directly to the extinguishment of an existing or future liability of the taxpayer. In these circumstances the full deduction should be available at the time of payment (see TR 94/25). This approach is consistent with the reasoning of the *High Court in FCT v Energy Resources of Australia Ltd* (1996) HCA 10.

14.150 Repairs

A deduction is allowed for the cost of a repair to premises, part of premises or a depreciating asset (as defined in s40-30) held for the purpose of producing assessable income. If the property is held or used only partly for that purpose, a deduction is allowable for so much as is reasonable in the circumstances (s25-10). The tax law does not require that the property or depreciating asset be owned by the taxpayer. It may be owned by another entity, such as a landlord. However, where the expenditure is on a repair and the taxpayer holds or uses the property or depreciating asset in the income year for the purpose of producing assessable income, then a deduction is allowable provided that the expenditure is:

- incurred by the taxpayer claiming the deduction
- incurred in the year of income that the deduction is claimed, and
- incurred in respect of premises or a depreciating asset.

A “depreciating asset” is defined in s40-30 to be an asset that has a limited effective life and can reasonably be expected to decline in value over the time it is used. For a detailed definition and exclusions as to what constitutes a depreciating asset refer to 15.010. Capital expenditure cannot be deducted under s25-10. This would include improvements, initial repairs, additions and alterations. However, such expenditure may be deductible by way of decline in value (depreciation) under Division 40 (see 15.000) capital works (15.200), or the small business tax system (10.000).

What is a “repair”?

On the face of it, deciding whether a claim can be made under s25-10 should be relatively simple, but in reality there are significant difficulties present when deciding whether or not the “repair” is of a capital nature. ITAA97 does not define the term “repair” and therefore it takes on its ordinary meaning. The Shorter Oxford Dictionary states that it is the ... *restoration of some material thing, by the removal of some decayed or worn out parts*. In practice, it is often difficult to assess whether expenditure is really for repairs and it is therefore necessary to determine if the expense is:

- an improvement
- the replacement of a subsidiary part or of an entirety, or
- a capital expense in respect of recently acquired property.

Renewal, replacement or reconstruction of the entirety of premises or plant etc. would not be a repair. The same may apply where there is a renewal, replacement or reconstruction of a substantial portion of an asset.

While a repair obviously improves the condition of an item which existed before the repair took place, a repair essentially involves the restoration of a thing to the condition it formerly had without changing its character.

In deciding whether the work carried out is a repair or not, it is more important to decide whether there has been a restoration of efficiency or function rather than an exact repetition of form or material.

For example, if a rental property is repainted because the paint has flaked off, it would not matter that the paint is of a different colour and better quality than the original. Similarly, if a car (used to produce assessable income) has a broken windscreen replaced and the replacement windscreen is only available with a band tint and is laminated (neither feature available with the original windscreen), that is a repair because there has been a restoration of efficiency of function, although not exactly of the same material as the original.

A repair will always be the renewal of a part of capital equipment or a structure, with the portion being replaced being no more than a subordinate part of the whole. For example, a building is considered to be an entirety, rather than a subordinate part, but the components that make up that building are subordinate parts.

The following are listed in TR 97/23, as tests (each applying separately) to identify an entirety:

- *is the property (eg a chimney) physically, commercially and functionally an inseparable part of an entirety (eg a factory)?*
- *is the property separately identifiable as a principal item of capital equipment?*
- *is the thing or structure (eg a timber staircase) an integral part of the entire premises, and is it capable of providing a useful function without regard to any other part of the premises?*
- *is the thing or structure (eg meters and pumping plant) a separate and distinct item of plant in itself from the thing or structure (eg a light and power station) to which it supplied something (eg electric light and power) or an integral part of some larger item of plant?*
- *is the property a unit of “property” (for depreciation purposes) bearing in mind that, to be such a “unit”, the thing or structure must be “functionally” separate and independent?*

For example, if a window (consisting of frame and glass) in a block of flats was blown out as a result of a gas explosion and had to be rebuilt, even though the window is restored in its entirety, the restoration would be a repair to the premises. The same principle applies to an item of machinery. In TR 97/23 the ATO accepts that if a taxpayer uses a truck for the purposes of producing assessable income or carrying on a business for that purpose, then a deduction is allowed for the cost of replacing the vehicle’s engine as it is a functional part of a motor vehicle and the cost of replacing a worn out engine with one of the same description or its modern equivalent returns the vehicle to its former condition without changing its character. This concept is confirmed in ss40-30(4) example 1 which states: *A car is made up of many separate components, but usually a car is a depreciating asset rather than each component.*

However, if for example a petrol engine is replaced with a diesel engine, this would be an improvement because of increased efficiency and likely longevity (see Case C73 (1953) 3 TBRD). Similarly, if the engine was unserviceable when the truck was purchased and a new engine had to be installed, the cost would be capital.

Maintenance

Maintenance is usually accepted as being for the conservation, preservation, protection or upkeep of an object. Maintenance is about keeping something in a state of good repair rather than actually carrying out repair work.

Expenditure incurred on maintenance of machinery such as greasing and cleaning would not be a repair because the plant is in good working condition and it is done to prevent a future problem and to allow the machine to operate. Such expenditure would usually be deductible under s8-1.

Initial repairs

No deduction is allowed to remedy any defects, damage or deterioration existing at the date of acquisition of the asset.

Initial repairs of an asset after its acquisition must be included in the asset's cost base (see 12.094) if:

- the repair is capital in nature, or
- it enhances or improves the value of the asset either immediately or at the time of its disposal.

The basic principle is that the need for repairs existed when the asset was acquired and did not arise from the taxpayer's use, so a deduction is denied. In substance the expenses are part of the cost of acquisition. The denial of the deduction occurs even if the taxpayer was not aware of the need for repairs when the asset was acquired.

Control of health risks

The ATO takes the view in TR 97/23 that ... *work done to property in controlling health risks associated with the use of dangerous substances* ... such as asbestos, pesticides, arsenic etc. are not repairs unless the work remedies or makes good defects in or damage or deterioration "in a mechanical or physical sense of the property".

Note, however, that a deduction may be allowable under either subdivisions 40C, 40H or 40I as environment protection expenditure.

Improvements

The ATO often targets for audit, claims for repairs to rental properties because commonly the "repairs" being claimed as a deduction are in fact "improvements". It is therefore essential to determine if expenditure is a deductible repair, a non-deductible improvement or is subject to a capital works claim under Division 43. Refer to TR 97/23 and *Structural improvements* at 14.250.

In TR 97/23 the ATO sets out relevant considerations in deciding whether or not an expense is an improvement:

- whether or not the thing replaced or renewed was a major and important part of the structure of the property
- whether the work performed did more than meet the need for restoration of efficiency of function, bearing in mind that "repair" involves a restoration of a thing to a condition it formerly had without changing its character
- whether the thing was replaced with a new and better one, and
- whether the new thing has considerable advantages over the old one, including the advantage that it reduces the likelihood of repair bills in the future.

For example, a shop has a wood framed single glass sheet front display window. The glass is broken by a vandal and in the course of replacing it, it is discovered that the frame has rotted and new glass cannot be successfully fitted. If the frame is replaced with the same material and new glass fitted, a deduction would be allowable as a repair. That would also probably apply if the frame is aluminium (as a modern equivalent of wood serving the same function) provided that it does no more than the old frame. However, let us assume that the owner took the opportunity to install a bay window in a "colonial" style, which she believed would assist in window presentation.

In such a case the work exceeds the need for efficiency and function because it is better than the old window and substantially changes the appearance of the facade. The expense is non-deductible capital expenditure but a deduction may exist for capital works under Division 43 ITAA97 (see 15.200).

The ATO also states that landscaping and/or insulating a house are considered improvements rather than repair.

EXAMPLE

A fence is repaired by adding new palings, or even replacing all of them. But if posts and rails are also replaced, it is a "different" fence and the cost is not allowable as a repair (but a replacement of the entirety). Taking out an old shop front, and putting in a newer one, is not a repair.

Use of different materials

There is a common belief that a deduction for repairs cannot be allowed if the material used to carry out the "repair" is not the same as the original. However, this is not always the case. There have been numerous cases where the Board of Review, AAT or the Courts have allowed claims even though the material used in carrying out the repair was entirely different. The test to determine deductibility is whether there has been a ... *restoration of a thing's efficiency of function (without changing its character) rather than exact repetition of form or material.*

EXAMPLE: A non-deductible repair

In AAT case J24 (77 ATC 222) a wooden fence at the rear of a shop had fallen into a bad state of disrepair and was replaced with a fence made of cement blocks. The new fence constituted a substantial improvement in that it became a retaining wall and required no maintenance. In addition, the AAT considered that because the whole fence was replaced, the work done did not meet the description of a repair to a subsidiary part of a whole, and therefore was not a repair.

Repairs to property previously used for non-income-producing purposes

A deduction may also be allowed for repairs if plant has been previously used by the taxpayer for non-income-producing purposes provided the expenditure is incurred on repairs to plant while the property is being used to produce assessable income.

In TR 97/23, the ATO accepts that a deduction is allowable (provided the expenditure is not of a capital nature), even though some or all of the deterioration or damage giving rise to the repairs may be attributable to use of the asset by the taxpayer prior to its use for the purpose of producing assessable income.

EXAMPLE

An employee purchased a second hand van in January 2010 and used it only for private purposes until January 2013 when he became self-employed as a carrier. The van was used only in his business.

In June 2014, the motor of the van became unserviceable and repairs had to be carried out. The account was paid before 30 June 2014. The repairs are deductible under s25-10 as they were incurred when the van was being used only for the purposes of producing assessable income. It does not matter that a portion of the repairs by way of deterioration may relate to when the van was used only for private purposes.

Note that a deduction would not be allowed if it was an initial repair or capital in nature.

Repairs to property not owned by the taxpayer

Section 25-10 does not require that property be owned by the taxpayer for a claim for repairs to be made. However, the property must be held or used for the purposes of producing assessable income. That means that a lessee of premises or plant can claim a deduction provided that the expenditure is not capital in nature and the property was being held for the purpose of producing assessable income at the time the expenditure was incurred.

Apportionment is required when property is used only partially to produce income.

Also, a taxpayer may deduct an amount paid for failing to comply with a lease obligation to repair premises if the premises were used to produce assessable income (s25-15).

Assets used partly to produce income

If an asset is used wholly for income-producing purposes in the income year when the claim is made, the cost of any repair is fully deductible in that year even if the asset was not wholly used to produce assessable income in the earlier years. Alternatively, if the asset is used only partly to produce assessable income in the year of the repair, the claim will be limited to the income-producing use of the asset in that income year.

14.155 Leasing and hire purchase

Leasing

A deduction is typically allowed in the year the expense is incurred for all the costs of obtaining a lease of premises or properties to be used for income-producing purposes. Section 25-20 allows a claim for expenditure incurred by the taxpayer for the preparation, registration and stamping of a lease, or an assignment or surrender of a lease, of property (that is to be, or has been) held, to the extent it is for the purpose of producing assessable income. Generally this is regarded as applying to leases of premises, but “property” could apply to plant and equipment also. Balloon payments (or up-front deposits) may be deductible (see TR 98/15) but the claim will be subject to the Prepayment rules (see 14.170).

In addition, s25-20(2) provides that if the property has been, or will be, used only partly for the purpose of producing assessable income, an apportionment is required so that the expenditure is deductible only to the extent that it has been or will be so used. ATO ID 2012/36 clarifies that the phrase “will use” is a reference to actual use rather than the intended use of the property.

Hire purchase

Before making a claim for lease expenses, it is important to determine whether those payments are deductible rental expenses or an arrangement to buy or retain the particular asset after the lease is terminated.

Income Tax ruling IT 28 sets out the ATO’s view and guidelines for determining whether payments are deductible as lease payments, or are in substance consideration for the sale of the goods purported to be leased. In the latter case the payments would largely be capital in nature and non-deductible for income tax purposes (note that a finance or interest charge may still be deductible with payments of these types). The capital cost of the particular item may then be considered for depreciation.

The ATO considers that if the arrangement confers on the lessee a right which, if the lessee chose to exercise the option, would have the property in the goods pass to the lessee from the lessor at any point of time, this would for all practical purposes constitute a contract for sale.

Similarly, the ATO would not regard as a normal commercial lease an arrangement whereby at the termination of the lease the lessee is permitted or enabled to retain the use of the goods. If the agreement contains provisions that would enable disposal of the goods at termination of the lease other than at a public auction, this would raise the presumption that the lessee has rights of purchase.

A residual value which does not reasonably reflect market value in leases of relatively short term (eg up to five years) would raise a strong presumption that the transaction was not an ordinary commercial lease.

The following table from TD 93/142 (as modified by ATO ID 2002/1004), illustrates the acceptable minimum residual values for various categories of plant and machinery (classified according to effective life in years) at the end of leases ranging from one to five years. Different residual values may be acceptable based on particular circumstances.

Minimum residual values – percentage of cost:						
Plant and machinery classified according to effective lives in years						
Term of lease	5	6.66	8	10	13.3	20
1st year	60.00	63.75	65.63	67.50	68.50	70.00
2nd year	45.00	52.50	56.25	60.00	62.50	65.00
3rd year	30.00	41.25	46.88	52.50	55.00	60.00
4th year	15.00	30.00	37.50	45.00	50.00	55.00
5th year	nil	18.75	28.13	37.50	45.00	50.00

Expenditure incurred on items of property (including plant or equipment) under hire purchase agreements is deductible, however special rules apply.

While the hirer does not become the legal owner of the property until such time as the final payment is made, for tax purposes the transaction is treated as a sale of property by the financier to the buyer financed by a loan from the financier to the buyer. The buyer would be considered the “holder” of the asset for the purposes of s40-40 and therefore entitled to deductions for the decline in value of the asset. The rules covering hire purchase and similar transactions are set out in Division 240.

Based on the business use of the asset, the buyer is entitled to deduct the interest component of the hire purchase payment. The holder of the asset is similarly entitled to claim depreciation for the decline in value of the asset (see from 15.000 and special rules from 15.800). There are also GST implications (see from 23.110, 23.230 and 23.300).

Lease premiums and improvements by lessees

An outgoing paid as a lease premium is usually a non-deductible capital outgoing. Depreciation deductions may be available in respect of plant owned by a lessee and installed and used by the lessee for income-producing purposes (see 15.010). A deduction can be claimed for construction expenditure for capital works incurred by a lessee or holder of quasi-ownership rights (see 15.200).

14.160 Bad debts

The debt has to be more than doubtful and certain conditions must be satisfied (see TR 92/18). There is no claim for mere provision of doubtful debts and a debt is not necessarily bad merely because time has passed without payment being made.

The deduction is available under s25-35 for a debt that is written-off as a bad debt in the income year, if:

- it was included in the taxpayer's assessable income in the current or former income years, or
- it is in respect of money lent in the ordinary course of a business of lending money by a taxpayer who carries on that business.

To claim a tax deduction, the debt must:

- be in existence (eg no deed of release has been executed)
- be bad, and
- be written-off as a bad debt in the year of income the deduction is claimed.

If a debt is "bad" based on a commercial judgment, it is also bad for s25-35 purposes. It is not essential that a creditor take all legally available steps to recover the debt.

A debt is considered to be "bad" if:

- the debtor has died leaving no, or insufficient, assets to meet the debt
- the debtor cannot be traced and the creditor cannot find the existence of (or location of) assets against which action could be taken
- the debt has become statute barred and the debtor is relying on this defence (or it is reasonable to assume so) for non payment
- the debtor is a company in liquidation or receivership and there are insufficient funds to pay the whole debt, or the part claimed as a bad debt, or
- if, on an objective view of the facts or probabilities existing at the time, there is little or no chance of the debt (or part of it) being recovered.

A debt will generally be accepted as "bad" (depending on the particular facts of the case) if the taxpayer has taken all reasonable steps to try to recover the debt and not simply written it off as bad.



If all or part of a debt earlier written-off is recovered, the amount recovered must be shown as income in the year it is received.

Partial debt "write-offs"

The entire debt does not have to be written-off to get a deduction under s25-35. A deduction may be obtained for the part which is bad and written-off. A partial debt would be deductible only if and when it is found that the remaining debt could not be recovered from the debtor. The same tests for deductibility apply as for the whole of the debt.

Deduction allowed

A deduction for a bad debt is allowable in the year in which the debt is written-off. The debt must actually be written-off before the income year ends, subject to the arrangements outlined in tax ruling TR 92/18. Making a general provision is not appropriate. It is not sufficient to decide to write off the debt after the income year ends, such as when the annual accounts are prepared.

A deduction is allowed if (TR 92/18):

- a board meeting authorises the writing-off of the debt and there is a physical recording of the debt and of the board's decision before the end of the income year, but the writing off in the books of account occurs after year's end, and
- a written recommendation by the financial controller to write off a debt is agreed to by the managing director in writing before year end, followed by a physical writing off after year end.

Claims under s8-1

If a deduction for a bad debt is not allowable under s25-35, a deduction may, in limited circumstances, be available under s8-1. To obtain a s8-1 deduction it would be necessary to demonstrate that the loss was incurred in the course of carrying on business for the purposes of deriving assessable income. Refer: (1968) 14 CTBR (NS) Case 80. Note that the debt would be subject to the negative limbs of s8-1 in this case.

Companies

Companies wishing to claim bad debts must meet stringent tests laid down to avoid "trafficking" in bad debts (ss25-35(5) and Subdivision 165). These tests require that a company satisfy either a more than 50% continuity of ownership test or a same business test, comparing the year in which the deduction is claimed with the one in which the debt was incurred (see also 6.400). In addition, a deduction is reduced if a debt is forgiven and the debtor and creditor are companies under common ownership and have agreed that the creditor forgo the deduction to a specified amount (s245-90 Schedule 2C ITAA36) (See 6.600).

NOTE: A company cannot deduct a debt that it writes off as bad on the last day of the year if the debt was incurred on that day (ss165-120(3)).

Trusts

Certain trusts cannot deduct a bad debt under s25 if there has been either a change of ownership or control or an abnormal trading in the units of the trust (Divisions 266 and 267 ITAA36; s25-35) (see 7.900). Any bad debt for which an amount is recouped may be included in assessable income.

14.165 Loss by theft

Losses incurred by theft or stealing by an employee or agent are allowable unless committed by a person who is only employed for private or domestic purposes (s25-45). The operation of s25-45 was considered in detail by the Federal Court in *FCT v Lean* (2009) FCA 490.

14.166 Illegal activities

Deductions are denied for losses and outgoings to the extent that they were incurred in the furtherance of, or directly in relation to, activities where the taxpayer is convicted of an indictable offence. Similar expenditure will also be excluded from the taxpayer's cost base or reduced cost base for CGT purposes.

NOTE: In a situation where the taxpayer is undertaking a lawful business but is convicted of an illegal activity while carrying out that business, deductions will only be denied for expenditure which directly relates to entering into and carrying out the actual illegal activity. If the expenditure would have been incurred in any case, regardless of the illegal activity, then deductions will still be allowed.

14.167 Boats

Deductions for ownership and operation costs are allowed in respect of boats if the taxpayer holds a boat as trading stock, or uses a boat (or holds it) mainly for letting it out on hire in the ordinary course of a business. Merely providing the boat to an operator for a fee is not necessarily the carrying on of a business, see TR 2003/4 for details. A deduction is also allowed if a taxpayer uses the boat (or holds it) mainly for transporting the public or goods for payment in the ordinary course of business, or otherwise using the boat for a purpose that is essential to the efficient conduct of a business being carried on. There are also deductions allowed for provision of fringe benefits in relation to boats. For related capital allowance claims, see 15.010.

Where none of the above exclusions apply, provisions operate to "quarantine" each year's losses from using or holding boats so that they apply to the following income years where there is a profit from the activity in those following years. That is, the quarantined amount/s can be set off against future otherwise taxable income from the boat. The quarantined losses can also be used to reduce a capital gain from a CGT

event happening in relation to a boat. Should a capital loss be made on a boat, the reduced cost base will not include amounts which s26-47 quarantines.

EXAMPLE

Sue is the owner of a boat and leases it to a charter operator. In the first year of operation she has \$80,000 in deductions relating to income-earning use of the boat (though not qualifying as business use) in regard to interest, depreciation, running costs and management fees. Income of \$50,000 is obtained in that year from leasing the boat. The result is that a loss of \$30,000 is quarantined and carried forward.

In the second year, Sue has \$100,000 of boat deductions and no income from the boat. The amount quarantined will now be \$130,000 and can be carried forward.

In the third year, Sue has \$50,000 of boat deductions and \$140,000 income from the boat. Therefore, Sue can claim \$140,000 in deductions (ie matching the income earned in the third year), and the amount of \$40,000 will be quarantined and carried forward for future use against assessable income from the boat and/or reducing any capital gain from sale of the boat.

EXAMPLE

Fred operates a boat chartering business and has \$100,000 in boat deductions for the year. The income from the boat for that year is \$50,000. As Fred is actually conducting a business, the \$50,000 loss is not quarantined and may be offset against other assessable income for the year.

14.168 Leisure facilities

A leisure facility is land, a building, or part of a building or other structure, that is used (or held for use) for holidays or recreation (eg tennis courts, golf courses, holiday cottages, swimming pools, and related buildings). Deductions are restricted by s26-50 unless certain conditions are met: ss26-50(3) and (4). Deductions are not prevented where a fringe benefit is provided. For depreciation see ss40-25(3) and (4). There may also be Division 7A ITAA36 implications if these types of assets are held in a company and no payment is made for use of the assets by shareholders (or associates) of the company (see 6.300).

14.169 Support payments to subsidiary entities

A support payment is a payment made by a parent entity to a subsidiary in circumstances where the payment is objectively made because the subsidiary has made a loss or losses or have not been sufficiently profitable.

NOTE: A support payment does not include a payment by the parent entity by way of a genuine loan to the subsidiary.

According to TD 2014/14, support payments are not deductible for the partner entity under s8-1 as they are capital in nature. Instead, they are included in the cost base and reduced cost base of the parent's investment in the subsidiary and are therefore not deductible under s40-880.

14.170 Prepayments

The treatment of prepaid deductible expenditure varies depending upon the status of the taxpayer, the nature of the expense, and if the taxpayer is a Small Business Entity (SBE) (see Chapter 10).

As a general rule, prepaid expenditure must be apportioned over the period in which the relevant service is provided. Special rules apply to tax avoidance arrangements, non-business taxpayers, small business entity taxpayers and forestry plantations. The prepayment rules do not apply to excluded expenditure.

Exclusions

The following expenses are excluded from the prepaid expenditure rules and are deductible in the year that they are incurred:

- amounts less than \$1,000 (GST exclusive amount – see ATO ID 2004/398)
- amounts required to be paid by Court order or Government legislation, and
- payments under a contract for service (payments of salary or wages).

Expenditure is also excluded from the prepayment rules if it is of a capital, private or domestic nature, or is incurred in meeting an obligation incurred on or before 11.45am on 21 September 1999.

SBE taxpayers and individuals incurring non-business expenditure

For SBE taxpayers (see Chapter 10) and individual taxpayers incurring non-business expenditure (eg employees, investment and property owners) a 12-month rule allows an immediate deduction for prepayments where:

- the payment is incurred for a period of service, referred to as the Eligible Service Period (ESP) not exceeding 12-months, and
- the period of service ends in the next income year.

Where the ESP does not meet these requirements, the deduction for the prepaid expenditure is claimed proportionately over each income year during which the services are to be provided, to a maximum period of ten years.

EXAMPLE

Brownlow owns a rental property that is negatively geared. He is not carrying on a business activity and his income tax year ends on 30 June. On 30 November 2013 he made an interest only payment of \$7,000 in relation to a loan used to finance the acquisition of the rental property.

If the prepayment was for the period 1 December 2013 to 1 November 2014, Brownlow is entitled to an immediate deduction of the \$7,000, because the ESP was not longer than 12 months (it was for 11 months) and the ESP ends before 30 June 2015 (end of the income year).

If the prepayment was for the period 1 December 2014 to 31 March 2015, the ESP is longer than 12 months and the prepaid expenditure needs to be apportioned over the ESP. In this case the deductions would be:

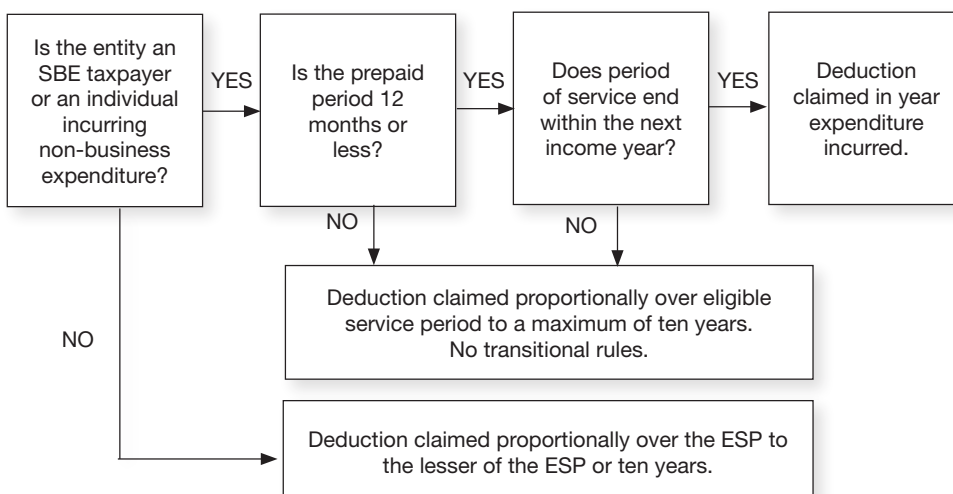
- year ended 30 June 2014: $\$7,000 \times 211 \text{ days} \div 484 \text{ days (1 Dec 13 to 30 June 14)} = \$3,052$, and
- year ended 30 June 2015: $\$7,000 \times 273 \text{ days} \div 484 \text{ days (1 July 14 to 31 Mar 15)} = \$3,948$.

Other taxpayers

For all other taxpayers who are not small business entity taxpayers or individuals incurring non-business expenditure, there is no immediate deduction for prepaid expenditure and the expenditure must be apportioned over the eligible service period. The deduction is claimed proportionately over each income year to a maximum of ten years.

Flowchart of prepaid expenses

The following flowchart sets out the rules for prepaid expenditure.



Some expenses are not allowable

Section 82KJ ITAA36 denies a deduction where expenditure has the following attributes:

- it was incurred under (or in connection with) a tax avoidance arrangement, and
- it exceeds (at the time it was incurred) what was reasonable having regard to the benefits hoped to be obtained, and
- the taxpayer (or “associate”, see 25.002) has acquired an asset, or might reasonably be expected to acquire an asset, at a cost which is less than that which would have been incurred had the advance payment not been made.

Some deductions are deferred

Where expenditure incurred by a taxpayer is to an “associate”, s82KK ITAA36 provides that:

- if a deduction will be allowable to the taxpayer in respect of the expenditure, but
 - the amount will not be included in the assessable income of the associate until a subsequent year,
- the deduction will be deemed to have been incurred by the taxpayer in the year the relevant amount is included in the assessable income of the associate.

Interest

Interest payments (or those of a nature similar to interest) made in return for making available loan funds, will be for the period of time over which the interest is payable, not for the period of the loan.

EXAMPLE

A loan agreement is for ten years with monthly repayments of principal and interest. However, the borrower chooses to make 36 payments at the start of the loan. The deduction allowable for the interest component of the advance payment is spread over 36 months, not the full ten year period.

Rent or lease payments

Similar to payments of interest, payments of rent, leasing or similar payments are taken to relate to the period over which the payments are to be made, and not over the period of the lease.

If initial lease payments are high

If the initial lease payments are high compared with later payments required under the lease, this may indicate that the payments are capital and not deductible, unless it merely reflects the decrease in value of the item over the specific period covered by the payment, which should not exceed 13 months. Also, if plant is leased for a short initial period at a high rate of rental, with a provision for renewal at a nominal rental for a further period that corresponds with the remaining useful life of the asset, this would indicate that the lease payments are capital in nature.



If the lessee has equity in an asset by way of an initial deposit or down payment, the ATO will generally not consider that the arrangement constitutes a lease (see TR 98/15).

Leasing balloon payment

A balloon payment on revenue account covering a period not exceeding 13 months which reflects a decrease in the market value of the asset over the period covered by the payment will be deductible when incurred. See TR 98/15 for detailed commentary from the ATO regarding the tax treatment of lease payments.

Insurance premiums

Claims for insurance premiums are deductible when incurred, however the prepayment rules may apply to apportion this expense based on the period over which the insurance cover is provided, even though the insurer's obligations on claims may be met after the end of the insurance period.

Discharge/transfer of rights

If expenditure which has not been claimed as a deduction is brought forward, it will be deductible in the year the taxpayer discharges the prepaid agreement or transfers the rights to a third party. However, the prepaid expense provisions apply independently to expenditure incurred by the person acquiring the remaining rights.

Provided the expense is allowable under s8-1, prorating will apply where the necessary conditions are met.

Transfer of partnership rights

If rights under a prepaid agreement are transferred on the formation, reconstitution or dissolution of a partnership, the person or partnership holding the rights after the change will be entitled to the deductions that would have been available to the person or partnership that incurred the expenditure. However, at least one of the original partners must have an interest in the rights after the partnership change. A proportionate deduction will be allowed in the year of change. Note that the negative limb of s8-1 may apply to limit a deduction in this case.

Prepayment of trading stock

Deductions for prepayment of trading stock can be denied in some circumstances.

Deductions will not be available unless the goods purchased are reflected in either:

- trading stock sold or destroyed during the financial year, or
- trading stock on hand at the end of that financial year (see from 14.230).

Tax shelters

The tax shelter provisions deny an immediate deduction for certain prepaid expenditure incurred in respect of a tax shelter arrangement. Broadly, the deduction is spread over the period to which the service relates.

Tax shelter arrangements are those where all significant aspects of the management of the arrangement during that income year are conducted by people (the manager) other than the taxpayer and either more than one taxpayer participates in the arrangement or the manager, (or associate) manages similar arrangements on behalf of others.

Refer: s82KZME ITAA36 for the definition of “tax shelter” arrangements and details of the five exceptions to the general rule.

14.200 Trading stock

Costs of acquiring trading stock are usually deductible, including the cost of the stock itself, transport, storage, insurance, packaging, taxes and government charges (eg inspection fees). Expenses incurred or deemed to have been incurred to purchase trading stock are not considered to be capital (s70-25). See rules for primary producers from 21.260 and 21.400. There are separate rules for those who have elected to adopt the “small business entity” regime in Division 328 (see from 10.000).

What is trading stock?

The definition in s70-10 is:

... trading stock includes anything produced, manufactured or acquired that is held for purposes of manufacture, sale or exchange in the ordinary course of the business and live stock.

For livestock see 21.400.

Items which become part of articles produced for sale or further manufacture (raw materials, containers, labels, etc.) are trading stock; see TR 98/7.

It also includes anything that is held for the purpose of manufacture, sale or exchange and includes containers, labels, packing or binding materials (paper, string, glue, etc.) and accessories held by the business are trading stock if:

- the materials form part of the product manufactured, sold or exchanged, or
- the materials are held for the purposes of sale, or to be provided to the customer as part of the core goods sold in the course of business (TR 98/7).

In either of the cases above, ownership of the materials transfers to the purchaser.

Materials and spare parts held by persons carrying on a business providing service for reward (eg a builder, tradesperson or repairer) may be trading stock. For details of the circumstances see TR 98/7.

The definition of trading stock also encompasses items which were originally acquired for non-trading purposes but became trading stock (eg a farm which is entered into a land development project. In this case the stock is valued under s70-30).

Special rules apply where the taxpayer dies (see 14.230).

Racehorses kept solely or mainly for resale or to sell their offspring are trading stock; see from 21.490.

Taxpayers may choose between four methods to value their trading stock at the end of the year of income (see below).

Matters relating to trading stock are specifically covered by Division 70.

Section 70-35 states that where a taxpayer carries on any business, the value of all trading stock on hand at the beginning and the end of the income year, must be taken into account to determine taxable income.

If the value of all trading stock on hand at the end of the income year exceeds the value at the beginning of that year, the excess is assessable income (see s70-35(2)).

When the opening value of all trading stock on hand at the beginning of the income year exceeds the closing value, the excess is an allowable deduction (see s70-35(3)). The value of trading stock on hand must include any which is in transit but owned by the taxpayer.

Not included in trading stock

The following are not trading stock (s70-10):

- financial arrangements under the TOFA rules (referred to as “Division 230 financial arrangements”), and
- CGT assets owned by a complying superannuation fund, complying ADF or a PST, or which are complying superannuation/FHSA assets of a life insurance company, which are subject to capital treatment under Subdiv 275-B (managed investment trusts) (applicable in relation to CGT assets owned after 7.30 pm, by legal time in the ACT, on 10 May 2011, unless owned and held as trading stock before that time).

In addition, trading stock does not include:

- standing or growing crops or trees
- fruit still attached to the tree (included as trading stock only when actually harvested or picked)
- fodder purchased or harvested for “own use” by the farmer
- any animals used as beasts of burden or which do not work in a primary production business
- tobacco leaf on hand but not ready for sale (it is not a commodity and therefore not trading stock (TR 94/9)): tobacco leaf ready for sale is divested in a statutory tobacco marketing board and therefore not trading stock of the grower
- land (eg a farm) not originally acquired for resale where the land is not returned into a business or profit-making undertaking but is subdivided for later sale (see s70-30)
- stocks of spare parts held for the repair or maintenance of your own plant. This does not apply if the taxpayer is in the business of selling the particular spare parts: deductibility will usually be in the year used
- building materials purchased by a building contractor for the purpose of fulfilling a building contract on another person’s land
- new plant or equipment held on standby to replace existing plant
- goods used to earn income by hire or rental not for manufacture, sale or exchange (eg rental videos of a video lending library). (Under the ITAA97 when items which move between trading stock and stock used for other purposes, the items are deemed to be acquired if disposed of at cost. When these items become trading stock, the effect is the amount is added to assessable income. When the item is used for other purposes, it is deemed to have been bought back for the same amount. That amount will be the cost for depreciation purposes)
- consumable aids to manufacture (eg cleaning or bleaching agents, sandpaper)
- goods in transit where a bill of lading has not been made out so the goods are not yet legally owned by the taxpayer (see below), and
- materials or spare parts supplied to customers, but only as a minor and incidental aspect of providing services for the customer (TR 98/8).

Trading stock in transit

Whether a deduction is available to a business for trading stock acquired for an income year depends on whether the trading stock is “on-hand”. The interpretation of the term “trading stock on-hand” was established by the Courts and has been considered by the Commissioner of Taxation (the Commissioner) in tax ruling IT 2670.

The generally accepted proposition is that goods are trading stock “on hand” where the taxpayer is in a position to dispose of the goods. This is the case notwithstanding that they have not been physically delivered to the taxpayer’s business premises or outlet (IT 2670). This is referred to as having “dispositive power”.

This proposition is supported by the Full Federal Court decision in *All States Frozen Foods Pty Ltd v. FC of T* (1990) 21 FCR 457. In that decision, the taxpayer was found to be the owner of goods en-route even though it did not have physical possession because they were on board vessels at sea at the time.

The Court reasoned that because the taxpayer had accepted the bills of lading (see below for discussion), they were considered to be its owners as:

- the goods were held “at risk”
- they were entitled to possession of them, and
- they had control over them.

Where goods are in transit, the passing of the goods to the purchaser is determined by the intention of the parties to the transaction (see IT 2670). Those intentions, according to the Commissioner, are reflected by:

- the contract terms (including implied terms)
- the conduct of the parties (including their practice over a course of dealing), and
- the circumstances of the case (including commercial practice in that industry and assumption of risk).

Moreover, in TD 93/138, the ATO states that there is no hard and fast rule for when there is a presently existing liability in respect of the purchase of trading stock in transit. There is often no presently existing liability until the purchaser either:

- accepts the shipping documents (bill of lading), or
- accepts or endorses the financial documents relating to the liability for payment of the goods (unless conditional upon further actions by the supplier).

Stocktaking

A physical count is generally accepted as the most accurate method of determining the value of stock on hand. It also gives an estimate of the spoilage or theft of stock.

In TD 93/125, the ATO states that while the Act does not stipulate it is necessary to do a physical stocktake, in the majority of cases, it is the only way to arrive at an accurate value. It is not acceptable to guess the value of trading stock or estimate the value based on a stocktake of an earlier year.

In some businesses, purchases and sales of trading stock are recorded in a perpetual system ie a continuous record of stock on hand is kept. This is adjusted if physical stocktakes during the year show discrepancies caused by losses or errors in the system. If such a record is properly maintained, and:

- stocktakes are done regularly during the year, and
- all items of stock are counted at least once during the year

the value of stock on hand can be determined without the need to complete a year end stocktake.

It is important that stocktakes are carried out appropriately. The accuracy of stocktakes and the methods of valuing stock for tax purposes will typically form part of a tax audit.

SBEs can choose not to conduct a stocktake (and account for changes in the value of your trading stock) if there is a difference of \$5,000 or less between:

- the value of your stock on hand at the start of the income year, and
- a reasonable estimate of the value of your stock on hand at the end of the income year.

Choosing how to value trading stock

You must show on the “income side” of your return, the value of trading stock at the end of the income year. That closing stock value is in effect added to the sales figure for the year, and then a deduction is allowed for the cost of trading stock on purchases: the result is the gross profit on sale of goods.



Choose the method of valuation carefully because the gross profit can be altered depending on the method used. The valuation method adopted can be a useful tool to bring forward or delay the taxing of income and/or claiming surplus deductions and carry forward losses. If cost price is adopted, the taxable gross profit includes the difference between sales and the cost of the stock sold. Whereas if market value is adopted, the effect is to tax a profit which is computed as if all of the stock on hand was sold.

There are three primary methods given in s70-45. Any method may be chosen for each item of stock. A fourth method may be used if an election is made and the value is reasonable. If adopting a mixture of valuing methods, be sure to prove the closing stock value shown was properly based.

The available methods are:

1. cost price to the taxpayer
2. replacement value at the end of the year
3. market selling value, and
4. a lower value where that is reasonable due to obsolescence or other special circumstances (s70-50).

Adopting “cost price” is the usual way of valuing stock, because it reflects what was the profit on the business done during the year; but here are some comments on the various methods. Also, see below for entities of \$10 million turnover.

1. Cost price

Sometimes it is not possible to identify the actual cost of the item left on the shelf, unless the owner of the store includes the cost price in a code attached to the article.

Any increase in the stock value above the actual historical cost has the effect of increasing your taxable income in the current income year and correspondingly reduces the profit to be taxed when the item is eventually sold. With quick moving items, this may not matter, but being legally able to defer any book profit until a slow moving item is sold would be a distinct advantage.

All overheads should be included in the cost of production. For work-in-progress and manufactured goods, full absorption costing must be used when “cost price” is adopted (see IT 2350). Retailers and wholesalers are both to use absorption costing when valuing stock at cost. The specific requirements and costing is found in TR 2006/8. For taxpayers with an annual turnover of less than \$10 million, a reasonable estimate of overheads to be absorbed is acceptable.

The ATO will not accept the direct cost method (after the decision in the *Philip Morris* case). Absorption costing includes the cost of labour and materials, plus an appropriate proportion of variable and fixed overheads, (eg power, rates, rent and factory administration costs); see IT 2350 and TR 2006/8.

Set out in IT 2350 is the ATO approach to determining the cost price of trading stock on hand at the end of a year of income where the taxpayer is a manufacturer.

The ATO view is that the absorption cost method is the correct one for determining the cost of trading stock on hand at the end of a year in a manufacturing business. Absorption costing deals with costs of materials and direct labour and also indirect costs such as factory overheads. Relevant will be material costs, direct labour and production overhead costs (variable such as light and power, and fixed such as factory rent). Only the part of total production overheads costs relating to manufacturing operations should be absorbed into product cost.

IT 2350 deals in detail with what items are included in production overheads costs. For the ATO view on use of the cost basis for taxpayers including consolidated groups with gross turnover of \$10 million or more see PS LA 2003/13. Taxpayers not covered by the statement are still expected to use

As a general rule, the Commissioner accepts the following valuation methods:

- **FIFO:** the first items purchased are assumed to be disposed of first and the cost of trading stock on hand at the end of the year is the cost of the items most recently acquired

- **Average cost** (if the actual cost of stock cannot be ascertained): the cost of each item of a particular type on hand at the end of the year is the weighted average of the cost of all such items that were on hand at the beginning of the year and all those acquired during the year.
- **Standard cost** (if standards are reviewed regularly to equate with current prices): a predetermined standard cost per unit is used.
- **Retail inventory** (if old stock is not marked down as it falls in value): goods in stock are marked at their retail selling prices, the marked prices are added together in the course of stocktaking and this figure is then reduced by the amount of the mark-up to arrive at the cost of the goods on hand.

2. Replacement value

This is a simple method in many cases. Rather than keep records of what items cost, simply check the replacement cost as at the end of the income year.

NOTE: TD 92/198 states that to be able to use replacement value, the relevant items must be available in the market and be substantially identical to the replaced items.

3. Market selling value

Value the closing stock at the market selling value (ie the market value in the person's selling market) applicable at year-end. This method would most commonly be used when an item of stock has fallen in value to a level below cost.

4. The special valuation method

In some instances (eg where stock is obsolete), none of the three methods contemplated by s70-45 may be appropriate (eg fashion clothing). When trading stock becomes obsolete (eg spare parts held for a sporadic market or the line is discontinued etc.) a taxpayer may elect to use a reasonable value which is lower than the lowest value which could be determined using any of the three methods. The ATO view is set out in TR 93/23.

Section 70-50 allows the taxpayer to elect to value an item of trading stock at a lower value if ... *warranted because of obsolescence ... or other special circumstances*. Previously, the value was to be determined by the Commissioner.

The value given to closing stock must be reasonable. To determine a "reasonable" value, take into account:

- the quantity of trading stock on hand at the end of the income year
- the quantity of trading stock sold, exchanged or used in manufacture after the end of the income year and the future prospects for the disposal of further quantities
- the quantity of the same kind of trading stock sold, exchanged or used in manufacture during the year of income and the preceding years of income, and
- any other matters considered relevant.

Trading stock purchased with foreign currency

The rate of exchange used to translate trading stock on hand at the end of a year of income to Australian dollar terms for Australian income tax purposes depends on the basis of trading stock valuation elected by the taxpayer.

Where the taxpayer chooses to value closing stock on an actual cost basis, the relevant rate of exchange will be the rate applying at the date of acquisition of the stock.

Use of market selling value or replacement cost would require translation at the rate of exchange on the last day of the accounting period (IT 2498 and IT 2498A).

14.230 Valuing stock under special conditions

Taxpayers have a choice of four methods to value trading stock (see from 14.200). However, in certain situations contemplated by the tax laws, other requirements may arise.

Disposal not made in the ordinary course of business

Sometimes stock is disposed of other than by sale in the ordinary course of business (eg a sale of business which includes trading stock). Section 70-90 provides that the market value of the stock is included in the assessable income of the taxpayer.

Section 70-85 provides that certain property will be deemed to be trading stock and the market value brought to account as assessable income under s70-90 where:

- a taxpayer disposes by sale, gift, or other means, property which is trading stock, standing or growing crops, crop stools, or trees which were planted and tended for sale
- that property constitutes or constituted the whole or part of the assets of a business which is or was carried on by the taxpayer, and
- the disposal was not in the ordinary course of carrying on that business.

A person who acquires that trading stock is deemed to have acquired it at the same value. If there is insufficient evidence of market value, the ATO may include a value which it considers “fair and reasonable”.

NOTE: Market value is the price at which goods can be purchased in this particular market and does not include any input tax credit to which the taxpayer might be entitled.

Items becoming trading stock

If an asset held for another purpose subsequently becomes trading stock, the taxpayer is treated as having sold the item in an arm’s length transaction just before it became trading stock and immediately bought it back.

The taxpayer may elect the deemed sale to be at either:

- its cost (worked out under ss70-30(3) or (4), or
- its market value.

If a business is “wound up”

Trading stock is considered to have been disposed of “other than in the normal course of business” where a business is wound up and there is an in specie distribution of the stock at market value by the liquidator (see *FC of T v St Huberts Island* 78 ATC 4104).

Purchases at non-arm’s length

If the vendor and purchaser were not dealing with each other at arm’s length in respect of the sale of trading stock (see s70-20) and the transaction price is greater than its market value, the transaction price is deemed to be the market value of the trading stock (ie its arm’s length price). The effect on the purchaser is that the value of the deduction for trading stock is reduced whilst the vendor’s assessable income is decreased by the difference between the actual price and the market value of the stock.

Donations to tax deductible body

If a gift of trading stock of \$2 or more is made to a body which is tax deductible under Division 30, s30-15 allows a deduction of the market value included in assessable income under s70-90.

Trading stock lost or destroyed

Trading stock lost through fire, flooding, theft, spoilage etc. is not specifically covered. However, because the losses will be reflected in the value of trading stock on hand at the end of the year, a deduction is effectively allowed. Any insurance compensation received for loss of stock is returned as ordinary income under s6-5. If not, it is assessable under s70-115.

Death of taxpayer

Section 70-105 provides that, upon the death of a taxpayer carrying on business, assessable income to the date of death will include the market value of trading stock on hand at that date, however in certain circumstances the Legal Personal Representative (LPR) of the taxpayer may elect to value trading stock on hand at the date of death in accordance with s70-45.

Where an asset of the business of the deceased taxpayer was standing or growing crops, crop stools or trees planted and tended for sale, the LPR of the taxpayer may elect to include no amount in assessable income.

Elections can only be made by the LPR of the taxpayer where:

- the business continues after the date of death, and
- the trading stock or other asset continues to be held as part of that business.

Changes in partnerships

Where the composition of a partnership changes, there is a deemed disposal and reacquisition of trading stock at market value. However, provided the members of the former partnership retain a 25% interest in the new partnership, an election can be made to account for the deemed transaction on the basis of the valuation methods contained in s70-45. The stock must remain an asset of the business and the market price must be greater than the ordinary value to be used.

Prepayments of trading stock

Section 70-15 denies a deduction for the prepayment of trading stock which is not on hand at the end of the year of income in which the payment is made. A deduction only applies to the portion of a prepayment relating to stock actually on hand. The ATO considers this does not apply to expenditure incurred in bringing trading stock into existence through manufacturing or production processes of the taxpayer (except as it relates to the acquisition of inputs to the manufacturing or production process which are themselves trading stock) (see TR 93/9). Section 70-15 would therefore not apply to:

- expenditure of a primary producer on seed for planting or the purchase price of an orchard which has a growing crop, or
- livestock breeding arrangements where it is part of a livestock breeding business of the taxpayer.

Section 70-15 provides that if an item becomes part of trading stock on hand either before or during the income year in which the outgoing is incurred, it is deductible in that year. Otherwise, the deduction is made in the year:

- when the item becomes part of trading stock on hand, or
- an amount is included in assessable income in connection with the disposal of that item.

Cost of acquiring trees

Special rules apply (s70-120) which allow a deduction for the capital cost of acquiring land carrying trees or acquiring a right to fell trees, to the extent that the felled trees are for sale or use in manufacture by the owner. This occurs because the trees are trading stock.

Valuing trading stock at cost for entities with \$10 million or more turnover

The ATO has released Practice Statement PS LA 2003/13 relating to taxpayers (including consolidated groups) in the retail and wholesale industries where the consolidated gross operating turnover for the financial year is \$10 million or more. Taxpayers not covered by the Practice Statement will be expected to use a reasonable and practical basis to correctly bring to account their trading stock. (Note that valuing stock at cost is a choice rather than compulsory).

The Practice Statement provides guidance in determining what costs to include in valuing trading stock on hand at cost applying full absorption costing. Costs to which the absorption rules must be applied include purchase, distribution centre costs, warehousing costs and freight (from supplier's premises to retail premises and from retail warehouse to retail outlet).

14.280 Stock taken for private use

The value of trading stock taken for private use is accounted for by including the market value in sales. It is necessary to be able to demonstrate that the value attributed to goods taken from stock for private use was fair and reasonable. Under self-assessment (see from 4.000) the value of stock taken for private use must be added back as income and declared in the business tax return. Taxpayers must keep accurate records to calculate the value of goods taken from stock that they have applied for their own (or dependant's) use.

The ATO released a guide for the value of goods taken from trading stock for private use in the 2014-15 income year (TD 2015/9). See TD 2014/2 for amounts for the 2013-14 income year. Note also that if a partner in a partnership takes trading stock for private use, Division 130 GST Act provides for an increasing adjustment (see from 24.260).

Business	Adult/Child over 16 ¹	Child 4-16 ¹
Bakery	\$1,350	\$675
Butcher	\$800	\$400
Restaurant/Cafe (licensed)	\$4,580	\$1,750
Restaurant/Cafe (unlicensed)	\$3,500	\$1,750
Caterer	\$3,790	\$1,895
Delicatessen	\$3,500	\$1,750
Fruiterer/greengrocer	\$790	\$395
Takeaway food shop	\$3,410	\$1,705
Mixed business ²	\$4,230	\$2,115

1: GST exclusive

2: Includes milk bar, general store and convenience store

If a taxpayer considers the values in the table above do not reflect their particular circumstances, then they may elect to maintain their own records of items taken from trading stock for personal use. Practice Statement PS LA 2004/3(GA) sets out the records the ATO will accept. These include:

- the date the item was taken from stock
- the reason the item was taken from stock
- a description of the item, and
- the cost or market value of the item (as required).

14.400 Debt forgiveness

The Commercial Debt Forgiveness (CDF) provisions apply where certain debt is forgiven. The effect of these rules is not to assess the economic benefit of the debt forgiven to the debtor but to deny future income tax benefits.

Commercial debt

A commercial debt is defined in s245-10 as a debt in respect of which interest, (or amounts akin to interest) if it was paid or payable in respect of the debt, would be deductible under s8-1 even if disallowed under another section.



Ensure that what is forgiven is actually a debt and not, say, a disputed claim that may not be a legally enforceable debt.

What is “forgiveness”?

A debt is considered to be forgiven if:

- the obligation to pay is released, waived or otherwise extinguished
- the right to sue for recovery ceases due to the statute of limitations
- “debt parking” occurs, or
- a subscription for shares occurs to enable the company to discharge some or all of the debt.

The debt forgiveness rules do not apply to debts forgiven:

- if the debt waiver constitutes a fringe benefit
- the amount of the debt has been, or will be, included in the assessable income of the debtor
- under an Act relating to bankruptcy
- where forgiveness is effected by will, or
- for reasons of natural love and affection.

Calculating net amount forgiven

The legislation requires calculation of the “net forgiven amount” of the debt. This amount is calculated as:

Gross forgiven amount of the debt:

- *less amounts included in assessable income*
 - *less reductions in allowable deductions*
 - *less reductions in cost bases of assets*
 - *less certain group company adjustments*
- = Net forgiven amount of the debt**

The total net forgiven amount is applied successively to reduce the debtor's:

- deductible prior year revenue losses
- carry forward capital losses from income years prior to the forgiveness year
- undeducted balances of deductible expenditure for the forgiveness year or any later year (eg opening tax depreciation written down values, capital allowance amounts, pooled software expenditure, certain borrowing expenses (s25-25), telephone line expenditure for primary producers, electricity connection expenditure, scientific research expenditure, R&D expenditure, clearing expenditure for primary producers, grape vine establishment expenditure, water plant/structure expenditure, certain plant or equipment in large development projects, environmental impact assessment expenditure, certain advance revenue expenditure, mining and quarrying expenditure, mineral exploration expenditure, mineral transportation expenditure, forestry road expenditure, certain timber milling buildings, certain industrial property expenditure, intellectual property expenditure, Australian film expenditure, building allowance, horticultural plant expenditure and spectrum licence expenditure)
- cost bases of certain assets for CGT purposes with some exclusions like certain private dwellings, goodwill, trading stock, personal use assets and with some restrictions as to investment assets in associated entities like certain shares in companies or units in trusts.

Once amounts are exhausted any excess is disregarded.

Gross forgiven amount

The gross forgiven amount of the debt is calculated by working out the notional value of the debt less consideration in respect of the forgiveness. The notional value is the lesser of:

- the value of the debt if the debtor's ability to repay at the time of forgiveness was the same as at the time the debt was incurred, where either the debt was a money lending debt or the debtor and creditor were dealing with each other at arm's length, and
- the market adjusted value of the debt.

EXAMPLE

If the exchange rate was \$US1:\$A1.30 when a \$100 debt was incurred, and \$US1:\$A1.40 when the debt was forgiven, the first amount would be \$140 and the second \$130.

The notional value of the debt is the lesser of the two applicable amounts, ie \$130.

For non-recourse debts (see below) the notional value is the lesser of:

- the amount of the debt when it is forgiven, and
- market value of the rights to which the creditor has recourse at the same time.

A non-recourse debt is a debt incurred directly in respect of financing the cost of the debtor's acquisition, construction or development of property and the rights of the creditor against the debtor are limited to the property itself or rights in relation to the property, or goods or services provided by the property.

For debts previously parked, the notional value will usually be any consideration paid by the debtor for the assignment of the debt, plus any consideration paid by the new creditor for the debt.

Otherwise, where the assigned debt was not a money lending debt and the original and new creditors were not dealing with each other at arm's length, the notional value is the market value of the debt at the time of assignment.

Consideration

Consideration is the amount of money and/or property the debtor is required to give in respect of the forgiveness. If the debt is for “money” (from a loan made in the ordinary course of a money lending business) the consideration also includes the market value of any obligation of the debtor to pay amounts in the future.

As with CGT, market value rules may apply to determine consideration in respect of the forgiveness of a “non-money” debt. Specific rules also apply to determine consideration for the purposes of the debt forgiveness provisions where debt parking applies or where there is a debt for equity swap.

Amounts included in assessable income

An amount may have been included in the debtor’s assessable income under Division 7A (see 6.300) for example, upon forgiveness of a loan from a private company. In such a case, the net forgiven amount of the debt does not include any such amount.

According to ATO ID 2014/33, where a creditor forgives a commercial debt as part of a settlement agreement and also pays the debtor an additional amount under the agreement that is assessable income of the debtor, the additional amount will not reduce the gross forgiven amount of the debt.

Application of the net forgiven amount

Prior year revenue losses

Reduce prior year revenue losses available under s36-15 or s36-17 ITAA97.

If the net forgiven amount is less than the amount of prior year revenue losses, the debtor may choose the order and the amount of losses to be reduced up to the total net forgiven amount. If the net forgiven amount exceeds prior year revenue losses, the excess is applied next against deductible carry forward capital losses.

Carry forward capital losses

A deductible net capital loss means a net capital loss that:

- the debtor had for an income year earlier than the forgiveness year of income, and
- apart from the subdivision, could be applied in working out the debtor’s net capital gain for the forgiveness year of income (assuming the debtor had enough capital gains).

The taxpayer may elect the order in which the net forgiven amount is deducted against capital losses.

Undeducted balances of deductible expenditure

The net forgiven amount is next applied, to the maximum extent possible, in reducing deductible expenditure, as identified in s245-145 ITAA97.



See from 11.005 if previously claimed expenditure has been recouped as that recoupment is assessable.

These expenses are excluded from deductible expenditure:

- expenditure incurred in respect of assets:
 - disposed of by the debtor in an arm’s length dealing
 - disposed of before the forgiveness of a debt
 - no amount is included in assessable income or is allowed as a deduction to the debtor as a result of the disposal
- expenditure incurred in respect of an asset disposed of, lost or destroyed on or before start day of the debt forgiveness provisions, and
- expenditure recouped on or before the start of the debt forgiveness provisions.

The debtor may choose the order to which and the amount to which the residual forgiven amount is to apply to deductible expenditure. If the residual forgiven amount exceeds all deductible expenditure the excess is applied to reduce the cost base of assets.



As a tax planning measure a debtor would usually choose to reduce the opening tax written down value of, say, a work of art (prime cost depreciation rate of 1%) in preference to the opening written down value of an asset that depreciates, say, at a rate of 20% pa prime cost over five years. It is generally preferable to defer the deduction denied to the maximum extent possible.

Cost base of CGT asset

To the extent to which the total net forgiven amount cannot be applied as above, it is to be used according to sections 245-165 to 245-190 (in reduction of the relevant cost bases of certain assets of the debtor at the beginning of the forgiveness year of income). The taxpayer can choose the assets in respect of which the cost base is reduced and the extent of the reduction.



When purchasing a company or other legal entity, check to ensure that the debt forgiveness provisions have not previously applied or will not apply on purchase. The entity purchased may have less revenue or capital losses, less future tax benefits in the form of future deductions or hidden CGT exposures on the subsequent disposal of reducible assets for CGT purposes.

Remainder

Any remaining unapplied net forgiven amount is disregarded (after applying various tax benefits) (s245-195).

NOTE: Companies under common ownership may choose for the creditor company to forgo a capital loss or deduction if both parties enter into an agreement provided certain conditions are met (s245-90).

Partnerships

Partnerships are treated in the same manner as other taxpayers. However, a partnership would not have carried forward revenue and/or capital losses as they are distributed to partners on an annual basis. If the total net forgiven amount is unable to be applied fully against the partnership's reducible amounts, the excess is allocated to the respective partners to the extent that the partner shares in the net partnership income or loss (Sub-division 245-F).

Trusts

The former s245-26 Schedule 2C ITAA36 specifically provided that the CDF rules apply to a trustee of a trust estate (in their capacity as trustee and not in their personal capacity) in respect of the trust estate's debts.

This provision has not been imported into the ITAA97 rewrite and the current CDF provisions are silent as to the treatment of trusts. However, paragraph 960-100(1)(f) specifies that a trust is an entity for the general purposes of the ITAA97. By extension, the CDF regime applies to a trust as to any other "entity". There has been no practical change in the treatment of forgiven debts of trusts.

Related companies under common ownership

A creditor and a debtor may choose to enter into an agreement under s245-90 ITAA97, whereby the debtor's net forgiven amount is reduced by a particular amount in return for the creditor forgoing its entitlement to claim that same amount as either:

- a capital loss arising from the forgiveness
- a general deduction under s8-1 arising from the forgiveness, or
- a specific deduction (for a bad debt) under s25-35 arising from the forgiveness.

This choice is available if the following conditions are met:

- the debtor and the creditor are both companies
- from the time when the debt was incurred until the time when the debt is forgiven, the debtor and the creditor are "under common ownership", defined in s995-1 as either:
 - members of the same wholly-owned group, or
 - ultimately owned (directly or indirectly) by the same individuals in the same proportions, and
- the debtor and creditor enter into a written agreement. The written agreement must be signed by the public officer of each company, and is made before the earlier of:
 - the date of lodgment of the income tax return of the creditor for the year in which the forgiveness occurred
 - the date of lodgment of the income tax return of the debtor for the year in which the forgiveness occurred, and
 - any later date as determined by the Commissioner.

14.450 Losses from non-commercial business activities

Losses from non-commercial activities carried on by individuals are only deductible against other income in that income year if the taxpayer satisfies at least one of four tests and they have an adjusted taxable income (ATI) as defined in ss35-10(2E) of less than \$250,000. Exceptions to this rule may be available in cases of primary production or professional arts businesses. Alternatively, the Commissioner may exercise a discretion to allow the deduction. This can be done where the activity is affected by a situation outside the taxpayer's control or where an activity has been started and it is to be expected that it will meet one of the tests or generate taxable income within a period that is commercially viable; see TR 2001/14 and TR 2001/14A. If none of the deductibility conditions are satisfied, the business losses will be quarantined and carried forward for deduction against future income from the same source.

14.460 Commerciality tests

A taxpayer can only offset their business losses against assessable income from other sources such as salary and investment income if:

- the taxpayer's ATI is less than \$250,000
- one of the four tests is satisfied (profits test, assessable income test, real property asset test, other assets test) (see below)
- one of the exceptions for primary production or professional arts businesses apply (see below), or
- the Commissioner has exercised his discretion to allow the loss to be deducted.



Any excess deductions from the non-commercial business activity must be excluded when calculating the taxpayer's ATI.



The non-commercial loss rules only apply to individuals and individuals in partnership.

The four tests are:

- **Test 1: Assessable income test** – assessable income from a business activity is \$20,000 or more.
- **Test 2: Profits test** – the business activity has produced a tax profit in at least three out of the last five income years, including the current year.
- **Test 3: Real property test** – the value of real property assets (excluding any private dwelling) used in carrying on a business is \$500,000 or more.
- **Test 4: Other assets test** – the value of other assets (excluding cars, motorcycles and similar vehicles) used in carrying on a business is \$100,000 or more.

The assessable income test

Under this test, the taxpayer must be able to demonstrate that the assessable income derived from the business activity is \$20,000 or more for the year.

For those carrying on business activities in partnership, there is a requirement to determine the proportion of assessable income that is attributable to each partner for the purpose of this test. A taxpayer may include that part of the partnership's assessable income attributable to other individual partners. That is, if a taxpayer is a partner in a partnership and all other partners are individuals, the assessable income of the whole partnership must be \$20,000 or more. This test is based on assessable income for the entire year. Where a business activity commences or ceases during an income year, the taxpayer is entitled to make a reasonable estimate of what the assessable income would have been for the full year. Where there are seasonal variations, the taxpayer may use an estimate rather than pro-rating.

EXAMPLE

In year 1 the taxpayer incurs a loss of \$10,000. The income derived from the business activity was \$15,000. In year 2, the taxpayer derives assessable income of \$40,000 from the same business activity resulting in a net profit of \$5,500. The taxpayer derived other taxable income of \$15,000. Applying the assessable income test, the taxpayer is not entitled to claim any deduction for the loss incurred in year 1. The loss of \$10,000 is deferred.

In year 2 test 1 is satisfied as the assessable income is above \$20,000 and therefore \$5,500 of the carry forward loss is deductible against the business activity income and the balance (ie \$4,500) is allowed as a deduction against the taxpayer's other taxable income.

The profits test

Under this test a taxpayer must have earned a profit in any three of the past five income years (including the current income year in which the loss occurs). There is no minimum taxable income threshold.

Taxable income applicable from the business activity is simply the difference between the assessable income derived from the activity and the sum of deductions allowed in that income year.

Special rules apply for partners. They must aggregate their share of income and any deductions from the business activities conducted in the partnership with any income and deductions applicable in their own hands.

EXAMPLE

Income year	1	2	3	4
Business activity	\$5,000	\$5,000	(\$6,000)	\$4,000
Loss deferred	Nil	Nil	Nil	(\$6,000)
Current year result	\$5,000	\$5,000	(\$6,000)	(\$2,000)
Other taxable income	\$40,000	\$30,000	\$20,000	\$35,000
Loss for current year (quarantined)	Nil	Nil	(\$6,000)	Nil
Taxable income	\$45,000	\$35,000	\$20,000	\$33,000

Using only test 2 the taxpayer would not qualify for deduction in year 3 as the taxpayer does not have three profitable years during the past five years. The non-commercial loss is deferred. In year 4, however, that test is now satisfied as the taxpayer can demonstrate a profit in three of the past four years (refer: TR 2001/14).

The real property test

The taxpayer will satisfy this test if the value of real property, which is used on a continuing basis in carrying on the business activity, is \$500,000 or more at the end of the income year. When valuing the property the value to be used is the greater of:

- market value, and
- CGT reduced cost base.

Only the real property (including any fixtures whether they are depreciable or not) used mainly in the business activity is counted. Private dwellings and adjacent land used in conjunction with a private dwelling are specifically excluded.

If a business ceases during an income year, the value of the real property is to be calculated at the time when the business ceased.

Fixtures are included under the other assets test.

EXAMPLE

A taxpayer has a five hectare property that is used partly for private purposes and partly for storing car bodies that are used for spare parts for his newly established business. The total market value of the property is \$800,000 of which \$450,000 relates to the private dwelling and adjacent land used in association with the private dwelling. No other real property is owned or used by the taxpayer in his business.

The taxpayer would not satisfy Test 3.

The other assets test

This test deals with assets used on a continuing basis in carrying on the business activity, excluding real property (which is dealt with under Test 3). This test is satisfied when the value of those assets is \$100,000 or more. Assets included under the real property test cannot be used when evaluating compliance with this test.

Assets included under this test are:

- an asset for which a capital allowance deduction is available

- an item of trading stock
- an asset leased from another entity, and
- trademarks, patents, copyright etc.



Assets allocated to an SBE/STS pool cannot be included under the “Other assets test” because they are not deductible under Division 40 (see s35-45).

Commissioner’s discretion

If a taxpayer fails to satisfy any of the tests and would therefore be denied a deduction, the ATO has a discretion to allow the losses to be deducted. For that discretion to be exercised, either of the following conditions must be satisfied:

- there were special circumstances outside the taxpayer’s control (eg natural disaster such as drought, bushfire, floods, power plant shutdowns, oil spills, government restriction on land use or illness of key personnel), or
- the nature of the business activity is such that there is a lead time between the activity commencing and the production of assessable income (eg grape growing, plantations etc) and there is an expectation that within a period of time reasonable for the particular industry, the taxpayer will satisfy one of the four tests or be profitable, or
- where the individual’s ATI exceeds \$250,000 but can independently demonstrate that the business is genuinely commercial and will, within a period that is commercially viable, produce profits

Normal economic or market fluctuations do not constitute special circumstances.

14.470 Quarantined losses

Losses are quarantined where none of the four non-commercial loss test are satisfied and can be deferred for use in a later year.

If the business activity makes a profit in a following year, the deferred loss can be utilised against the profit.

The deferred loss can also be utilised against other income in a following year if:

- the income requirement and the business passes one of the four tests in that year, or
- the Commissioner has exercised discretion.

There is no time limit for deferring the losses.

The loss can be deferred indefinitely until one of the following applies:

- there is a profit from the business activity, in which case the deferred loss can be offset to the extent of the profit from the business activity
- the income requirements are met and one of the four tests are satisfied: one of the following exceptions:
 - a primary production or professional arts business and income from other sources (excluding capital gains) is less than \$40,000, or
 - the Commissioner exercises his discretion to offset the loss

If the business activity meets any of the above exceptions, the deferred loss can be offset against income from other sources.

If the deferred loss can be utilised in the current year, the current year losses plus the deferred losses from earlier years can be offset against other income in the current year.

EXAMPLE: Offsetting deferred losses

Martin has a full time job but also runs a mobile pie van at various sporting grounds on the weekend. His net figures are below.

Year	Assessable income (1)	Allowable deductions (2)	Net(1) – (2)	Deferred deduction from previous year	Deferred deduction for current year
1	\$10,000	\$11,000	(\$1,000)	\$0	\$1,000
2	\$14,000	\$15,500	(\$1,500)	\$1,000	\$2,500
3	\$18,000	\$17,000	\$1,000	\$2,500	\$1,500
4	\$20,000	\$22,000	(\$2,000)	\$1,500	\$0

In the first year Martin makes a loss of \$1,000 but cannot offset this against his other income because he doesn't meet any of the 4 tests.

In the second year Martin makes a loss of \$1,500. He cannot offset this loss because none of the four tests are satisfied. He now has a \$2,500 deferred loss to carry forward (\$1,500 is added to the \$1,000 loss from the first year)

In the third year Martin makes a profit of \$1,000. He can offset \$1,000 against the deferred loss. Martin now has a deferred loss of \$1,500 (\$2,500 less \$1,000).

The losses will continue to be deferred until either:

- Martin satisfies one of the four (4) tests and meets the income requirement
- the Commissioner exercises his discretion to allow the loss.

In year four, Martin meets the income requirement as he has assessable income of \$20,000. Martin can deduct the \$1,500 deferred loss and the \$2,000 loss for year four against his other income for that year.

Non-commercial losses can be utilised in any particular order. Each deferred loss is included in the calculation of any loss from the business activity for the next year so the order is not relevant.

14.600 Capital protected borrowings

Capital Protected Borrowings (CPB) are financing arrangements which are used to mitigate some of the investment risk of holding securities such as listed shares. CPBs are dealt with by Division 247.

A CPB involves an investor borrowing funds to enable the purchase of investment assets such as tradeable securities. A distinguishing feature of a CPB is the ability of the borrower to repay the loan by simply transferring the securities purchased back to the lender if the market value of the shares falls below the borrowing. The borrower is not required to make any further repayments under the facility and by transferring the securities back to the lender may fully satisfy the debt outstanding. A CPB borrowing will typically attract a higher interest rate than borrowings without the capital protection element.

Investors may claim a deduction for the interest paid on a CPB where the borrowing is used to acquire income producing assets. However, following the decision of the *Full Federal Court in Federal Commissioner of Taxation v Firth* (2002) 120 FCR 450, there have been limitations on the extent to which interest on a CPB will be deductible.

NOTE: TD 2013/1 states that the CPB rules do not apply to a full recourse loan (interest loan) to fund the prepayment of interest on a capital protected borrowing to which Div 247 applies.

Capital protected borrowings entered into from 13 May 2008

The appropriate benchmark interest rates for an original CPB entered into or an amendment extension made after 31 May 2008 is the Reserve Bank indicator variable rate for standard housing loans plus 100 basis points. An interest component exceeding this rate is not deductible.

Transitional rules covering 16 April 2003 to 13 May 2008

There are two methods for calculating the non-deductible interest component for a CPB under the transitional rules. These methods are the indicator method and the percentage method. The borrower must use the method that results in the greater non-deductible amount.

The details of the transitional rules are contained at 13.600 of the *2013-14 Tax Summary*.

Tax treatment of the non-deductible interest component of a capital protected borrowing

The non-deductible interest component under a CPB is treated as an amount paid by the borrower to acquire a put option from the lender. The put option gives the borrower the ability to transfer the shares back to the lender in full satisfaction of the debt. The put option is as issued to the borrower at the commencement of the CPB and will normally cease at the conclusion or expiry of the CPB.

Put option not exercised (Market value equals or exceeds outstanding loan balance)

If the put option expires without being exercised, CGT event C2 will mostly likely apply. A capital loss arises where the capital proceeds received for the put option are less than assets reduced cost base.

The borrower will not normally receive any capital proceeds on the expiry of the put option and therefore realises a capital loss equal to the capital protection amount (ie non-deductible interest component). The investor can offset the capital loss against capital gains.

Put option exercised (Market value less than outstanding loan balance)

The borrower is taken to have disposed of the put option at the time it is exercised triggering CGT event C2 which is normally at the end of the agreement. However a special CGT rule requires the capital loss to be disregarded where a taxpayer exercises an option over an asset that is subsequently sold.

The CGT consequences are that when the taxpayer exercises the put option for the lender to acquire the shares, there is no separate CGT event for the put option. Instead, the whole series of events is treated as one sale transaction, with the cost base of the (borrower) taxpayer's interest in the shares comprising:

- the original purchase cost of the shares, and
- the non-deductible capital-protection component of the "interest" on the loan.

In the case of CPBs, the shares are effectively sold back to the lender at the market price at the time of the transfer. The non-deductible component of the interest which is deemed the consideration for the put option is added to the second element of the borrowers cost base of the shares. The capital cost of the put option is effectively rolled into the cost base of the shares. The shares are in turn sold for their market value when handed back (deemed consideration) triggering CGT event A1.

NOTE: The cost base of the original shares also needs to be adjusted for the recoupment of the loan balance shortfall which does not need to be paid back to the lender (CGT recoupment rule) (ss110-45(3)).

